

The Role of Tax Policy in Ireland's Economic Renaissance

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ABSTRACT

This paper analyzes the role of tax policy in the transformation of the Irish economy from the 1980s to the 1990s. Details are provided of the marked underperformance of the economy in the 1980s, evidenced by rising unemployment, falling employment, stagnant living standards, and a looming fiscal crisis. The correction of the fiscal imbalances in the late 1980s was followed by a remarkable transformation of the economy. In the 1990s, the Irish economy led Europe in terms of employment creation, unemployment reduction, and improved living standards. The increasing ratio of debt to gross domestic product was reversed, and Ireland easily qualified to adopt the European common currency in 1999.

INTRODUCTION

A pleasant side-effect of Ireland's recent economic boom has been a steady stream of invitations to international conferences seeking insights into our success. It is especially agreeable to be invited to talk on this topic in Ottawa, where the intention to make Ireland a republic was announced in 1948.

I should, at the outset, draw attention to the risks in using the Irish experience to illustrate a particular point of view or a belief in the efficiency of particular measures as the key to economic success. In fact, I believe that the one message that can with certainty be drawn from our experience is that economic success is due to many factors—and a substantial dollop of luck helps too! The difficulty of identifying the contribution of individual factors to our amazing recent performance also should be acknowledged at the outset.

In this short paper, I begin by outlining the nature and extent of the transformation that occurred in the 1980s and the achievements of the Irish economy in the 1990s. I turn then to an examination of the factors that have been identified

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as having contributed to this success. The following section is devoted to the role of tax reform and tax policies in the Irish success. I conclude by considering what lessons may be drawn from the developments summarized in the paper.

THE RECORD

Historians reviewing Ireland's achievements since Independence in 1922 traditionally gave the country's economic performance low marks. One influential study stated, "It is difficult to avoid the conclusion that Irish economic performance has been the least impressive in western Europe, perhaps in all Europe, in the twentieth century."¹

The most striking symbol of long-run failure was the continued decline of the population. While the mass exodus from the country after the famines of the 1840s could be blamed on British misrule, the renewed emigration and population decline of the 1950s were due to shortcomings of domestic policy. Average living standards were little higher in 1961 than in 1914. Relative to Britain and the rest of Europe, Ireland had fallen further behind.

Not until the 1960s, 40 years after Independence, was the population stabilized and a significant improvement in living standards achieved. But while the rate of growth rose in the 1960s and 1970s, the change was not sufficient to close the gap in living standards with the richer European countries. Fiscal extravagances in the 1970s and the subsequent inevitable correction ushered in a period of renewed stagnation in the 1980s. As late as 1988, *The Economist* in one of its periodic surveys characterized Ireland as the "poorest of the rich."² A year later, a prominent US economist referred to Ireland's "failed stabilization."³ Irish economists continued to be preoccupied with the problems of slow growth and underperformance into the 1990s. Little in their writings presaged the renaissance that was already under way.

Since the late 1980s, however, and especially in the 1990s, Ireland's rate of economic growth has been markedly above the European and OECD averages. We avoided the world recession of the early 1990s and truly remarkable growth rates have been recorded since the mid-1990s. When *The Economist* reviewed the country again in 1997, it hailed Europe's "Shining Light."⁴

1 J.J. Lee, *Ireland 1912-1985: Politics and Society* (Cambridge: Cambridge University Press, 1989), 521. For more up-to-date material on the Irish economy, see Frank Barry, ed., *Understanding Ireland's Economic Growth* (Basingstoke: Macmillan, 1999); and Anthony Leddin and Brendan Walsh, *The Macroeconomy of Ireland*, 4th ed. (Dublin: Gill and Macmillan, 1998).

2 "Poorest of the Rich: A Survey" (January 16, 1988), vol. 306, no. 7533 *The Economist* 1-28.

3 Rüdiger Dornbusch, "Credibility, Debt and Unemployment: Ireland's Failed Stabilization" (1989), 8 *Economic Policy* 173-209.

4 "Ireland Shines" (May 17, 1997), vol. 343, no. 8017 *The Economist* 16; and "Europe's Tiger Economy," *ibid.*, at 21-24.

