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ECON-415-E
0-304-061

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Ireland: The Celtic Tiger

Rewriting Ireland's Fiscal Policy (The 2001 Budget)

"We need to ensure that the benefits of sound economic management and growth are distributed fairly and, in particular, are used to tackle the underlying causes of poverty and social exclusion"

(Mr. Bertie Ahern T.D., Irish Prime Minister)[1].

After several years of extraordinary economic growth that had turned Ireland into the "Celtic Tiger" – a name drawing a comparison with Southeast Asia's dynamic economies of the early to mid 90s – in 2000 Ireland's government decided to shift its fiscal policy towards an expansionary stance. The country's priorities, therefore, changed from economic growth to poverty reduction through income and fiscal policies.

This objective was pursued through the "Sharing in Progress" – National Anti-Poverty Strategy (NAPS). NAPS was "a policy initiative which, over a ten-year period, aims to significantly reduce the number of people identified as being in consistent poverty". NAPS was launched in 1997, and by late 2000 the Irish government's objective was to use the "booming economy

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[1] Opening Address by the Taoiseach (prime minister) at the launch of the Second Annual Report of the National anti-Poverty Strategy (29 September 2000).

This case was prepared by Antonio López Abelló, Research Assistant, under the supervision of Professor Jordi Gual, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. April 2004.

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Last edited: 11/7/08

and low unemployment... [to] break cycles of deprivation". Under pressure from left-wing lobbyists, such as the Combat Poverty Agency, the Irish government proposed a fourfold strategy:

- updating welfare payments in line with wages
- ensuring an adequate basic payment for children in welfare-dependent families
- providing assistance with childcare costs for low-income families
- reducing the tax burden for low-paid workers

Additionally, Ireland had recently introduced a minimum wage of IEP[2] 4.40 per hour. These measures were included in Ireland's 2001 Budget, which foresaw a 10.9% increase in current expenditure and a 9.6% increase in the Public Capital Program. As a consequence of this fiscal laxity, the 2001 Budget caused an onslaught of criticism from investors. Jim O'Leary, economist at the prominent Davy Stockbrokers was a strong opponent of the measures about to be implemented:

> "[The 2001] Budget was the most expansionary on record. The opening exchequer surplus amounted to IEP 3.5bn. By the time the Minister for Finance resumed his seat again, he had whittled this down to just over IEP 2.5bn. The net reduction of almost IEP 1bn was achieved despite... IEP 400m worth of creative accounting and IEP800m of tax buoyancy... The budget will find favor with social partners [as] Minister [Charlie] McCreevy delivered the goods yesterday. And deliver, he did: big, judiciously distributed tax cuts; generous welfare improvements; very substantial increases in child benefits and also a sting in the tail directed at the corporate sector in the form of a lifting of the ceiling on employers' PRSI contributions[3]. But, for tax cuts to moderate wage inflation, it is not enough to gratify the preferences of the social partners. Unless these tax cuts have the effect of increasing labor supply, they will have zero effect on private [and public] sector wages (...). In such circumstances, the risk that attaches to the Budget is that the stimulus it imparts to the economy is entirely dissipated through inflation and congestion and will yield no tangible benefit. If this is the case, it will have negative consequences for economic welfare and will diminish Ireland's attractiveness as a place in which to live, work and produce goods and services."

Additionally, international agencies such as the OECD also issued warnings about the impact of rising prices in wage expectations. Higher inflation, according to this organization, could "result in a greater slowdown of activity than foreseen".

On another front, Ireland's European Union partners saw the expansionary budget as a breach of the country's duty to maintain fiscal prudence and as a threat to price stability. Pedro Solbes, European commissioner for economic and monetary affairs, said that Brussels would recommend EU finance ministers to combat Irish fiscal policies, and warned Ireland of the consequences of non-compliance. This move by the

[2] 1 EUR = IEP 0.787564 (irrevocable Euro conversion rate). Source: European Central Bank.

[3] PRSI (Pay-Related Social Insurance) are contributions paid by employees and their employers and by self-employed people.

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European Union was seen "as a trial of its ability to co-ordinate budget policies among member countries".

In the meantime, Irish authorities liked to remind European officials that Ireland had a sizeable budget surplus and the lowest indebtedness of the Union, in addition to being the fastest-growing country in Europe. During the standoff, Mr McCreevy stated that any move by the European Commission to reprimand Ireland would be greeted with "amusement", adding that "there is no question of any change in Irish economic policy... Perhaps when other countries in Europe have that sort of success I will take more cognizance".

The Irish Economy: the Economic Boom (1987–2001)

During the 1980s, Ireland's macroeconomic fundamentals put it among the laggards of the EEC. GDP per capita averaged 68% of that of the EEC during the decade. Despite the obvious need for a package of measures to guarantee economic stabilization, political infighting prevented the necessary consensus to back credible economic policies.

Given the failure of the first set of economic stabilization policies, in 1987, a new Minister for Finance, Mr Ray MacSharry, opted for a sharp reduction of public expenditure, in particular current expenses. The aim of this policy was to boost confidence in the economy, to cause an increase in private savings and to spark a substitution of public spending by private investment.

The policies introduced by Mr MacSharry, together with other factors, have been quoted as the key elements behind the growth Ireland experienced during the following 15 years, and that has been called the "Irish miracle":

a. New Incomes Policy: Mr MacSharry also implemented a complete reversal of incomes policy. According to Stewart, the deep economic crisis, "brought the social partners, employers, unions, farmers and government together (...) The unions supported the need for fundamental reform in public finances, and were convinced of the need for moderate wage increases in both the public and private sector. The trade-off was that the government undertook to lower personal taxation and to maintain the value of social welfare payments". The consequences of this agreement were immediate: inflation declined, as economic agents did not anticipate higher wages.

b. Transfers from the European Union: "As a low-income member of the EEC/EU, Ireland qualified for receiving structural funds (...). The total net transfers received between 1973 and 1998 were IEP 24bn and reached a peak of 6.5% of GDP in 1991, before tapering off to 3.5% in 1998." Some researchers estimated that the injection of these funds contributed to 25% of Irish GNP growth during the decade to 1999.

c. Promoting Foreign Direct Investment (FDI) in Ireland: Since the 1960s, the Irish government had put forward a set of initiatives to foster foreign investment in Ireland through the Industrial Development Agency. These initiatives had a dual objective. First, they took advantage of the island's privileged position, from a geographical and

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