

Chapter 5 Economic Freedom and Growth in Ireland, 1980 to 2014

Robbie Butler and John Considine

Introduction

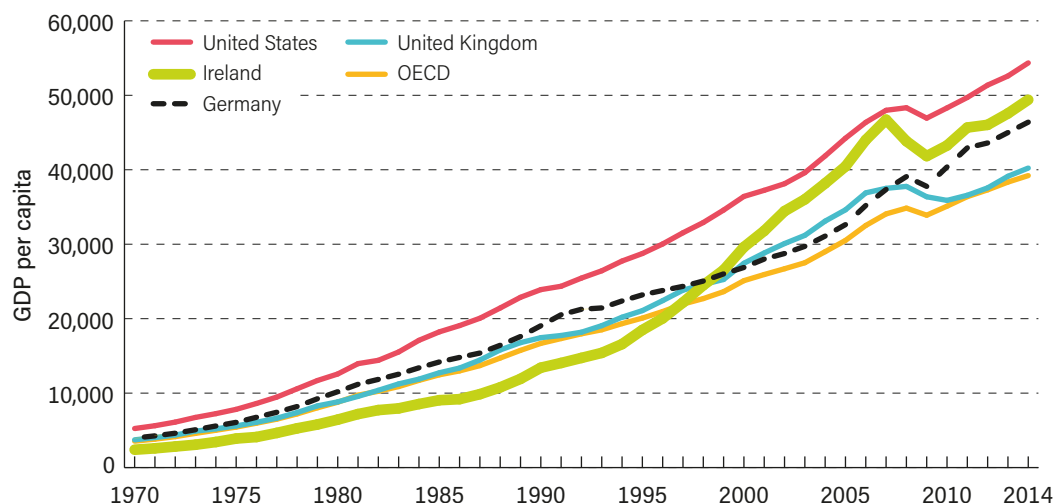
Ireland has displayed some of the most impressive economic growth rates in the world in the period since the mid-1980s. While Irish growth rates suffered more than most in the Great Recession, the change in Ireland's relative position over the last three decades has been phenomenal, as can be seen in **figure 5.1**. In terms of Gross Domestic Product (GDP) per capita, Ireland is now one of the leading countries in the world. Even those who criticize the use of GDP as a measure of Irish living standards admit that the Irish economic performance is of a different magnitude since the mid-1980s. While Gross National Product (GNP) grew by just over half a percentage point less per annum for the period, it follows the same pattern as GDP, and it also shows Ireland converging on the world leaders.

The annual average growth rate, regardless of how it is measured, cannot capture the variation in economic performance over the period. A number of sub-periods can be identified and there is little disagreement from the view that the years 1986/7, 1993/4, and 2007/8 represent important turning points. The annual average GDP growth was 1.47% between 1980 and 1986, and 3.91% between 1987 and 1993. For the full period from 1994 to 2007, the annual average GDP growth rate was 7.18%. Some or all of these years are classified as the "Celtic Tiger" period. Many argue that this period could be sub-divided to reflect different underlying forces. There is agreement that international trade drove the economic growth in the early years and that a domestic credit and property bubble drove economic growth in the years before 2007. The change in the dominant underlying driving force occurred somewhere between 2000 and 2002. One could also wonder if all the years after 2008 should be in the same sub-period or whether 2008 and 2009 should be listed

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Figure 5.1: GDP per Capita in Selected Countries and the OECD, 1970–2014, US\$



Source: Organisation for Economic Co-operation and Development (OECD), 2016.

separately. It was only in 2014 that GDP rose above its 2007 value, with large negative growth in 2008 and 2009. Data for 2015 shows Ireland has returned to posting the largest growth rates in the European Union (EU).

There is a variety of explanations for the Irish growth performance offered in the literature. This chapter will examine the growth performance of Ireland using the index published in *Economic Freedom of the World* (EFW Index) by the Fraser Institute. It will follow the approach taken by Powell (2003) and McMahon (2000), and to a lesser extent Dorgan (2006). The final section of this chapter will locate this explanation within the literature on Irish economic development for the period.

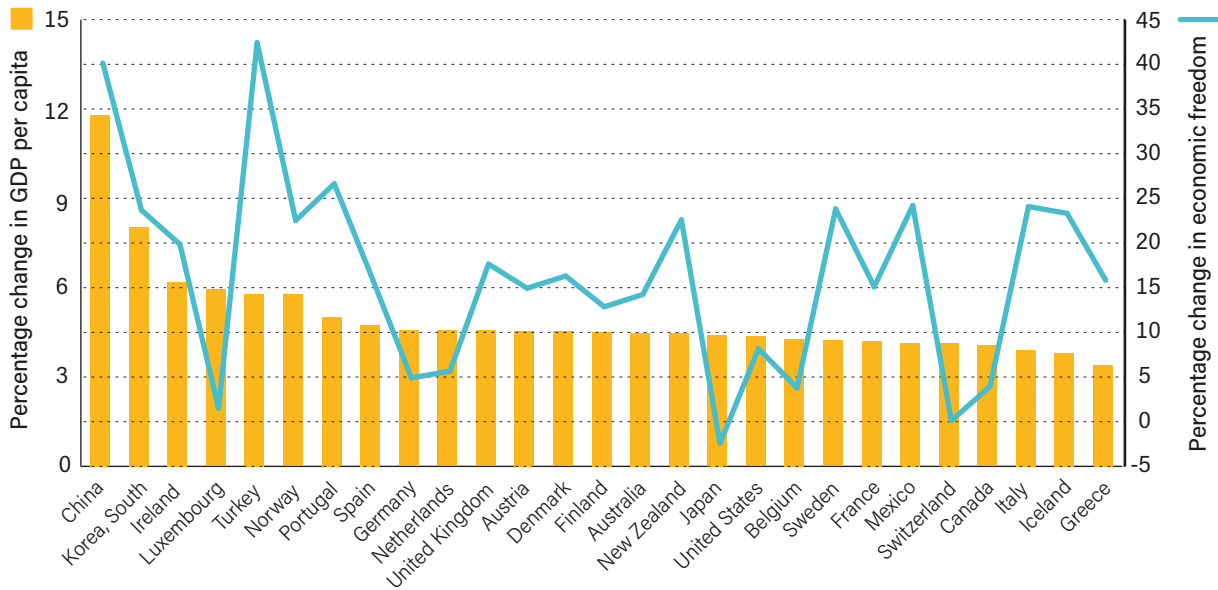
While this chapter will not examine Ireland within a cross-section of countries, it is worth noting the positive relationship between the change in economic freedom and real GDP growth per capita in OECD countries for the period from 1980 to 2014. The correlation between the two variables is 0.46 (the correlation between economic freedom and GDP per capita in 2013 is 0.57). **Figure 5.2** presents both variables for selected countries in descending order of GDP growth per capita.