Figure 1 shows the growth rates of gross domestic product (GDP) in Ireland and the European Union (EU) since 1979. It is clear that 1989 was a turning point, after which Ireland consistently outperformed Europe. While GDP may overstate the economy's performance (a point I return to later), there is no doubt that the growth rate has been spectacular since 1994.

In view of Ireland's traditional concern with emigration and unemployment, the performance of the labour market deserves special attention, and in fact it is here that developments have been most dramatic. Figure 2 shows how the decline in employment in the early 1980s gave way to an extraordinary employment boom in the 1990s, when unparalleled rates of job creation were recorded. The numbers at work in Ireland have risen by over 40 percent since the mid-1980s, over a period when there has been little net employment growth in the EU as a whole. Figure 3 shows how sharply the unemployment rate declined during the 1990s. These statistics do not reflect a wholesale resort to part-time employment or a significant increase in non-participation in the labour force. The employment population ratio rose sharply owing to the changing age structure of the population and the steady rise in the labour force participation rate of women. Moreover, the proportion of women working part time has remained below the EU average. The only adult group to record a decline in labour force participation rates has been men aged over 55, and even this trend has been reversed in recent years. In all these respects, the Irish performance has been even more "miraculous" than the Dutch, which relied heavily on part-time work and reductions in labour force participation rates to lower measured unemployment.⁵ The most dramatic indicator of the change in the Irish labour market is the replacement of the traditional stream of emigration by the highest net immigration in the EU (figure 4).

The exceptional growth in Irish GDP quickly moved the country up the EU "living standards league table." Whereas in the mid-1980s we were in much the same relative position as when we joined the European Economic Community (EEC) in 1973, by 1999 we were above the European average (figure 5).

To complete this glowing picture, we should recall that it has not been achieved at the cost of fiscal irresponsibility or high inflation. On the contrary, as the Irish growth rate accelerated ahead of the rest of Europe, our inflation rate fell and the public finances improved steadily. We easily qualified under the criteria laid down in the Maastricht Treaty to adopt the new single currency—the euro—in January 1999. In fact, there was a greater need to fudge the criteria to allow countries such as Belgium, France, and Italy to join than there was for Ireland. The speed with which our national debt:GDP ratio fell during the 1990s confounded those who were so understandably depressed by its rapid rise in the first half of the 1980s (figure 6).

5 Jelle Visser and Anton Hemerijck, *A Dutch Miracle: Job Growth, Welfare Reform and Corporatism in the Netherlands* (Amsterdam: Amsterdam University Press, 1997).

Figure 1 GDP Growth Rates, Ireland and the EU, 1979-1999

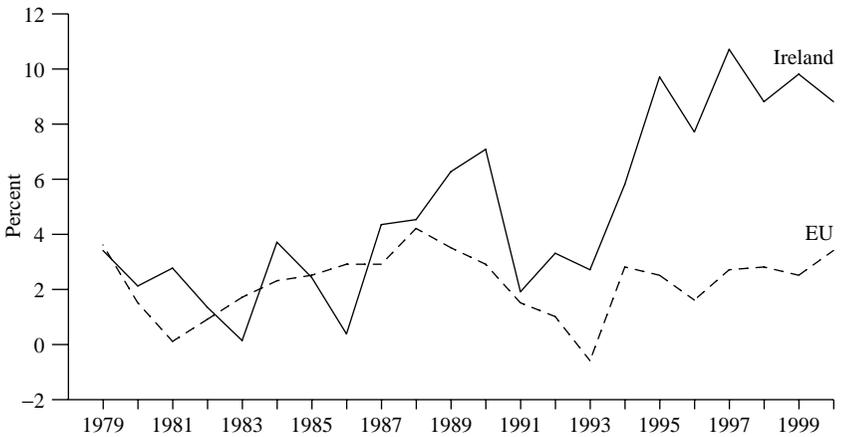
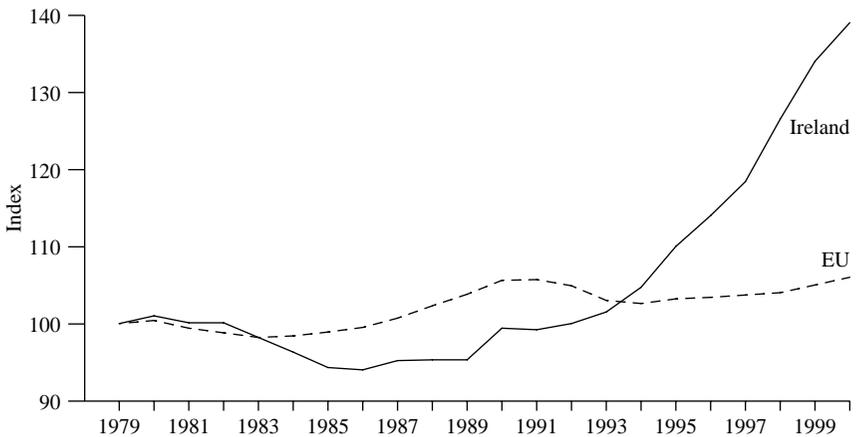


