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Developing Ireland

Committing to Economic Openness and Building Domestic Institutional Capabilities

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Abstract

This paper sets out to explain the factors behind Ireland's exceptional period of economic growth from the early 1990s to the mid 2000s. It suggests that an unbending commitment to economic openness and an on-going effort to establish quality domestic institutions were the main drivers of the so-called 'Celtic tiger' phenomenon. The commitment to economic openness manifested itself in the relentless search for inward investment and a willingness to accept deep forms of European integration. Building domestic institutional capabilities involved adopting new-classical macroeconomic policies, creating a robust system of social partnership and reforming the educational system. The two factors positively interacted with each other to create dynamic effects.

Keywords: Ireland, economic growth, economic development, inward investment, economic systems

JEL classification: E02, F23, J58, O52, P16

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Acronyms

EMU	European Monetary Union
FDI	foreign direct investment
IDA	Industrial Development Authority

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1 Introduction

Ireland’s economic performance over the past fifteen years has been nothing short of spectacular. During this time, economic growth rates have far exceeded those of other EU member states, averaging 10 per cent in the second half of the 1990s. Even more impressive has been the job generation record. More than one million jobs have been created in the past decade, which has doubled the size of the labour market. This economic success is newly found. For most of the twentieth century Ireland was an economic laggard relative to other European countries (Kennedy, Giblin and McHugh 1988). Economic growth rates were consistently unimpressive. Employment generation was almost never able to keep pace with new entrants into the labour market, causing immigration to be continuously high. The standard of living was poor relative to the European average. All in all, Ireland was an underperforming part of Europe: there was even talk at the turn of the 1990s of Ireland being a ‘third world’ economy (Caherty 1992).

Thus, Ireland has experienced a huge transformation in its economic fortunes within a relatively short period of time. In this paper, three main factors are identified as lying behind this big transformation. One is the positive benefits that have arisen from placing economic openness at the centre of the country’s economic development strategy. Another is the creation of high-quality domestic governance structures to manage both the economy and society. A third is the concerted effort to upgrade the country’s stock of human capital. These three factors are set out in greater detail below. In addition, the paper assesses the sustainability of the model of economic development that has been created in Ireland and teases out some of the lessons that can be learnt from the Irish experience.

2 Development through economic openness

What is now known as the Irish Republic gained its independence form Britain in 1921. But a bloody civil war over the terms of the settlement meant there was a high level of turbulence in Irish politics and society throughout the 1920s (Garvin 1981). A level of political stability only returned when Fianna Fail, under the leadership of the Eamon DeValera, was returned to government in 1932. This political party, which was to rule the country virtually uninterrupted for half a century, introduced an economic programme of economic self-sufficiency that sought to decrease dependence on foreign imports, primarily from the United Kingdom, and to promote import substituting industrialization (O’Grada 1997). The consensus is that this self-sufficiency programme was a disaster for the Irish economy, retarding economic growth and industrialization, causing employment generation to falter and leading to huge numbers of people emigrating from the country in search of a better life elsewhere (Garvin 2004).

By the mid-1950s, it was accepted by leading civil servants that closing off the Irish economy from the outside world had only resulted in a vicious circle of poverty, high unemployment and mass emigration (Bew and Patterson 1982). As a result, work started within government to overhaul the policies of economic isolation, which culminated in the introduction of a new economic development plan in 1958. There were three main elements to this new plan: (i) capital grants and tax concessions were provided to encourage export-led manufacturing growth; (ii) the country’s newly established

Industrial Development Authority (IDA) was given the task of attracting foreign firms to Ireland; and (iii) import levies were gradually to be dismantled so that the country could integrate properly into the world economy. The introduction of the plan represented a decisive moment in the economic history of the Irish Republic as it marked the end of protectionist Ireland and the placement of economic openness at the centre of the country's development model (Lee 1989).

3 FDI and the Irish economy

Ireland's long affair with foreign direct investment (FDI) started in the 1960s and since then attracting multinationals has been the backbone of economic development in the country. The IDA got very busy enticing multinationals to the country with the sales pitch that Ireland had an abundance of young, English-speaking and low-cost labour and that any subsidiary established would only have to pay 10 per cent corporation tax on all profits from exports. The activity of the IDA amounted to first mover advantage in this policy area: no other country was making such a concerted, large-scale effort to attract inward investment: the IDA was out there on its own (Ruane 2004). Throughout the 1960s, FDI grew rapidly in the country: in 1960, foreign firms accounted for 2.3 per cent of GNP but this figure had risen to 15.9 per cent by 1973. By the early 1970s, multinationals were producing 40 per cent of the country's industrial output. Many of the multinational subsidiaries were either located in low productivity sectors such as food and drink or were engaging in relatively routine activities such as the assembly of intermediate parts made elsewhere to be sold abroad. Invariably, the skill content and added-value potential of these subsidiaries were low, but this was not a major worry to the Irish authorities, which viewed the benefits arising from FDI mostly in employment terms, compensating for the significant job losses occurring in agriculture (Barry 2004).