The next section will examine the major changes to the components of EFW Index for Ireland. This will be followed by a section outlining the major policy changes and other factors that influenced these changes. The final section will examine the relationship between economic freedom and other variables on Irish economic development.

Historical background on political and economic institutions

For all of the nineteenth century and the first two decades of the twentieth century, two islands on the north-west periphery of Europe existed as the political entity called the United Kingdom of Great Britain and Ireland. The Anglo-Irish Treaty of 1921 gave independence to the larger part of the smaller island, which was designated the Irish Free State. The north east of the island remained part of the United Kingdom of Great Britain and Northern Ireland (UK).

Figure 5.2: Average Annual Percentage Change in Real GDP per Capita and the Overall Percentage Change in Economic Freedom, Selected Countries, 1980–2014



Sources: Organisation for Economic Co-operation and Development (OECD), 2016; Gwartney, Lawson, and Hall, 2015.

The Irish Free State remained within the British Commonwealth and it effectively operated a sterling-backed currency for the next 50 years. Maintaining the one-for-one link with sterling was the main purpose of Irish exchange-rate policy and it underpinned Irish monetary policy. A fiscal relationship was tied to these political and monetary linkages. As a member of the Commonwealth, Irish ministers attended the Ottawa Imperial Conference of 1932 where it was decided to give preferential trade terms to members. The protectionist tone of the conference chimed with both the post-1929 economic environment and the philosophy of the newly elected Fianna Fail government. In addition, the sea journey to Canada brought the Fianna Fail delegation into contact with their British counterparts (McMahon, 1984). However, any potential for greater cooperation on economic policies was soon destroyed by the outbreak of an economic war between the two countries. The economic war lasted until the late 1930s when Britain's attention turned to the potential for war in Europe. While the economic war was settled on financial terms that were favorable to Ireland, the economic dislocation caused by the war raised issues about economic nationalism (Bielenberg and Ryan, 2012).

A movement towards self-sufficiency may have been a policy choice during the 1930s but there was little choice in the matter during World War II (or “the Emergency” as it was known in Ireland). During these years, a fledgling air link with the United States was forged via boat-planes from Foynes and regular aircraft from Shannon. After World War II, Shannon witnessed the first significant use of tax reductions to promote regional economic development in Ireland when the Customs-Free Airport Act 1947 was passed. Within a decade, Ireland would embark on a competitive corporate-tax policy designed to promote national economic development.

World War II only served to highlight the strange relationship between Dublin and London. Ireland remained neutral in the conflict but there was relatively free movement of labor between the two political entities. The political links between the separate entities, which were weakened with the 1937 Constitution of Ireland,

were effectively broken with the Republic of Ireland Act, 1948. Crucially, the monetary link remained. For the decades after World War II, the one-for-one link with sterling was to the forefront of Irish economic policy as the British authorities struggled with the management of sterling. During the late 1940s, efforts to restore the convertibility of sterling at too high a level failed. Suspension of convertibility and devaluation followed. In addition to overvaluing the currency, the sterling zone imported more than it exported. London would communicate this problem to governments in the sterling zone and encourage remedial action. This channel of communication explains the complaints that Irish budgetary policy was written in Threadneedle Street (Bank of England). The importance of the monetary link for fiscal policy is probably best illustrated by the 1952 Budget when faulty UK economic forecasts resulted in one of the most contractionary Irish budgets in the history of the State.

Another example of the complications caused by the link with sterling is the macroeconomic crisis of 1955/6. Domestic policy errors, combined with the sterling link, contributed to the crisis (Honohan and O'Grada, 1998). The decision of the Irish banks not to follow the increase in interest rates of their British counterparts led to an outflow of funds. The problems were compounded when the Irish fiscal authorities sought to address the issue using increased import taxes. Garvin (2004) claims that the macroeconomic crisis of 1955/6 resulted in a collective recognition that the protectionist, inward-looking policies of the previous two decades needed to change. The publication in 1958 of *Programme for Economic Expansion* (Government of Ireland, 1958) is widely seen as a shift away from the isolationist policies that were in place since 1932.

The 1955/6 crisis and the *Programme for Economic Expansion* gave impetus to a change that was already starting to occur (Brownlow, 2010). Policy makers were aware of the difficulties in achieving import substitution and had turned their attention towards increasing exports. A central plank of the new policy was to attract foreign, exporting, enterprises to Ireland and, therefore, provide employment for the Irish and stem the flow of emigration. In 1956, Export Profit Tax Relief was introduced, with 50% tax remission on income from the export sales of manufactured goods. This was increased to 100% remission in 1958. In addition to signalling a change in the orientation of industrial policy, it illustrated what could be achieved by a country with powers over fiscal decisions.

The successful introduction of the Export Profit Tax Relief was a combination of historical accident and clever design. Historical accident meant that there were no powerful vested interests in the industrial sector to hamper the introduction and implementation of the policy (unlike the situation in Northern Ireland as illustrated in Brownlow, 2007). Clever design of the tax resulted in the limiting of relief to income from manufacturing exports. As a result, it did not invite competition in the domestic market, thereby generating political opposition to the measure. In addition, it did not erode that particular part of the tax base. The competitive approach on corporate taxation was to prove hugely successful in attracting investment and contributing to Irish economic growth in the longer term. Over the next six decades, closer ties with Europe would force Ireland to modify its strategy on corporate taxation. While taxation remained broadly a matter of the Irish government, Europe would force the Irish to adjust its stance on the discriminatory application of corporate taxes. Ironically, the forced adjustments made Ireland more competitive in many respects.

Ireland did not seriously consider entering the European Economic Community (EEC) independently during the 1960s when General Charles de Gaulle objected to British membership. Ireland, Britain, and Denmark became members of the EEC in 1973. It represented another step in reorientation towards the world economy. Ireland gained enough confidence during its first six years of EEC membership to opt into the European Exchange Rate Mechanism (ERM) in 1979 even though Britain decided to stay out. This decision broke the one-for-one link with sterling and the Irish currency was free to move against others within the narrow bounds set by the ERM. These narrow bounds were widened in 1993 after a volatile period following the reunification of Germany and Britain's high-profile entry and exit from the ERM. By this stage, Ireland was on the path to full monetary union with a number of European countries.