Figure 2 Level of Employment, Ireland and the EU, 1979-1999



EXPLANATIONS

Irish commentators are agreed that the factors described below should be included in the list of those that contributed to the recent success of the economy.⁶

Fiscal Stabilization

In the course of the 1980s, Ireland struggled to correct the major imbalances in the public finances inherited from the recklessness of the late 1970s, by undertaking

6 Brendan Walsh, "The Irish Economic 'Miracle'" (1999), vol. 6, no. 4 *New Economy* 223-28.

Figure 3 Unemployment Rates, Ireland and the EU, 1979-1999

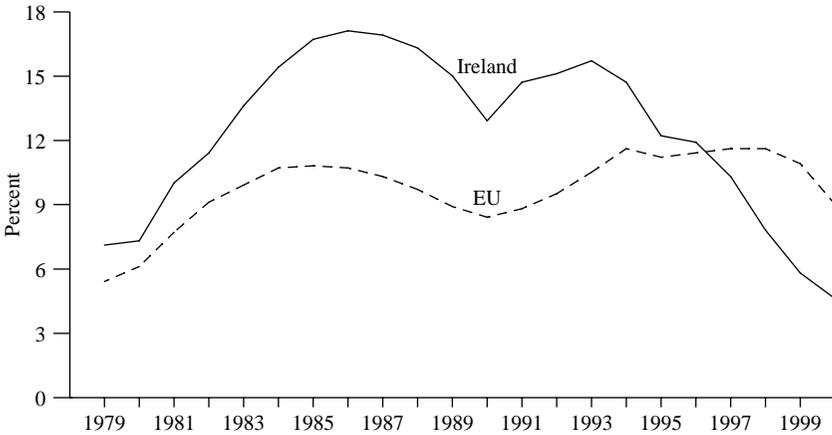


Figure 4 Net Migration Rate, Ireland, 1980-1996



a major shift in resources from domestic absorption to net exports.⁷ This painful adjustment process was largely completed by the late 1980s.

An “Expansionary Fiscal Contraction”?

Initially the approach to stabilizing the public finances in the 1980s relied heavily on increased taxation. This strategy met with only limited success owing

7 See Brendan Walsh, “Stabilisation and Adjustment in a Small, Open Economy: Ireland, 1979-95” (October 1996), 12 *Oxford Review of Economic Policy* 74-86.