In the 1970s, the IDA made a greater effort to attract higher grade multinational subsidiaries. This strategy was successful as there was a significant shift change in the sectoral composition of FDI towards engineering, chemicals and pharmaceutical industries (Gord and Ruane 1997). Employment in foreign-owned companies increased by 23 per cent between 1973-80. Greater awareness emerged amongst policymakers that the benefits to be gained from attracting multinationals went beyond employment creation as domestic firms could learn about new products, production techniques and organizational skills from foreign companies. Efforts to both enlarge the foreign sector in the Irish economy and increase its quality continued into the 1980s. Multinationals in the electronics and computing sectors started to arrive in sizable numbers during this period, including most of the big brand names (O'Rian 2004). This increase, no doubt, was helped by the change in fiscal incentives to attract inward investment. Under pressure from the European Commission, the Irish government revised the preferential corporate tax rate of 10 per cent for foreign-owned companies so that it applied to all profits, not simply to those arising from export sales, which made locating in the country even more attractive (Buckley and Ruane 2006).

By the turn of the 1990s, a large foreign-owned sector had emerged in the Irish economy. Multinationals were producing about two-thirds of all manufacturing output. Whereas employment in domestic manufacturing firms fell by 19 per cent between 1975 and 1990, it increased by about 27 per cent in the foreign manufacturing sector during the same period. Multinationals played an important role in diversifying the Irish industrial base: many domestic firms were concentrated in low value-added sectors, but the arrival of large numbers of pharmaceutical, electronic and software companies from abroad significantly increased the size of high-tech sectors in the Irish economy (FitzGerald 1999). During the 1990s the FDI sector continued to grow. In 1986 there were 650 foreign firms in Ireland, but by 1997 this number had increased to over 1,000. Inward investment was occurring mostly in modern high-tech sectors: between 1994 and 1995 alone these sectors increased by almost 20 per. In one year, 1997, manufacturing output grew by 16 per cent, which was primarily attributable to foreign-owned, high-technology sectors (Sweeney 1998). On top of these developments in the manufacturing sector, the International Financial Services Centre created in Dublin by the Irish government began attracting significant inward investment in the international traded services sector. By 2000, Ireland was receiving 10 per cent of all FDI into the EU from outside the EU, even though it accounted for only 1 per cent of the EU population.

Most inward investment into Ireland is from the USA. At the end of 2000, US firms owned assets in Ireland worth US$33.4 billion—equivalent to US$9,000 per person living in Ireland at the time. Table 1 breaks down the number of foreign-owned multinationals in Ireland by country of origin and by the number of people they employ. It clearly shows the huge contribution USA-owned firms make to the Irish economy. All in all, the stock of FDI in Ireland now stands at €149 billion, about 30 per cent of GDP. These companies generated exports of €73 billion and directly spent €15 billion in Ireland in 2005, facts which highlight that the foreign-owned sector has become a hugely important part of the Irish economy. The contrast with the late 1950s could hardly be greater—the country has moved from *protectionist Ireland* to *global Ireland*.

Clearly a generous regime of fiscal incentives has played a big part in attracting multinationals to the country, but the activity of the Industrial Development Agency (IDA) has also been important. The IDA is the main state agency responsible for attracting multinationals and its work has got progressively more sophisticated since the 1960s. Forty years ago, FDI was attracted by the blanket offer of generous tax holiday incentives. However, policy became more selective in the 1970s. Potential investors were identified in high-tech sectors such as electronics and pharmaceuticals and then offered higher than normal financial incentives to locate in Ireland. Policy was further fine-tuned in the 1980s, becoming less sector-based and more project-based. A more systematic approach was taken to selectivity: niche high value-added market segments with European growth potential were, first of all, identified; then enterprises which were

Table 1
FDI in Ireland by country of origin, 2006

Country of origin	Number of companies 2006	Employment 2006
US	470	95,515
Germany	122	10,782
UK	111	7,356
Rest of Europe	201	16,504
Asia Pacific	39	2,991
Rest of the world	47	2,339
Total	980	135,487

Source: IDA Annual Report 2007.

significant players in the segments were pinpointed, particularly those that might be considering opening a new or additional production facilities in Europe; the short-listed enterprises would then be contacted to discuss Ireland as a possible investment site; if interest was shown, a financial package would be constructed that would be favourable for the company, but also advantageous for Ireland. More and more, these financial packages are becoming highly customized, resulting in the scale and nature of support varying from one project to another.