After Ireland's entry into the EEC, a series of Treaties brought about closer political and economic ties between the European member states. Of particular importance was the Single European Act, which aimed at establishing a "single market" by the end of 1992, and the Maastricht Treaty, which established the European Union and led to the establishment of the Euro.

In less than 80 years, the 26 counties of the Republic of Ireland in the 32-county island went from political and economic integration with Great Britain to being a member of both the European Union and the Euro zone via a flirtation with self-sufficiency and isolation. It is likely that these changes to political and economic institutions had larger long-term implications for Irish economic development than either short-term exogenous shocks (e.g., oil-price shocks, currency market turmoil, and the bursting of the dot-com and property bubbles) or short-term policies.

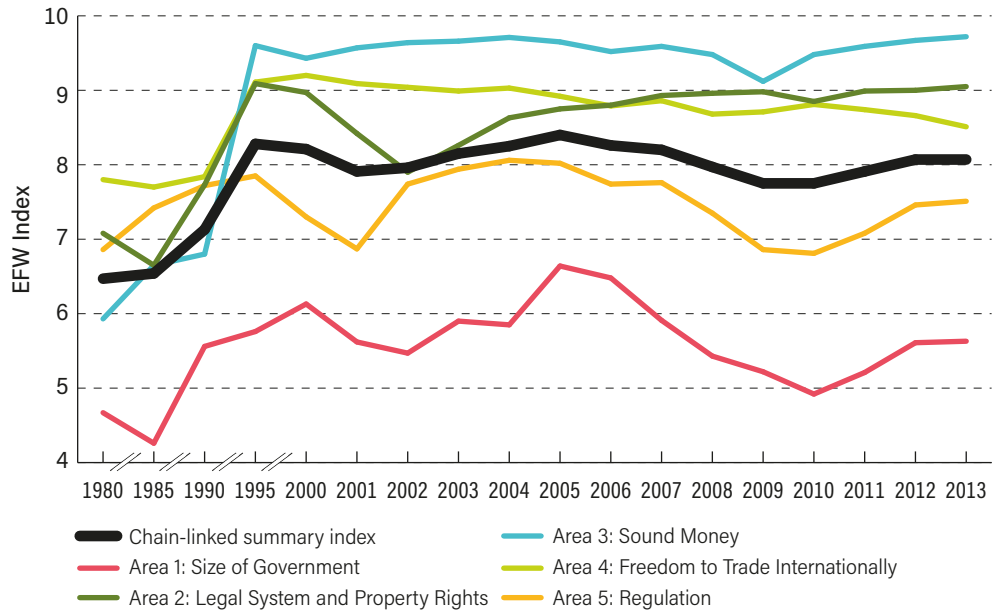
Analysis of major changes to the main components of economic freedom

The index published in *Economic Freedom of the World* produced a score for 157 countries in the 2015 world report. Ireland's overall score for economic freedom of 8.07 ranked joint fifth highest, and was just 0.80 points behind first placed Hong Kong (Gwartney, Lawson and Hall, 2015). Ireland was the second-highest European country on the index, behind Switzerland, and is the highest among the members of the European Union. Like all of the 157 countries measured on the index, Ireland's overall score is attributed to five equally weighted areas. The five are *Size of Government*, *Legal System and Property Rights*, *Sound Money*, *Freedom to Trade Internationally*, and *Regulation*. These five areas are further broken down into components and sub-components. In total, the five areas have 49 components and sub-components constituting each area score.

Figure 5.3 presents the time profile of the overall EFW Index for Ireland and its five major component parts. Note that there are five-year gaps between the data points up to 2000 whereas the data thereafter is annual. The summary index is represented by the black, heavy line running through the centre of figure 5.3. It increases from 6.54 in 1985 to 8.28 a decade later. It then moves between 8.40 and 7.75 for the following 20 years.

All of the component parts also improve between 1985 and 1995. (Chain-linked data are not available for individual components; the following discussion is of non-chain-linked data.) The most obvious improvement is in Sound Money between

Figure 5.3: Economic Freedom in Ireland—Chain-Linked Summary Index and Ratings for the Five Areas, 1980, 1985, 1990, 1995, and 2000–2013



Source: Gwartney, Lawson, and Hall, 2015.

1990 and 1995. This change is the direct result of allowing Irish citizens to own and operate foreign-currency bank accounts outside Ireland. This change arose because of the implementation of the Single European Act. Changes associated with the act can also account for the large increase between 1990 and 1995. The large change in *Area 1: Size of Government* between 1985 and 1990 is explained by the fiscal adjustment undertaken after 1987. From 1995 onwards the two areas that show the greater variability are *1. Size of Government* and *5. Regulation*. Both tend to follow the performance of the economy for reasons that will be explained in the next section. (While it is not the objective of the paper to provide a detailed account of each of these, **table 5.1** illustrates the variables that measure *Area 1: Size of Government*.)

It is more difficult to explain the changes in the *Area 2: Legal System and Property Rights*. The data on the sub-components are not available prior to 2000. In addition, these component parts are based on survey results from the *Global Competitiveness Report*. It is harder to trace these relatively subjective measures. For example, it is possible that the high profile, failed, attempt by the Minister for Finance to nominate a judge to the European Investment Bank reduced this sub-component in the early 2000s.

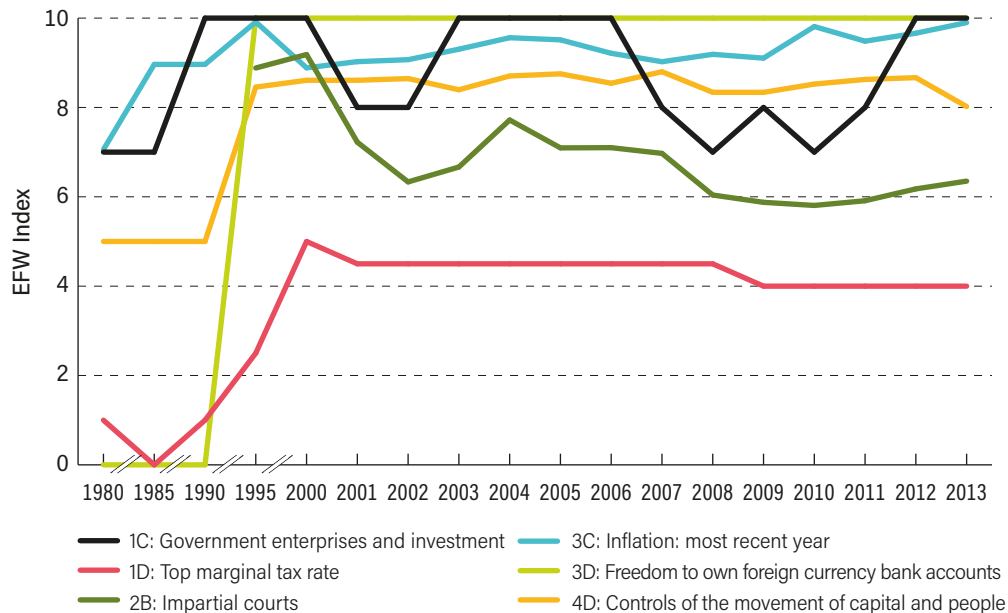
In the case of Ireland there has been movement in all of the component and sub-component parts since 1980, with the exception of component *2E: Integrity of the legal system*. Since data for this became available in 1995, the country has consistently scored the top mark of 10. Other elements of each area have been more unpredictable. **Figure 5.4** is a combined graphic showing some of the more volatile components for Ireland. To be included in this illustration, a component had to change by +2 or –2 points on the EFW Index from the 1980 figure to the 2013 figure. Some components moved outside this range during the period from 1980 to 2013 but revert back and finished inside the range from +2 to –2. These are not included. A component that moves +2 or –2 in a given year or over a number of years is only included if the change still exists in 2013.