Figure 5 Relative Living Standards, Ireland and the EU, 1986-1998

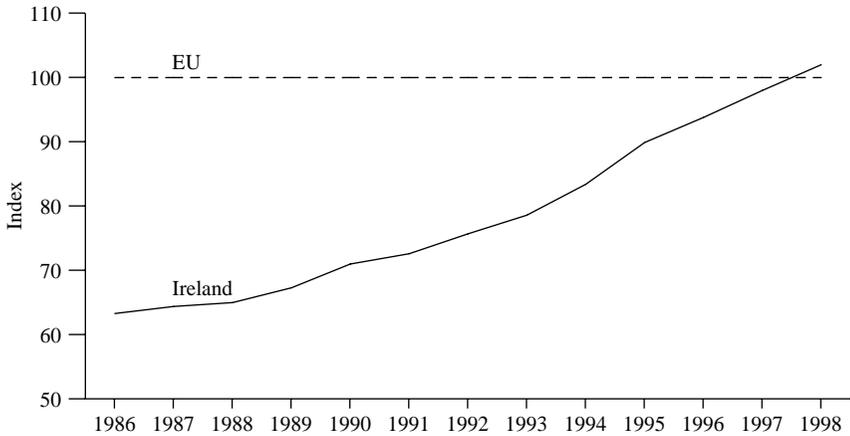
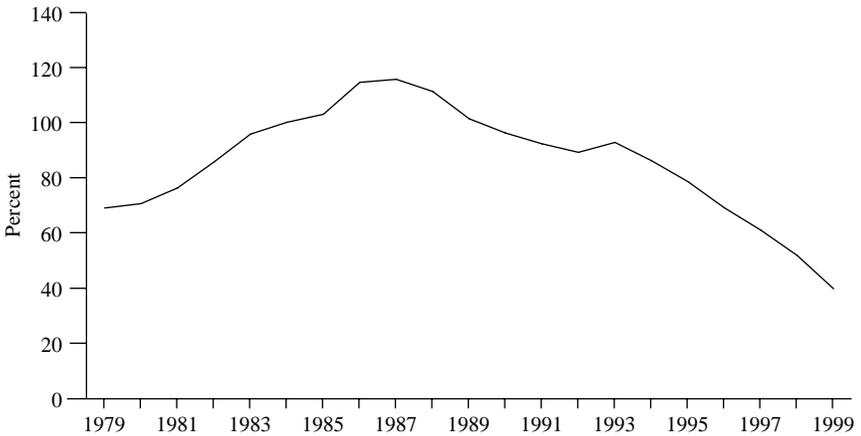


Figure 6 Debt:GDP Ratio, Ireland, 1979-1999



to Laffer-curve effects varying from emigration to cross-border shopping and capital flight. The unemployment rate soared, and the economy seemed to be sinking under the effort. After 1987, the emphasis shifted. Public expenditure was pruned. Both current and capital spending fell in nominal terms. The economy responded positively.⁸ A virtuous circle was entered, and higher growth facilitated reductions in the burden of taxation. It should, however, be borne in

8 For a review of these developments, see Patrick Honohan, "Fiscal Adjustment and Disinflation in Ireland: Setting the Macro Basis of Economic Recovery and Expansion," in Barry, *supra* footnote 1, 75-98.

mind that there were no significant changes in the corporate profit tax (CPT) regime at this time.

Favourable Climate for Foreign Direct Investment

The climate for overseas investment in Ireland has been consistently favourable since the 1960s. Among the factors that have encouraged firms to choose Ireland as their European location, the low rate of CPT is paramount. This is discussed in more detail below. In addition, a ready supply of well-educated labour, reasonably easy access to the east coast of the United States, and close cultural ties with America are further reasons for the preference shown by many leading US companies for Ireland. Our main competitor for US foreign direct investment (FDI) in Europe is probably the United Kingdom, with which we share many of these attractions.

The Irish boom coincided with a marked increase in the inflow of FDI, especially from the United States. Ireland's share of the flow of FDI from the United States to the EU rose from 2 percent in 1987 to over 7 percent in 1993.⁹ Exactly why we became more attractive to FDI at this time remains a puzzle. No changes in the corporation tax regime occurred at that time, but several other factors might have played a role.

Increased Success in Industrial Promotion

A gradual refinement of our industrial promotion policies led to more sophisticated targeting of overseas investment in the 1980s and 1990s. The main industrial promotion agency, the Industrial Development Authority, appears to have learned through a process of trial and error to identify the industries that are most likely to be attracted by the advantages that Ireland has to offer. Emphasis switched to subsidiaries of high-tech industries with a strong focus on electronic engineering, pharmaceuticals, medical instrumentation, computer software, and some food processing sectors. The industries that came to Ireland apparently shared a need for a ready supply of well-educated, flexible workers. The former insistence on regional decentralization was tacitly relaxed, permitting cities like Dublin, Cork, and Galway to attract significant clusters of firms in certain industries.