This highly flexible, enterprise-focused approach to winning FDI places considerable demands on the work of IDA officials. They have to be given considerable discretion so that they can deal with potential investors in a creative and customized manner. In many ways, these officials act as ‘street-level bureaucrats’, a term first coined in the 1960s to describe public officials who enjoy considerable autonomy when carrying out work tasks—policemen, teachers, social workers, for example. These workers require discretion and autonomy as they work in complex situations that are not conducive to the application of prescriptive rules. They often have to make decisions that package together multiple objectives in a highly contingent manner (Lipsky 1980). This is exactly how IDA officials operate in the field. They have to deal with each potential inward investment project differently and display a high level of creativity to construct an incentive package that meets the needs of the multinational and delivers benefits for Ireland.

To compensate for the discretion permitted to IDA officials, all proposed financial packages are subjected to a careful cost-benefit appraisal to test whether the project will deliver value for money. In addition, many of the incentives included in the financial package are performance-based and tied to transparent goals and clear reporting requirements. These design features allow the financial package to be continuously monitored. Thus, the discretionary role of IDA officials is complemented by an internal supervening structure that reduces the possibility of bad deals being forged or even corruption taking place. It is an internal structure that has worked well so far, given the very big presence of FDI in the country.

4 European integration

Commitment to deeper European integration political and economic integration has been the second pillar to the policy of economic openness. As soon as Ireland abandoned its policy of economic self-sufficiency, joining the Common Market, as the EU was known then, was a high economic priority for the government (Laffan 2003). But its ambitions on this front were thwarted as its application for membership got caught up in the Anglo-French row about the desirability of UK membership of the Common Market. Despite being refused membership, the government started to take action on the assumption that it would one day gain entry. In particular, it started to reduce external tariff barriers, the signing of the Anglo-Irish Free Trade Agreement in 1965 was probably the most significant step taken, to minimize the shock of entering a free trade area in Europe.

Finally, Ireland joined the EU in 1973 and immediately the workings of the custom union had an impact on the Irish economy (Blackwell and O’Malley 1984). Trade creation and trade diversion are widely considered the two dynamics effects of a customs union. On the one hand, trade creation effects occur when the removal of tariff barriers exposes indigenous industries to more efficient producers in other member states. On the other hand, trade diversion occurs when the external tariff barriers that a country accepts on joining the EU denies domestic consumers access to producers outside the EU which are more efficient than internal producers. Membership of the EU released stronger trade creation rather trade diversion effects on the Irish economy. A significant number of domestic firms in mature industries were unable to survive in the post EU-entry competitive environment (McAleese 2000). In the 1970s and 1980s, deeper trade integration with Europe resulted in about 20 per cent of domestically owned manufacturing firms going to the wall, which is a fairly sizable restructuring (O'Donnell 1991).

Of course, the shrinkage of the domestic industrial base was more than compensated by the arrival of foreign-owned companies (Barry 2006). Entry into the EU strengthened the policy of industrialization through inward investment as many multinationals, particular those of US origin, regarded Ireland as the ideal geographical location to maintain a presence in the European market. Another consequence of the trade creation effects of EU membership alongside the increased inward investment was a change in Ireland's trade structure. In 1960, virtually half of Ireland's imports and exports came from or went to the UK. But the combination of inward investment and the opening up of new trade relations with the rest of Europe has weakened the British trade connection: only around a quarter of Irish exports are now destined for the UK market: 1921 had brought political independence from the UK, EU membership brought economic independence and that played well in policy circles in Dublin. If the trade effects of EU membership forced the Irish indigenous manufacturing sector into an unwanted restructuring process, the working of the Common Agricultural Policy was hugely beneficial to Irish farmers, at least until recently. Even though the Irish agricultural sector continued to lose jobs, EU membership brought generous subsidies to many farmers, making some of them very prosperous (Matthews 2005).

Ireland, from the early 1970s to the mid 1990s, benefited from EU structural funds, a fiscal redistribution mechanism to help poorer member states and regions catch up with the richer parts of Europe and also to assist their preparations for monetary union. Between the mid-1980s and mid-1990s, these fiscal transfers amounted to about 2.5-3.0 per cent of Irish GDP. One popular view was that EU structural funds played a pivotal role in starting the Irish economic miracle. But the findings of a number of careful empirical studies suggest this view is false: in essence, the amount of money received from Europe was too small to trigger the Irish boom (Fitzgerald 2004). Nevertheless, EU structural funds did positively contribute to the economy, particularly by helping to finance a wide range of infrastructural projects. One positive unintended consequence from the operation of EU structural funds in Ireland is that it led to big improvements in domestic procedures for the evaluation and monitoring of public projects. Brussels was insistent that the Irish government introduce best practice financial and accounting methods to manage the distribution of EU funds in Ireland. When these methods were found to create high standards of programme transparency and financial accountability, the Irish government 'mainstreamed' the procedures to manage all public projects in the country (Fitzgerald 1998).