Table 5.1: Components and Sub-components of Area 1. Size of Government

Area 1. Size of Government				
Components	1A	1B	1C	1D
	Government consumption	Transfers and subsidies	Government enterprises and investment	Top marginal tax rate
Sub-components				1Di Top marginal income tax rate
				1Dii Top marginal income and payroll tax rate

Source: Gwartney, Lawson and Hall, 2015: 4.

Figure 5.4: Economic Freedom in Ireland—Components with the Largest Changes, 1980, 1985, 1990, 1995, and 2000–2013



Source: Gwartney, Lawson, and Hall, 2015.

Six components are included in figure 5.4. *1C: Government enterprises and investment* and *1D: Top marginal tax rate* are part of Area 1. *2B: Impartial courts* forms part of Area 2. *3C: Inflation: most recent year* and *3D: Freedom to own foreign currency bank accounts* are part of Area 3. *4D: Controls of the movement of capital and people* is found in Area 4. *Regulation (Area 5)* has no element included.

Of the six components illustrated in figure 5.4, *Freedom to own foreign currency bank accounts* sees the largest change of any component between 1980 and 2013. This occurred between 1990 and 1995 and captures Ireland's decision to join the European Union and the creation of the single currency area, the Eurozone. Also in Area 3, *Inflation: most recent year* improved considerably and is reported in 2013 as 9.90. This has risen by 2.84 points on the EFW Index and is representative of Ireland's move into the Euro area, and the price stability the country has enjoyed since.

Directly connected to the Sound Money components in Area 3, is *Controls of the movement of capital and people*. This component is part of Area 4 and, like the previous two addressed, witnesses a rapid improvement between 1990 and 1995. The same forces are at work, and Ireland's deeper integration within the European Union after 1992 considerably changed the ability of people on the island to move both themselves and capital to other parts of the EU. The index score rises by 3.02 points between 1980 and 2013 and is second only to *Freedom to own foreign currency bank accounts* in terms of the size of the change.

Two further improving components, which both assisted in raising Ireland's score on the EFW Index, are found in Area 1. *Government enterprises and investment* and *Top marginal tax rate* both see an identical increase of three points during the period. In the case of the former, government spending is quite unstable. This can be explained by both the extraordinary period of unprecedented economic growth Ireland enjoyed between 1993 and 2007, followed by the remarkable collapse of the country's public finances following the global financial crisis. The rise and fall of both are disproportionate in size when compared to the world economy. The top marginal tax rate does not include the public service Pension Levy that was introduced in the March 2009. This equated to a reduction of approximately 7% on gross incomes of public-sector workers. It is likely, should the economy continue to recover at the current pace, that these taxes will be reduced or eliminated in the years ahead, further improving the score on the EFW Index for *Top marginal tax rate*.

Lastly, unlike the other five components illustrated and addressed above, *Impartial courts* has largely declined over the course of the past two decades. The index score of 8.88 in 1995 when data starts, compares more favorably to the 2013 score of 6.35. This is a deterioration of 2.53 points. *Impartial courts* is the only component that has substantially declined and is acting as an impediment to Ireland improving its overall score for economic freedom and its relative ranking. Declining from 9.19 in 2000 to 7.22 in 2001, the component began to fall again after 2004, reaching an all-time low of 5.81 in 2010.

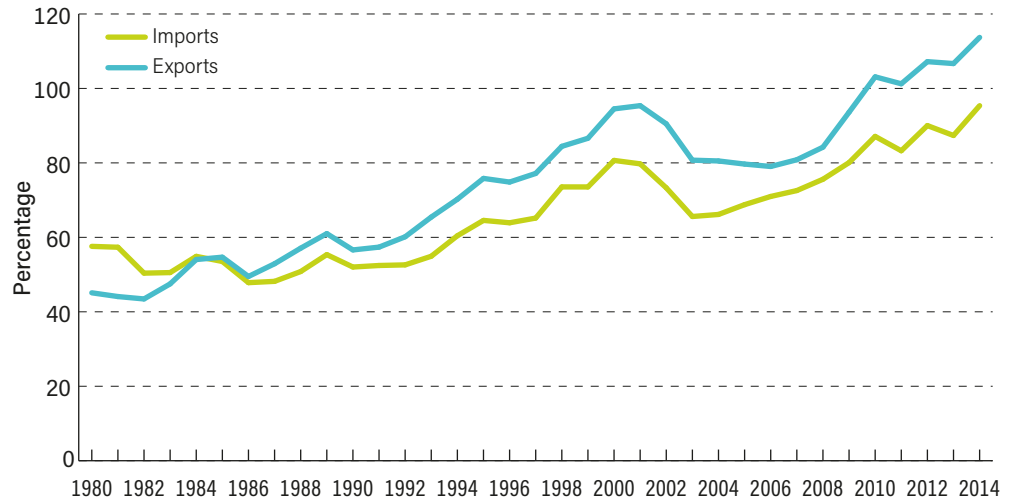
Policy changes and other factors that have influenced economic freedom since 1980

Freedom to trade internationally

Irish exports and imports have grown even more dramatically than GDP. This can be seen in **figure 5.5** where exports and imports are expressed as a percentage of GDP. Exports have increased from 45% of GDP in 1980 to 114% of GDP in 2014. Imports have also increased substantially, although not by as much. Given the size of exports and imports relative to GDP, plus the fact that imports and export tend to move in a similar fashion, it is easy to see why Ireland can be seen as an export platform for Foreign Direct Investment (FDI).