Low-Cost Labour Supply

When asked about the key attraction of locating in Ireland, it is "politically correct" for an industrialist to stress the importance of Ireland's plentiful supply of educated, English-speaking skilled labour. By the 1980s, young people with second- and third-level qualifications predominated in the outflow from the school system. They were eager to work in Ireland even though wage rates were

9 Barry, *supra* footnote 1, figure 3.10.

relatively low by comparison with those prevailing on the European mainland. High productivity levels have been achieved by subsidiaries of multinationals employing these young people.

Corporatism

Much of the credit for maintaining the supply price of labour at a competitive level is conventionally given to Ireland's system of wage determination. There was a return to centralized wage bargaining in the late 1980s. In the 1990s, a series of national wage agreements was negotiated between the "social partners"—employers, unions, and the government. The promise of steady reductions in income tax rates helped gain acceptance for moderate rates of pre-tax pay increases over three-year intervals. There was a marked drop in the incidence of industrial disputes. This arrangement has proved difficult to maintain in the present climate of an overheating labour market. However, early in 2000 another three-year wage agreement was negotiated (though it has not yet been ratified)—this one labelled the "Partnership for Prosperity and Fairness."

EU Aid

EU funds have been proportionately more important in Ireland than in any other member state. Ireland has benefited disproportionately from the common agricultural policy since joining the EEC in the 1970s. We received additional aid on joining the European monetary system in 1979, and more money flowed in from the cohesion, regional, and social funds in the early 1990s. This last infusion helped to insulate us from the global recession of the early 1990s. It is generally believed that we have used EU aid effectively. Indeed, the process of applying for funding led to a marked improvement in the overall planning of Irish public spending. However, the importance of this aid peaked in the early 1990s and has declined steadily in recent years.

Exchange-Rate Policy

In 1979, Ireland indicated its preparedness to join the new exchange-rate arrangements in Europe even if this entailed breaking the link with sterling, as quickly proved to be required. In 1999, we duly adopted the new European currency, thereby ending the brief life of the independent Irish pound. Some believe that Ireland, as the only English-speaking country in the new currency union, holds a significant advantage in attracting foreign investors, especially in the financial and information technology fields. The Irish boom really got under way shortly after the 10 percent devaluation of the Irish pound in the exchange-rate mechanism of the European monetary system in January 1993, and we managed to manoeuvre our currency to a competitive level before finally converting to the euro in 1999. An interesting sidelight is that our decision to break the currency union with Britain in 1979 does not appear to have had an adverse effect on Anglo-Irish trade flows. While this is reassuring on one level, it should serve as

a warning against expecting dramatic trade-creating benefits from the decision to adopt the single European currency.¹⁰

Overview

While the low rate of CPT and the reductions in personal income tax are included as important factors in this list, it would be wrong to conclude that changes in the tax system triggered the boom. It is noticeable that previous studies do not explicitly mention the CPT regime as an explanation for the increase in Ireland's share of US investment in the EU in the late 1980s.¹¹ Indeed, the effective CPT rate actually *increased* in the 1980s (see below) and thus cannot be invoked as an explanation for the *timing* of Ireland's economic boom, even though its importance in the economy's longer-term success is not disputed.

The importance of FDI in expanding the base of the Irish economy is illustrated by the fact that foreign-owned firms now account for about 47 percent of Ireland's industrial employment, 77 percent of net industrial output, and 83 percent of merchandise exports. Foreign firms are very much in evidence in the International Financial Services Centre (IFSC), where the level of employment has reached 7,000 in a mixture of back-office and higher-valued added activities in a designated area of Dublin. While output and employment in indigenous industrial and banking firms have grown in recent years, their relative importance in the total economy has declined.

In view of the targeting of the low CPT on manufacturing/export activities, it is hardly surprising that Ireland has bucked the general trend of declining industrial employment. However, the growth of employment has been spread across most sectors (see table 1), and in areas like building and construction, financial and other business services, and other services, the rate of job creation has been phenomenal.¹² Obviously the contribution of FDI to the economy cannot be measured simply in terms of the growth of employment in foreign-owned firms, because much of the additional employment in building and services has been induced by the expansion of the export base.