But the EU is far more than a trading zone or even an economic union. A powerful political mission underpins the working of the EU, pushing the member states ever closer together. This mission has had a big impact on the Irish policy elite, who have been unbridled supporters of deeper political and economic integration in Europe. The biggest consequence of this strong commitment was that it shaped a new economic policy vision for Ireland. Across political parties, amongst senior policymakers, employers and trade unions there is a consensus that Ireland's economic destiny lies with deeper European economic integration. This consensus is virtually unshakeable and has led to economic policies being proofed on an on-going basis to assess whether or not these advance Irish links with Europe: policies that threaten to dilute the European connection are cast to one side (O'Donnell 2002).

This policy vision has manifested itself in a variety of ways. Virtually all reputable macroeconomic models of the Irish economy now work from the assumption that Ireland is a region of the European economy: the idea that Ireland is a nation-state with a degree of macroeconomic manoeuvrability to influence the demand side of the economy has been abandoned by the economic modellers and serious policymakers. It is now assumed that the government can really only influence the supply side of the economy. In the run-up to entry into the European single currency club, all aspects of government economic policies were geared to meeting the Maastricht criteria for European Monetary Union (EMU) membership. Inside EMU the country has sought to be a credible member of the Eurozone. Thus, the vision of Ireland in a strong Europe not only has brought stability and predictability to economic policymaking, but it has also created a normative framework to guide the behaviour of all economic actors.

5 Building domestic macroeconomic stability

Foreign direct investment alongside European economic integration did much to revamp the structure of the Irish economy during the 1970s and 1980s. But one matter it did not succeed in doing was help Ireland catch up with average living standards in the EU. In 1970, Irish GNP per head was roughly 64 per cent of the EU average while in 1990 it was 67 per cent. Despite the predictions of economic integration theory that EU membership would trigger a catching-up process that would lead to the standard of living in poorer member states converging with levels prevailing in the richer member states, Ireland remained a European laggard. Convergence only started at the beginning of the 1990s with the emergence of the Irish boom. The gap in living standards between Ireland and the rest of Europe narrowed rapidly in the 1990s: by 2000 the country's GNP per head was 96 per cent of the EU average. This convergence process has continued during the new century to the point where the country now enjoys a living standard that is 7 per cent above the EU average: Ireland has become of the richest member states of the EU.

Poor economic management for most of the 1970s and 1980s was the main reason why the country failed to catch up with the EU average, which highlights that economic openness on its own is unlikely to trigger a process of economic convergence (Fitzgerald 1999). Without domestic institutional structures with strong capabilities, a country is unlikely to make significant progress towards reaching designated economic goals. In the 1970s and 1980s the Irish economy was in a mess (Garvin 2004). Difficulties started when the country, like most of Europe, was adversely hit by the big oil price increases of the early 1970s. The Irish authorities adopted a naïve Keynesian response to this economic shock, spending more or less continuously over the next decade to maintain economic growth and employment (MacSharry and White 2000). By the early 1980s, government debt had reached 14 per cent of GNP. Government finally realized that deficit spending was only pushing Ireland further into the economic mire and as a result started to take remedial action. Tax rates were increased to 48 per cent (in 1973 the rate had been 33 per cent), but the resulting increase in revenue was not enough to cover public expenditure. As a result public finances got even worse (Sweeney 1998).