It is estimated that "almost 80 per cent of Irish exports are produced by foreign-affiliate companies" (Barry and Bergin, 2014: 1302). This points to the success of the Irish competitive position on corporate taxation. For over 50 years, Ireland has sought to attract FDI through relatively low corporate tax rates. While the initial tax relief was targeted at manufacturing firms exporting from Ireland, the European complaints about the discriminatory nature of the Irish corporate tax regime has encouraged Ireland to extend many of these benefits to all corporate trading. After

Figure 5.5: Ireland—Exports and Imports as a Percentage of GDP, 1980–2014



Source: Central Statistics Office, 2016a, 2016b: table 5, *National Income and Expenditure Accounts*.

joining the European Economic Community, Ireland agreed to phase out the zero rate on Exports Profits Tax Relief. In 1978, Ireland implemented a 10% rate that applied to all manufacturing. In 1987, this 10% rate was applied to those entities operating in the Irish Financial Service Centre. In the 1990s, Europe questioned the discriminatory nature of the 10% rate. Ireland responded by raising the rate slightly to 12.5% but it gradually extended this flat rate to all trading corporations. The nature of these changes reflected the use of tax incentives to compete with other states to attract investment.

The success of the Irish policy is further illustrated by table 5.2. While all four countries in table 5.2 experienced an increase in FDI stock per person, due to the increased flows of FDI during the period, Ireland consistently has the highest amount after 1980. Ireland had some form of early mover advantage in 1980 compared to Spain and France. Spain has narrowed the gap on Ireland but much of this is the result of its relatively low starting position.

The Great Recession has brought greater international scrutiny of corporate tax regimes. It is difficult to know how these will shape the landscape for FDI into Ireland. Barry and Bergin (2014) note that moves by the G20 in 2009 to target regions with financial secrecy laws seemed to benefit Ireland because it adheres to the full exchange on information. However, some of the key players in Europe remain unhappy with the low statutory rate of 12.5% in Ireland. In 2010, they unsuccessfully sought an examination of the regime in return for funding a bailout of the Irish state. In 2013, Europe instigated an examination of an arrangement between the Irish tax authorities and Apple Inc. on the grounds of unfair state aid. In the past, Irish policy makers have satisfied European concerns in ways that actually benefitted the country. Whether they can continue to do this is an open question.

Money and banking

For the period up to 1979 Ireland maintained a one-for-one link with sterling. During this period, there was a regular complaint that there was a lack of capital for investment in Ireland, although it is also possible to argue that there was a lack of investment opportunities for capital (Daly, 1984). It could be argued that this

Table 5.2: Foreign Direct Investment Inward Stock per Capita (current US\$), 1985–2014

	Ireland	United Kingdom	Spain	France
1980	1,102	1,119	137	415
1985	1,313	1,130	233	594
1990	1,569	3,542	1,696	1,720
1995	3,251	3,408	3,331	3,119
2000	15,623	8,079	3,567	4,401
2005	40,590	18,831	10,847	7,927
2010	62,772	17,514	13,602	9,754
2014	80,158	25,720	15,520	11,066

Sources: FDI stock from UNCTAD, 2016; population from Eurostat, 2016; 1980 to 2000 figures from Barry, 2004; 2005 to 2014 from authors' calculations.

contributed to the 1955/6 macroeconomic crisis. Ironically, the decision of the banks not to follow a UK increase in interest rates, which was commended by the Minister for Finance, triggered a flight of capital. The consequences were obviously unforeseen as the fear of capital flight was ever-present in the minds of Irish policy makers, at least since the Exchange Control Act of 1954. The fear of capital flight can also help explain the difference in the taxation treatment of interest income earned by resident and non-residents. Following a 1963 White Paper, non-residents were not subject to tax. In the years that followed this led to wide-scale tax evasion as many Irish residents claimed they were non-resident to benefit from this distortion in the tax system.

Fear of capital flight played a bigger role when the one-for-one link with sterling was broken in 1979 and Ireland entered the European Exchange Rate Mechanism (ERM). There were frequent realignments with the ERM where the Irish pound lost value against the Deutsche Mark (Honohan and Conroy, 1994). The Irish pound was unilaterally devalued by 8% in August 1986 and again, by 10% in March 1993. The pressure to maintain the currency within the narrow bounds of the ERM resulted in the authorities turning a blind eye to tax evasion. While there was a progressive relaxation of exchange controls in the late 1980s and early 1990s in the run up to the “single market”, the exchange control requirements relating to the opening and operation of a foreign currency account outside the state remained in place until December 31, 1992. A major change in EFW Index occurred on January 1, 1993.

The 1990s also had important implications for Irish banking, which in turn had important implications for the Irish economy as a whole. The combination of the Single European Act and Ireland’s membership in the Euro opened up the market to competition. This represented a massive change from the lack of competition for most of the twentieth century (O’Grada, 1994; McGowan, 1986). The increased competition resulted in a lower price and a greater quantity in the market for home loans. There were also important changes in the way commercial banks were conducting business. Traditionally, the banks raised money through deposits from their branch network spread throughout the country. Towards the end of the twentieth

century, they started raising funds by a combination of access to the wholesale money markets and the securitization of their loan book (Whelan, 2014). This new business model was to have catastrophic consequences for the world financial markets within a decade. The problems in Ireland were exaggerated by a related property boom. The result was both a banking and financial crisis. The banking crisis resulted in the winding down of some banks, the government taking a majority ownership in others, the government effectively monetizing the funding of one bank by the use of promissory notes, and a withdrawal of some of the competitors that had entered the market a decade earlier. It also spawned a range of reports and an official enquiry into the crisis. While few Irish people wished for a return to the banking cartel of the nineteenth and twentieth centuries (O’Grada, 1994; McGowan, 1986), there was a concern that banking practice had cost the taxpayer and had contributed to the extent of the economic downturn.