TAX POLICY

Background

To understand the present Irish CPT regime, we need to recall that from the 1930s to the 1960s the country relied heavily on protectionist measures to

10 The effect of breaking the sterling link is explored in Brendan Walsh, *Two Islands—Two Monies: The Effect of Breaking the Sterling Link on Anglo-Irish Trade*, Paper no. WP/00/6 (Dublin: Centre for Economic Research, Department of Economics, University College, 2000).

11 Frank Barry, John Bradley, and Eoin O'Malley, "Indigenous and Foreign Industry," in Barry, *supra* footnote 1.

12 Detailed comparisons by sector are not possible owing to the reclassification of employment after the introduction of the Quarterly National Household Survey in 1997.

Table 1 Employment Growth by Sector, Ireland, 1989-1999
(Annual Average Growth Rates)

Sector	Rate (%)
Agriculture, mining, etc.	0
Production industries	3.3
Building and construction	8.5
Transport, etc.	4.1
Public administration and defence	1.5
Other non-agriculture	6.1
Average, all sectors	4.4

Source: *Labour Force Survey* and *Quarterly National Household Survey*

promote industrial development. The result was a growth of activity in small, inefficient firms oriented almost exclusively toward the tiny domestic market. A growing awareness during the 1950s of the limitations of this policy, heightened by the prospect of eventual economic integration in Europe, prompted a switch to other measures to promote industrialization. One of these new approaches was a more welcoming attitude to foreign investment, including the introduction of a preferential corporate tax rate on profits from exports and/or manufacturing and a generous system of capital grants for manufacturing. Initially foreign investment was encouraged only in areas where it would not represent a threat to established domestic firms. However, this consideration declined in importance as the prospect of dismantling tariffs and the almost inevitable collapse of employment in the “infant industries” loomed. It was hoped that new, outward-oriented firms would offset the loss of employment in the older firms.

The switch to outward orientation was gradual. In 1947, a customs-free zone was created at Shannon Airport. The Industrial Development Authority was established in 1949 and, during the 1950s, given increasing powers and resources to provide grant-aid to the manufacturing industry. In 1956, a 100 percent tax remission—known as export profit tax relief (EPTR)—was applied to profits from (mainly manufacturing) exports. Any remaining restrictions on inward foreign investment were removed by the repeal of the Control of Manufactures Act in 1958. Thus, by the 1960s, the attitude to FDI had been completely transformed from the former hostility to active encouragement. Foreign investors were offered the attractions of a low CPT rate and grant-aid to come to Ireland. No restrictions were placed on their freedom to remit profits from the country. Few other developing countries exercised as liberal a regime toward FDI at this time. The completion of change to outward-looking policies came with the passage of the Anglo-Irish Free Trade Agreement (1965) and Ireland’s entry into the EEC in 1973.

Recent developments

Membership in the EEC (EU) inevitably raised the question of the compatibility of the EPTR with Ireland’s obligations under the Treaty of Rome. Since the

measure was targeted on exports, it was deemed discriminatory and was phased out over the period 1981-1990. In its place, a 10 percent “preferential” CPT rate was applied to profits from manufacturing and internationally traded services.¹³ In the late 1980s, the 10 percent preferential CPT was extended to activities located in the IFSC in Dublin. In the course of the 1990s, our success in attracting FDI in the high-tech and financial sectors provoked claims of unfair tax competition from countries such as Germany and Belgium, which were not pleased to see a significant relocation of activity to Ireland.

Thus, the Irish corporate tax system has for long been dualistic, with low rates applicable to export sales (up to 1981) or manufacturing and internationally traded services (post-1981), on the one hand, and a high “standard” rate applicable to the remainder of the corporate sector, on the other. In the early 1980s, the standard rate was 50 percent; it has been steadily reduced since then (see below). Such has been the growth of manufacturing in the 1980s and 1990s that tax payments at the preferential rate quickly grew to more than half of the total take from CPT. In fact, the only major taxpayers of the standard CPT rate have been the non-IFSC banks.