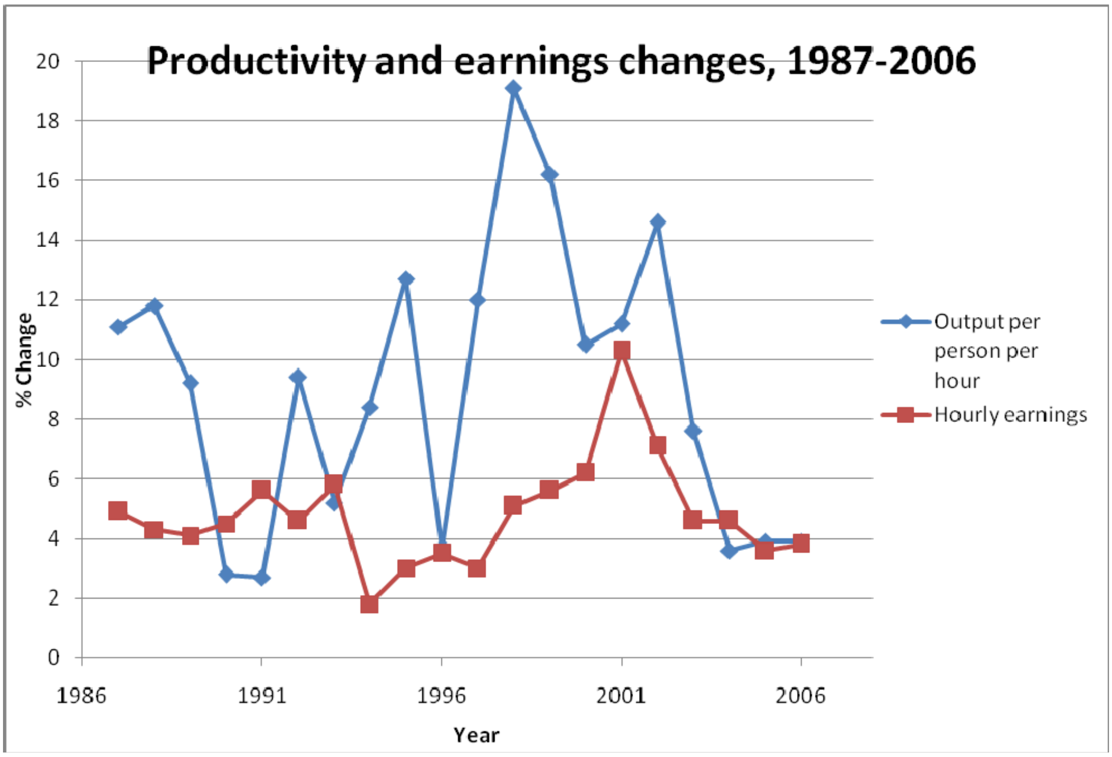
A series of budgets in the early 1980s that promised to stabilize public finances only aggravated the mess further. By the middle of the decade, the Irish economy stood at the edge of the abyss. Government debt had reached 16 per cent of GNP, inflation was running at 15 per cent, unemployment was more than 18 per cent and 30,000 people were leaving the country each year in search of a better life elsewhere. In 1987, a new government was elected committed to restoring macroeconomic stability. A new approach to macroeconomic management was adopted, which is still in operation today (see essays in Barry 1999). The content of this new approach has been mostly negative. Active fiscal and monetary policies were deemed as not producing large gains because governments face balance-of-payments constraints and public finance difficulties. At the same time, if limited scope was seen for the use of aggregate demand to improve unemployment and the economy more generally, there was also caution about its use against inflation. The new consensus can be summed up as thus: maintain pressure on inflation but avoid negative shocks to demand.

Stabilization became the by-word for macroeconomic management. A number of institutional changes were made to implement the new stabilization programme. Perhaps the most important of these was the creation of a national system of social partnership (Teague and Donaghey 2004). When first established the social partnership arrangements had two main functions: one was to moderate wage increases and the other was to maintain an orderly system of industrial relations. Between 1970 and 1987 industrial relations in the country had been volatile and unpredictable. National wage agreements would be in place for a few years and then they would break down, leading to fairly serious increases in industrial strife (Hardiman 1988). All the parties to the new social partnership were very determined that it would not fail—there was a real sense amongst the parties that the dire economic situation required them to work together. Twenty years on and the system of social partnership is still operating.

The economic contribution made by the national system of social partnership over the past two decades is contested. One view, held by mainstream economists, is that social partnership and the national social agreements which it produced made only a marginal contribution to the Irish boom (McCoy 2006). There is a begrudging recognition that the national agreements brought about some stability in industrial relations, but nothing much else (Honohan and Walsh 2002). A different interpretation is put forward in this paper: social partnership is seen as positively contributing to economic stabilization by establishing a regime of wage moderation and by sustaining orderly industrial relations.

Figure 1 shows that real wages have increased continuously during successive social partnership agreements. However, it also reveals that the rate of increase is below the rate of productivity increases. Even allowing for such practices as transfer pricing by multinationals, which inflate output and hence productivity figures, productivity rates have outstripped wage rates during the social partnership era. Thus, while real wages were rising, unit labour costs were falling, which had the effect of producing real wage

Figure 1
Productivity and earnings changes, 1987-2006



Source: CSO Ireland.

depreciation. This not only boosted the economy's competitiveness, but placed Ireland in a healthier economic position to enter and survive in the EMU. Thus, the pay deals have accomplished their mission, at least with regard to the private sector, which was to moderate wage increases: in all likelihood, pay increases for private sector workers would have been higher in absence of the wage agreements.