Size of government

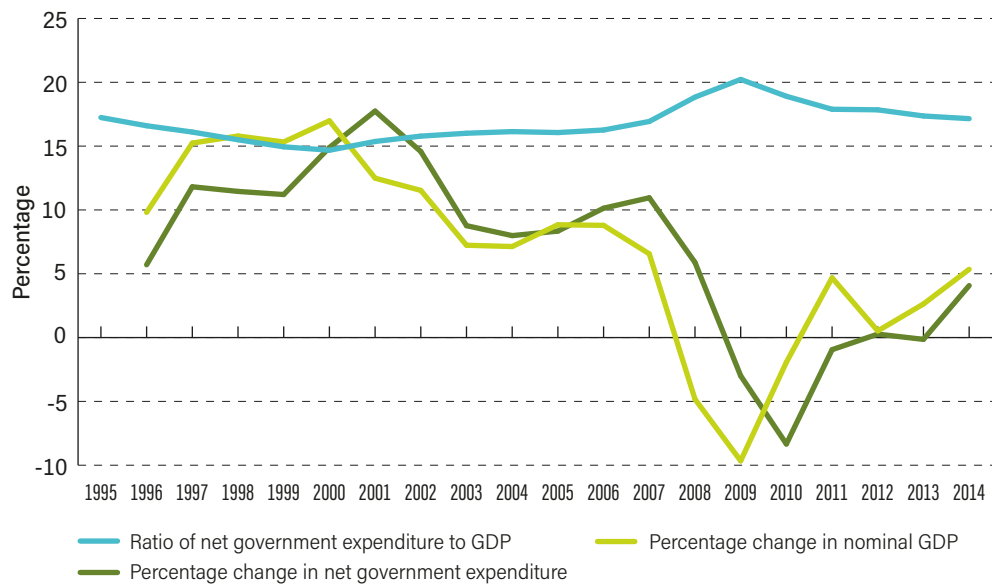
Gwartney (2009) outlines the ten things that have been learned from the *Economic Freedom of the World* project. One of these is that government spending as a share of the economy is not a very good measure of economic freedom or reliance on markets. This is particularly relevant for Ireland for the period under consideration for two reasons. First, the exact measure of economic activity is contested; for example, GDP versus GNP. Second, the dramatic variation in the growth rates of the Irish economy during the period makes it difficult to interpret a ratio measure.

Between 1980 and 2014, the average annual growth in the Irish economy was 4.03% when measured in GDP and 3.36% when measured in GNP. Moreover, GDP has been bigger than GNP since 1975. This represents a sizable difference when accumulated over the 34-year period. GDP is 283% bigger in 2014 than it was in 1980 whereas GNP is 207% bigger. The difference between GDP and GNP is an important factor to consider when considering the performance of the Irish economy and the movement of any variable expressed as a percentage of economic activity.

Figure 5.6 shows that the ratio of net government (central and local) expenditure to Gross Domestic Product ranged from 14.68% in 2000 to 20.23% in 2009. While this represents a sizable change within a decade, it hides much greater changes that were occurring in both GDP and net government expenditure. Nominal GDP grew dramatically between 1995 and 2007. The average annual nominal growth rate was approximately 11.25% (real GDP grew by 7.35%). Government expenditure then seemed to follow with a lag of one year. The correlation between the percentage change in GDP and government expenditure lagged one year is 0.95. It is difficult to imagine such growth in government expenditure being consistent with economic freedom.

The large growth rates in public expenditure can be explained by a number of factors. First, there was an equally large increase in revenues (figure 5.7). Unfortunately, many of the revenue increases in the period from 2000 were windfall gains from a property bubble. Second was the economic philosophy of Charlie McCreevy, as Minister for Finance, which linked changes in expenditure to changes in revenue. It was explicitly stated as “don’t spend it when you don’t have it” but it seemed to also operate as “spend it when you have it” (Glennon, 2001). It was as if the procyclicality of Irish fiscal policy identified in Lane (1998) became policy. Third was an EU deficit rule that was defined as a ratio to GDP. Given the large changes in the denominator (GDP), and the revenue part of the nominator, this rule fostered greater laxity on the public expenditure than might otherwise have been the case.

Figure 5.6: Ireland—Ratio of Net Government Expenditure to GDP, Annual Percentage Change in Nominal GDP, and Annual Percentage Change in Net Government Expenditure, 1995–2014



Note: Net government expenditure is the figure from the expenditure decomposition of national income. It does not include transfers. Including transfers and other payments brings the ratio to between 30% and 45% of GDP. Source: Central Statistics Office, 2016a: tables 5, 21, *National Income and Expenditure Accounts*.

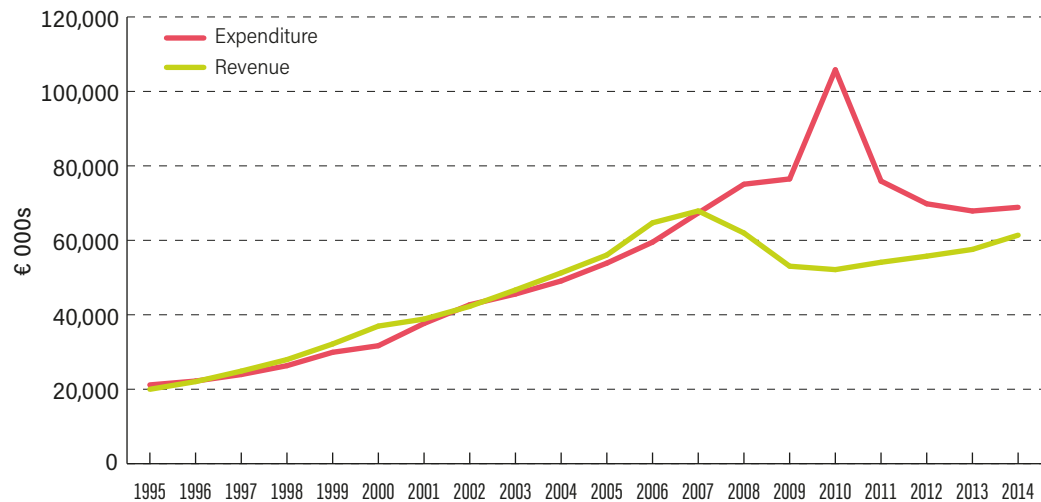
An important element in the improvement in EFW component Size of Government arose from changes in the income-tax system. There were five income tax rates in 1980 with a top rate of 60%. As the government struggled with imbalance on the public finances during the early 1980s they added another rate of 65% in 1983. In 1985, the system was reduced to three rates with a top rate of 60%. National wage agreements, plus a gradual improvement in the public finances, contributed to a reduction in these tax rates from the mid-1980s. The top rate of income tax fell to 56% in 1989 and 48% in 1992. In 1992, there were only two rates of income tax (27% and 48%). These two rates were reduced during the late 1990s so that they stood at 20% and 42% by 2001. A further reduction of 1% in the top rate occurred in 2007.

There were no changes to these rates during the fiscal crisis between 2008 and 2014. That is not to say that taxes on income have not increased in other ways. There has been the introduction of tax levies and there have been increases in these levies. These levies have been transformed into a Universal Social Charge and this explains the increase in the top marginal income and payroll tax rate in the EFW Index.