The anomalous situation in which the lowest rate of profit tax in the EU applied to one set of businesses and one of the highest rates applied to all the rest was never palatable to the EU. The preferential rate was originally introduced as a temporary measure, to be phased out in 1990, but it was subsequently extended to 2010 (2005 in the IFSC). As noted above, some features of the tax system—in particular, the application of the special inducements to attract activity to the IFSC—have been deemed unfair tax competition in some European circles. As a result of negotiations between the Irish government and the EU Commission, the following compromise has been approved:

- The preferential rate of tax will continue to apply to manufacturing firms until 2010.
- The preferential IFSC tax will continue to apply to qualifying firms until 2005.
- Remission of local taxes and special capital allowances in the IFSC are to cease immediately.
- A uniform CPT rate of 12.5 percent will apply to all firms by the year 2010 at the latest.

The 1999 Finance Act set out the schedule for achieving a single CPT rate of 12.5 percent by 2003.¹⁴ It has been informally indicated that the top rate of personal income tax will be reduced to 40 percent (plus a 2 percent social-

13 Numerous additional tax incentives were also introduced, such as accelerated depreciation allowances and tax breaks linked to preference share financing and leasing.

14 Finance Act, 1999, No. 2 of 1999, enacted March 25, 1999.

security-type “levy”) in the lifetime of the present government. However, even if this proposal is implemented, the gap between the corporate and personal tax rates will remain very large. There are fears that this disparity could give rise to a migration of personal income to the corporate sector.

EVALUATION

While Ireland's low rate of CPT has unquestionably bestowed enormous benefits on the economy, some aspects of this success story merit critical appraisal. In the first place, it is easy to exaggerate the high-tech nature of the new industries that have been attracted. The end-products produced and sold by the Irish subsidiaries of multinational corporations (MNCs) tend to be technologically sophisticated—ranging from state-of-the-art computer chips to the latest pharmaceutical and medical care products—but few of these firms have located a full range of functions in Ireland. While most Irish operations involve processes that are considerably more advanced than routine assembly, the highest corporate functions—managerial, financial, research and development (R & D), and marketing—are usually performed at home by the parent company. The average skill level in the high-tech sectors is significantly but not dramatically above the average for all industries; 19 percent of the employees in foreign-dominated sectors are “administrative and technical” personnel, compared with an average of 14 percent for all manufacturing. Despite the relative importance of manufacturing to the Irish economy, business expenditure on R & D as a proportion of GDP is below the EU average.¹⁵ However, these criticisms may have lost some of their force in recent years as the Irish subsidiaries of MNCs increase in sophistication and in the range of their functions, and as more indigenous firms start up to profit from the opportunities offered in the booming economy. The spinoff effects of the microelectronics industry in the software sector is a notable example.

Another frequent criticism of the Irish success story is the extent to which the picture has been distorted through transfer pricing. The low CPT rate encourages MNCs to use various internal pricing stratagems to inflate the profits attributable to the subsidiary located in Ireland. There is now a general awareness that the extent of this phenomenon in Ireland has a distorting effect on conventional measures of economic activity. The growth of enormously profitable subsidiaries of MNCs has inflated the figures for output and exports in certain sectors of the economy and led to a growing outflow of profits and other payments from the country. These effects are reflected in the exceptionally large gap between Irish gross *national* product (GNP) and gross *domestic* product. In 1998, GDP exceeded GNP by 14.3 percent—easily the largest gap in the OECD. National debt interest payable to non-residents accounts for a declining proportion of this outflow, the

15 Supra footnote 11.

bulk of which is attributable to dividends, distributions of branch profits, and inter-affiliate interest.¹⁶

Four sectors in particular exhibit characteristics that can only be explained by transfer pricing to take advantage of the low CPT: cola concentrates, software reproduction, certain organic base chemicals, and computers. The difference between Ireland and Europe in net output per employee in the cola concentrates industry was over £500,000 in 1995. This difference has been taken as an estimate of “entrepôt activity” in Irish industry, akin to the passage of vast amounts of goods through ports such as Hong Kong or Singapore. In aggregate, this activity has been estimated to equal over 15 percent of GDP,¹⁷ a figure that is close to the GDP-GNP gap.