The national wage deals operated differently in the public sector. Here, the concern was more about securing employment relations stability than with wage moderation. Public sector workers are highly unionized and have a much higher propensity to strike. The significant industrial relations unrest that occurred in Ireland during the 1970s and early 1980s was mostly in the public sector (Roche 1992). Thus, under successive agreements, public sector workers were able to secure pay increases that they would have achieved in the absence of social partnership: social partnership had virtually no moderating effect on wage rates in the public sector. The government was able to live with this situation as employment relations stability has more or less prevailed in this part of the economy.

Overall, the wage determination system introduced by social partnership successfully contributed to macroeconomic stabilization in the country and established the labour market conditions for the 'Celtic tiger'. The wage moderation regime that has been maintained under successive agreements has allowed a fall in unit labour costs which is extremely important to small open economies, as Katzenstein (1985) first emphasized in his seminal book, *Small States in World Markets*. The regime also signalled to other EU member states that Ireland had labour market institutions consistent with monetary union. But the social partnership system did more than deliver these economic benefits.

It created a quite deep shared understanding between the government, employers and unions that even though they had different, and often competing, interests, it was crucial for national prosperity that they collaborate as much as possible with each other. A core aspect of this shared understanding was that developing Ireland through economic openness required a high level of internal consensus-orientated policymaking on social and economic matters. Overall, social partnership has been at the centre of an improved system of economic governance that has emerged in Ireland over the past two decades, and this institutional change has made a major contribution to recent economic prosperity.

6 Strengthening human capital

New growth theory suggests that economic development will not progress by only active demand management, but also by endogenously determined factors such as infrastructure, education and innovation (Aghion and Howitt 1998). Many studies in this tradition establish a positive link between human capital and economic development: the more skilled and educated a country's workforce, the more likely it will be endowed with the capabilities to permit the rapid diffusion and effective use of technological innovations (Krueger and Lindahl 2001). On this view, the design and delivery of education has a pivotal role to play in advancing economic development in a country. A careful study by O'Grada and O'Rouke (1996) persuasively shows how economic growth in the 1950s was held back by Ireland's poor educational system. The massive expansion of education experienced by virtually every north European country during the postwar era by-passed Ireland. In the early 1960s, over 50 per of school children were leaving school at the age of 13, an appalling figure compared to the rest of Europe. It was not until 1967 that free secondary level education was introduced.

Since the late 1960s, successive governments have maintained high levels of investment in education. Even during the bleak years of the 1980s, funding for education was maintained: nearly every other area of public expenditure was cut back. As a result of this new commitment, Ireland's educational performance has caught up with the rest of Europe. Participation at all levels of education has increased dramatically in the past thirty years. The proportion of the labourforce in the 54-65 age-category, those who would have entered the labour market sometime in the 1970s, with at least upper secondary education was 38 per cent in 2005, while the same figure for those in the 25-30 age-category, those entering the labour market sometime in the past 10-15 years, was 78 per cent. About 58 per cent of school students are now staying on to do some form of third level education—an increase of a factor of six during the past thirty years (OECD 2007). The proportion of the 25-34 year-old cohort in the labourforce with tertiary level education is now above the OECD average. Ireland has belatedly experienced the educational revolution that occurred in other European countries in the 1950s.

A distinctive feature of the Irish educational system has been the rapid expansion of third-level provision, mainly in the form of enlarging the role of institutes of technology, formerly known as the regional technical colleges. In the 1960s students going to these institutes constituted less than a quarter of all third-level students, however they now constitute about half of the total. Enlarging the role of the institutes of technology resulted in a big rise in the number of third-level graduates with technical and scientific qualifications. One report suggests that Ireland has the highest number of science and engineering graduates amongst the 25-34 year-old labour-market cohort in the world (see Barry 2007). Another feature of the institutes is that they offer curricula that are more practical and more sensitive to the needs of business, which was exactly what the country wanted just at a time when multinationals were arriving in large numbers.

Ireland is a small country which enables one arm of government to work closely with another arm. There have been close and on-going interactions between the higher educational sector and the economic development agencies during the last 3-4 decades. In the late 1970s, for example, the IDA and Forfas pressed third-level education institutes, both universities and the institutes of technology, to produce more computing and electronic engineering graduates. The result was a near tenfold increase in computer science graduates in five years (White 2001). This high level of engagement continues today. Currently, there is a debate about whether the policy of producing large numbers of intermediate level technical graduates, which served the country well during the past two decades, has run its course. The argument is that to compete in the new knowledge-based economy requires the country to create a sophisticated national system of innovation, part of which will involve more research oriented, higher grade graduates. There has been no conclusion to this debate, but the universities are already ratcheting up their postgraduate provision in anticipation that they will be asked to help deepen the educational attainment of people even further.