There were also two important changes to the Irish tax system at the turn of the century. One was the result of a proposal to individualize the tax system. Between 1980 and 2000, married couples received double the tax allowances of single individuals. The change resulted in a smaller tax allowance for a married couple where there was one earner compared to where there were two earners.

The second change in the income tax system resulted in a move from tax allowances to tax credits. With a tax-credits system the first monetary unit a person earns is liable to tax whereas with a tax allowance system the person only pays tax on the amount above their tax allowance. Therefore, it appears that a person is entering a higher tax rate earlier. The change from allowances to credits can help account for a change in component 1D of the EFW Index for Ireland between 2000 and 2001.

Figure 5.7: Ireland—Government Expenditure and Revenue (€ 000s), 1995–2014



Note: The spike in 2010 is the result of over €30bn in Promissory Notes for the Anglo Irish Bank.

Source: Central Statistics Office, 2016a: table 21, *National Income and Expenditure Accounts*.

However, it should also be noted that Irish tax payers enter higher tax rates earlier than many of their European counterparts, as illustrated in Cronin, Hickey and Kennedy (2015). Using the 1996, 2003, and 2012 tax codes, they calculate the average tax rate for all income levels. They show how average tax rates have decreased, for all income amounts, over the period. The highest average income taxes were for the 1993 tax code and the lowest were for the 2012 tax code.

Regulation and competition

In a broad range of indicators of competition law and policy, Ireland is listed as below average (Hoj, 2007). This is not surprising as both Massey and Daly (2003) and Gorecki (2012) have documented the slow evolution of Irish competition law. On the positive side there has been a trend towards improvement and there is plenty of space for continued improvement.

Massey and Daly (2003: 27–46) document the evolution of Irish competition law during the twentieth century. It was only in 1953 that the State began introducing any legislation in the area. This was the Restrictive Trade Practice Act and it established the Fair Trade Commission (FTC). The FTC could make fair trade rules but these rules were not binding. The FTC could report to the Minister who in turn could make an Order that, if confirmed by the parliament, would become law. No Orders were ever made. A similar pattern was observed with respect to the Mergers, Take-overs and Monopolies (Control) Act of 1978. The Minister could ask the Restricted Practices Commission (previously FTC) to conduct an enquiry. The Restricted Practices Commission (RPC) would report to the Minister who could then take action. The Minister never requested an enquiry. A number of sectors—banking, for example—were exempt from even this limited legislation. This was changed in 1987 with the Restrictive Practice (Amendment) Act but the change made very little impact. As Massey and Daly (2003: 33) state “no order was ever made in respect of such sectors”.

The 1991 Competition Act did seek to transpose European Competition Law into Ireland. Sections 4 and 5 of the Act dealt with cartels and abuse of a dominant position, respectively. It also established the Competition Authority (CA), which did strike down a small number of anti-competitive agreements. “Although the Act gave the

Minister power to bring court proceedings, no such actions were instituted” (Massey and Daly, 2003: 37). The 1991 Act was amended in 1996. While Massey and Daly class it as a disappointment, it resulted in “favourable settlements in four civil actions and brought one successful summary prosecution” (2003: 39). It was slow progress.

Just as the Competition Authority was establishing some credibility with regard to enforcement, it seemed it was about to be emasculated by funding and manpower problems. The numbers of staff fell from 24 in 1998 to 14 in 2000. Fortunately, a report published in the same year, (commissioned by the Department of Enterprise, Trade and Employment) recommended greater staffing and funding. This led to a quadrupling of funding between 2002 and 2007. Staff numbers doubled between 2000 and 2006. And, crucially, a new Competition Act was introduced in 2002. According to Gorecki (2012), these changes were driven by a market model inherent in the legislation.

The transformation in Irish competition law that occurred at the turn of the century was damaged by the Great Recession. Gorecki documents a period of “carve outs and exemptions” (2012: 613) from competition law after 2008. For example, between 2002 and 2005 there were annually between 18 and 42 searches for documents related to anticompetitive behavior, whereas there was none in 2010 and one in 2011. He notes that it was only the conditions imposed by the EU/IMF/ECB, in return for a bailout, that brought renewed vigor to the process: there were nine searches in the first seven months of 2011.

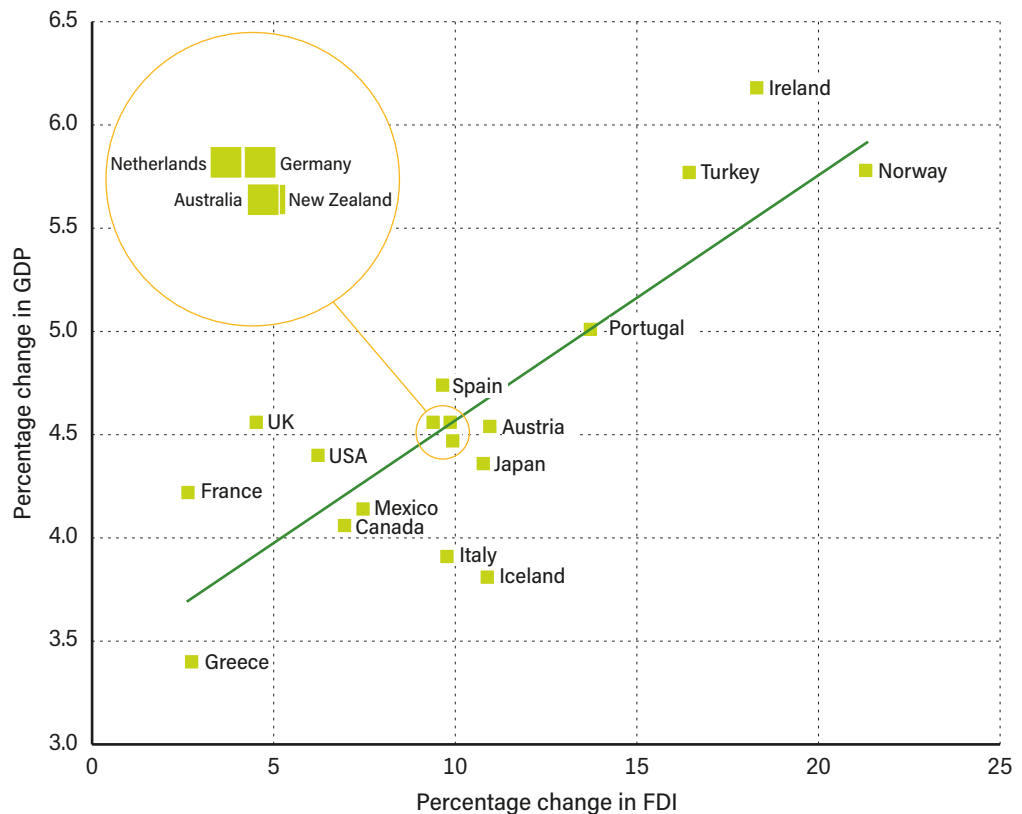
The three distinct periods identified by Gorecki (2012) reflect the changes in the EFW Index in figure 5.3. Economic freedom is lower in the “carve-out and exemptions” period. It is possible that this contributed to a perception of favoritism for particular well-connected firms and could be captured by sub-components like *SCiv: Extra payments/bribes/favoritism*.