Undoubtedly, the transformation of the education system has had a positive impact on the stock of human capital in the country. Working out how improvements in the educational system influence economic performance is difficult. The most reliable, though at the same time conservative, calculations estimate that rising educational attainment has contributed about 1 per cent annually to economic growth during the past two decades (Fitzgerald 1999). Another trend is that returns to education have increased significantly during the last 20 years; in other words, graduates are now being better paid than ever before for having qualifications. All in all, the Irish educational system has been massively transformed in the past 30 years and is now producing highly qualified people that can be rapidly integrated into the labour market. There is a wide consensus in the literature that this has been a contributing factor behind the Irish boom (Barry 2007).

7 The sustainability of Ireland’s development strategy

A lively, on-gong debate exists about the merits and sustainability of the Irish economic development model. One critical view is that the strategy of economic openness, which has been pursued by successive Irish governments without compromise, has turned Ireland into an *entrepôt* economy: a place which multinationals use mostly to assemble things to be sold in other countries (O’Hearn 1998). On this view, the strategy of developing the economy through attracting FDI has crowded out the ability of the indigenous part of the Irish economy to grow and to engage in higher value-added business activity. One variant of this argument suggests that the Celtic tiger was primarily caused by the American boom in the 1990s: USA companies used excess profits to establish subsidiaries in Ireland (Allen 2000). Those who hold this view invariably point to Scandinavian countries, which have been successful in acquiring a high standard of living by building up dynamic indigenous business sectors, as the development path that should have been adopted for Ireland (see Coulter and Coleman 2003).

There is no doubt that the extreme economic openness of the Irish economy has its down side, particularly in terms of making the country highly vulnerable to external economic shocks (Lane and Ruane 2006). On this point, there is wide agreement. But, the claim that economic openness has turned Ireland into a warehouse economy is too strong and can be challenged on a number of fronts. First of all, this view tends to understate the policy options that were realistically open to Irish policymakers 50 years ago in their endeavours to improve economic performance. In the 1950s, Ireland faced the classical development trap of late industrializing countries. On the one hand, it sought to leapfrog the experiences of already industrialized countries and diffuse state-of-the-art technologies and production methods to create a dynamic indigenous industrial sector. On the other hand, existing industries did not have the knowhow or the capabilities to absorb advance technologies. In the prevailing conditions of 1950s Ireland trying to turn around the country's poor economic performance by attracting inward investment was probably a more viable policy option than many (Krugman 1997).

A second criticism is that the *entrepôt* economy understates the benefits that have accrued to the Irish economy from inward investment. A range of studies have shown that multinationals make a net positive fiscal contribution to the Irish exchequer (see Buckley and Ruane 2006). Moreover, multinationals have created highly skilled technical and professional jobs that may not have been available otherwise, with the effect of allowing some of the best educated young people to remain in Ireland rather than leave for career opportunities elsewhere. FDI has led to the diffusion within Ireland of advanced technological innovations and production methods as well as state-of-the-art organizational and managerial practices: multinationals have helped upgrade the Irish business environment.

A third criticism is that the *entrepôt* economy thesis underestimates the degree of change that has occurred in the Irish indigenously-owned sector. A number of studies have pointed out that a leading edge, globally competitive local software industry has emerged in Ireland that has only tenuous links with software multinationals located in the country (see O'Rian 2004; O'Gorman, O'Malley and Mooney 1997). Local software companies employ as many people as the subsidiaries of software multinational companies. In addition, a local financial and business service sector, which is internationally oriented, has grown rapidly during the past decade, mainly as a result of the emergence of the Irish Financial Services Centre. The level of outward investment by Irish companies has boomed in recent years, increasing by 325 per cent between 2001 and 2005. In 2005 Irish outward FDI was valued at €118 billion. Manufacturing is the most common activity by subsidiaries of Irish companies, making up 26 per cent of the total: business services come next with 21 per cent. The pace of the increase in outward investment flows has been such that it now exceeds inward investment flows of overseas companies in Ireland (Forfas 2007). Thus, the important changes that have been occurring in the indigenous sector during the past few decades fit uneasily with the *entrepôt* view of the Irish economy.

Overall, the argument that Ireland has allowed itself to be turned into an *entrepôt* economy is a lopsided and partial account of how the country has developed over the past 40-50 years. At the same time, it must be recognized that the country faces some stern challenges in forthcoming years. During the past 15 years, the spectacular performance of the Irish economy suggests that it has been able to withstand the big pressures that arise from economic openness. As a result, the country has caught up with, and in some instance overtaken, the standard of living of other advanced economies. But this catch-up process has unavoidable consequences. In particular, as the economy has caught up, so its price and cost-base have increased. Ireland has become a fully paid up member of the club of rich nations. This poses problems. One is that it becomes more difficult to attract inward investment: the cost/skill mix in other countries currently riding the catching-up wave is as attractive, if not more so, to multinationals as Ireland's. The other problem is offshoring: the migration of firms and jobs out of Ireland. There has been no close study of the extent to which offshoring is occurring in Ireland, but there is widespread acceptance that it has been happening and, if anything, is gathering momentum.