Impact of developments in economic freedom on the economy and other relevant variables

In a critical review of the EFW measure and the literature that uses it to assess its relationship to economic growth, De Haan, Lundstrom, and Strum say that despite the issues they raise, “our conclusion is that the index is both reliable and useful” and that the better studies “find support for a positive relationship between changes in EF and growth” (2006: 182). More recent work than that reviewed by De Haan and his colleagues explains how the investment channel is a key one through which economic freedom influences economic growth. Gwartney, Holcombe, and Lawson (2006) show how economic freedom increases investment and how it also results in more productive investment. In a similar vein, Azman-Saini, Baharumshah, and Law (2010) argue that the impact of foreign direct investment (FDI) on growth is contingent on the level of economic freedom in the host country. They argue that there is support for the idea of absorptive capacity so that FDI has a bigger influence in countries that already have export-oriented policies and where there is some threshold level of human capital. Both of these conditions have held for Ireland for decades.

The relationship between FDI and economic growth for selected countries is presented in **figure 5.8**. A clear positive relationship appears to exist between the two. Ireland has seen the most impressive average annual increase in GDP per capita over the period, and is second only to Norway in terms of average annual increases in foreign direct investment.

Figure 5.8: Average Annual Percentage Change in Real GDP per Capita and Average Annual Percentage Change in Foreign Direct Investment, Selected Countries, 1980–2014



Sources: GDP from OECD, 2016; foreign direct investment from World Bank, 2016.

The impressive performance of the Irish economy has spawned much literature on the subject. A comprehensive review is beyond the scope, and not the purpose, of this study but it is important to locate it within the broad parameters in the literature. It is fair to say that the explanations of the Irish economic performance for the period since 1980 are influenced by when they were written or published and by the period studied. With the passage of time, the empirical reality of dramatic changes in economic growth rates made the explanations more complex. The longer time span, and more data, also focuses attention on the more important underlying issues like institutions rather than shorter-term policies.

Those writing and publishing during the 1980s did not have to worry about explaining the convergence of living standards. As Kennedy, Giblin, and McHugh put it, “when set in the European context, Ireland’s rate of progress emerges as mediocre” (1988: 252). A similar evaluation of Irish economic performance, the causes, and solutions, was offered by the historian Joe Lee. However, Lee did not seem to foresee what was about to happen: “If she [Ireland] now aspires after western European levels of income, therefore, quite spectacular growth rates, far exceeding the average, are necessary” (Lee, 1989: 521). The spectacular growth rates soon arrived.

By the mid-1990s, the changed economic reality was starting to be incorporated into the contemporary accounts of Irish economic history, for example, those of de la Fuente and Vives (1998). O’Grada (1997) noted the improved performance in

a comparative context—for example, Northern Ireland, the United Kingdom, and Europe—while highlighting the potential problems with GDP and GNP as measures of economic performance.

At the start of the new millennium, two animal metaphors appeared in the literature. The more popular metaphor, “Celtic Tiger”, was borrowed from the Asian experience where a transformation in the economic performance of a number of countries led to the term “Asian Tigers”. The second metaphor was “Irish Hare” (Honohan and Walsh, 2002), a reference to the hare’s late burst of activity in the ancient story of its race with a tortoise. A lack of convergence was explained by market-contrary policies and institutions. Delayed convergence was explained by the inclusion of some story explaining how the removal of policies and institutions that hindered convergence was delayed. The problematic policies and institutions included the economic isolationist policies after 1932 and the questionable demand-management policies of the 1970s. Powell (2003) also listed these issues but went on to make an explicit link between Irish economic growth and economic freedom. Delayed convergence was not the only explanation of the Celtic Tiger years. As an alternative to the delayed convergence hypothesis, there was the regional economic-boom hypothesis proposed in Barry (2002). Neither explanation is inconsistent with the economic freedom perspective.

A number of accounts of Irish economic performance have been published since the decline of the Celtic Tiger: for example, Bielenberg and Ryan, 2013; Donovan and Murphy, 2013; O’Riain, 2014; and O’Leary, 2015. All reflect the fact that it is not easy to provide a parsimonious theory that explains the empirical reality of wildly fluctuating economic growth rates of recent decades. Yet, all agree on the problems caused by protectionism. Bielenberg and Ryan (2013) and O’Riain (2014) focus on the importance of a reorientation towards Europe. Donovan and Murphy (2013) and O’Riain (2014) identify the problems associated with passive acceptance and lack of understanding of economic ideas and the importance of institutions. Although he probably has a different set of institutions in mind, O’Riain says that we should begin by “seeking to identify some of the empirical regularities in how institutions are structured” (2014: 26). This is exactly what *Economic Freedom of the World* seeks to achieve. We contend that there is enough evidence in this chapter to indicate that the greater economic freedom enjoyed by individuals and companies operating in Ireland contributed to the improved growth performance of the Irish economy.

Summary and conclusions

If one is going to blame the policy makers for the delay in convergence, then one must consider giving them credit for the convergence. There is nothing in the literature that suggests convergence of living standards is automatic. Policies and institutions are human artefacts and there is agreement that good institutions aid growth while poor institutions hinder growth. The decision to compete internationally for businesses that in turn would compete in international product and services markets has transformed the Irish economy. The decision to become a member of the EEC, part of the single market, and the Euro has increased the stage on which enterprises located in Ireland now compete. For three decades from 1987, Ireland posted some of the largest growth rates in the world, driven by an even more impressive increase in exports.

Ireland posted the highest growth rate in the EU for 2015 and indications for 2016 suggest a similar performance. Whether this marks a return to the impressive performance of the period from 1994 to 2007 is difficult to say. Respected commentators suggest that further convergence on the leaders is possible (Crafts, 2014). Much will depend on the policies and institutions that the Irish will continue to forge.

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