In a nutshell, as Ireland has prospered so the competitive challenge of maintaining, let alone increasing, current standards of living has intensified. Policymakers are acutely aware of this problem and a concerted effort has begun to upgrade economic and industrial policies. The IDA, for instance, is now less interested in attracting multinationals in the electronics and computing sectors and more eager to secure FDI in the growing bio-technology related industries. New policy incentives and programmes are being developed to make Ireland an attractive location for international bio-technology companies. In addition, a new agency called Science Foundation Ireland has been established to improve primary research in the universities and to deepen R&D and other innovation activity in the commercial sector. Current policy activities are nothing less than a bold attempt to re-orientate the economy towards knowledge and innovation. Every effort is being made to ensure that the country maintains its newly found prosperity.

7 Conclusions: learning from Ireland

The Irish economy has been transformed during the past 30 years. A range of factors are responsible for this transformation, which has left the country a prosperous and dynamic place. Several lessons can be drawn from the Irish experience. One is that policy elites—the state, if you like—in a country need to forge an economic development policy vision, not only to guide government interventions, but also to create a framework of understanding that will foster national awareness and buy-in into the development model (Chang and Rowthorn 1995). In Ireland there has been unwavering support for the economic openness programme to the extent that there is deep suspicion of any political party or proposed public policy that might compromise the global Ireland brand. But it is not sufficient to only have a widely accepted economic vision; policymakers also need to be pragmatic. As Dani Rodrik (2008) persuasively argues, very often policymaking in developing countries is about constructing second-best solutions to problems: first-best solutions are invariably out of the reach of policymakers. In Ireland, policymakers had to be pragmatic continuously when trying to stabilize the economy or hold together the national social partnership arrangement. One of the impressive features of Irish policymaking process is how it combines vision and pragmatism.

A second lesson from the Irish experience is the importance of building high quality institutions and institutional arrangements. The IDA is a first-rate economic development agency that continuously delivers on its mission to bring high-quality inward investment to Ireland in a way that benefits the country. The social partnership regime has not brought social democracy to Ireland, but it has created an orderly wage determination system and sustained industrial relations stability (O'Donnell and O'Reardan 2000). As a result, it not only helped pull the county back from the economic abyss, but it also has advanced the core economic objective of making Ireland an attractive place for inward investment. These institutional arrangements have been efficient in the functional sense as they have successfully performed the tasks they were set up to do. But they have also operated in a cultural way, embedding values and beliefs about the positive benefits that arise from economic openness for Ireland.

A third lesson from the Irish experience is the importance of policy consistency. Since the adoption of the policy of economic openness in the late 1950s, every effort has been made to ensure that all other economic and social policies are consistent with this goal. For instance, the government has resolutely ensured that the social partnership arrangement did not produce employment relations policies on trade union recognition or employee participation that might tarnish Ireland's attractiveness as a site for inward investment. Frequently, Irish governments have lined up with British governments to block the passage of EU social policies, a tactic deliberately adopted to signal to multinationals that Ireland is a good place for business. This idea of policy consistency should not be confused with the notion of policy complementary that is found in the political economy literature on 'varieties of capitalism' (Soskice and Hall 2001). Policy complementary is about different institutions and policy programme positively interacting with each other in a mutually reinforcing manner to produce dynamic gains. Nothing as intricate as this has emerged in Ireland: the emphasis has been on putting in place policies that are consistent with the core policy vision of economic openness.

A fourth lesson, which gives support to Hirschman's (1958) metaphor of development as a jigsaw puzzle, is that Irish policymakers have increasingly contextualized policymaking and have also become acutely aware that priority setting is crucially important. Ireland, in the 1970s, mimicked the response of other bigger countries to the oil price shocks and implemented Keynesianism demand management policies. But this approach had huge negative consequences for the economy. The lesson learnt from this experience was that the crude imitation of policies developed in other countries does not work: policies and programmes have to be moulded so they are in line with actual existing domestic conditions. Similarly, there is a growing recognition that everything cannot be done at once. As the Celtic tiger started to get into full swing, demands increased for the country to build a Scandinavian type welfare state. But these calls were resisted by the policy elite who were partly concerned about the fiscal implications of such a course of action and partly concerned that it would disrupt the workings of social partnership arrangements. In other words, the proposal was considered a step too far. Thus, the Irish experience suggests that international bandwagons should be treated with caution and the focus should be on addressing the most pressing domestic economic problems and constraints. Problem-solving and social learning are the by-words of economic development in Ireland.

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