The effects of transfer pricing on the measurement of economic growth should not be exaggerated. A minimalist calculation of the contribution of MNCs to the Irish economy that included only their labour costs reduced the estimated growth rate of national output by less than one-half of one percentage point.¹⁸ It is generally agreed that GNP provides a better guide than GDP to the “true” performance of the Irish economy. In fact, the more arcane concept of national disposable income is an even better yardstick, because it takes account of the importance of net internal transfers. While these measures have been growing by about one-half of one percentage point a year less than GDP, it is obvious that this correction does little to dent the record of the “Celtic tiger.”

Furthermore, even when ample allowance is made for the effects of transfer pricing, it is likely that the MNC subsidiaries operating in Ireland have substantially higher labour productivity than that attained in the indigenous industry. They have made a major contribution to reducing the economy’s dependence on agriculture and low-productivity traditional industries and services, and to raising overall living standards. Any fears of a crowding-out of employment in other sectors through a “Dutch disease” effect have been rendered irrelevant by the exceptional rate of overall employment growth in recent years. Finally, revenue from the 10 percent CPT rate on the inflated profits of the Irish subsidiaries of MNCs has swelled the Irish exchequer’s coffers.

It is, however, true that a low tax rate on one type of income erodes the tax base and, for a given level of public expenditure, increases the required rate of other taxes. This argument was particularly relevant in Ireland in the 1980s, when the low CPT rate contrasted starkly with the very high marginal tax rates

16 Royalties and licence fees paid abroad were formerly included in GDP but are now treated as a cost of production and excluded.

17 Patrick Honohan, Bertrand Maitre, and Charles Conroy, “Invisible Entrepôt Activity in Irish Manufacturing” (Summer 1998), *Irish Banking Review* 38-52.

18 Bill Keating, “Measuring Growth,” paper presented at the Conference on Measuring Economic Growth, Central Statistics Office and Irish Economic Association, Dublin, November 9, 1995.

paid by individuals. Employees of a company that paid less than 10 percent of profits in tax would have faced a marginal income (including social security) tax rate of almost 75 percent, as well as very high rates of value-added tax and excise taxes on alcohol, tobacco, electrical goods, and cars. As the incidence of these high taxes was shifted forward, they reduced the attraction of the low CPT rate. Despite the low CPT rate, the overall burden of taxation was well up to the EU average (figure 7). A more even spread of the tax burden would have resulted in lower aggregate deadweight losses. This case was made as long ago as 1984 by the Irish Commission on Taxation, which argued for a thoroughgoing simplification of the tax system and against excessive reliance on targeted tax incentives.¹⁹ The same points were reiterated in a review of Irish industrial promotion published in 1992.²⁰ Thus, the EU emphasis on standardization of tax rates and reduction in special tax incentives accorded with domestic policy advice. However, it is unlikely that this advice would have been acted on in the absence of the threat of sanctions from Europe.

It is striking that the burden of taxation in Ireland fell sharply after the watershed year of 1989, while it continued to grow in the EU. As a consequence, the gap between Ireland and the EU widened markedly during the 1990s. Ireland now has one of the lowest tax burdens, measured relative to GDP, in the OECD. Disentangling cause and effect is extremely difficult in this area. Did the accelerated growth rate lead to a fall in the tax burden, or was the faster growth due to lower tax rates? It is true that toward the end of the 1980s, the emphasis of policy shifted to tax cuts—especially to lowering the high marginal rate payable on wages and salaries. But no dramatic changes in tax rates or in the structure of taxation occurred in the late 1980s that can be identified as the factor that triggered the boom. And it is obvious that the rapid decline in the tax:GDP ratio during the 1990s was primarily a reflection of the large inflow of FDI and the exceptional growth of GDP rather than vice versa.

The structure of taxation has changed. The share of the CPT in total tax revenue fell to a low level in the late 1980s but rose sharply in the 1990s (figure 8). It is more plausible to see the behaviour of this ratio as a reflection than as a cause of the surge in FDI. However, the steady rise in corporate tax revenue as a proportion of GDP in the EU may well be one of the reasons for “Eurosclerosis.”

CONCLUSION

Simplistic conclusions regarding the contribution of tax policy to Ireland's economic boom are not warranted. The success of the economy has been due to a variety of factors, and we cannot establish the relative importance of each. Undoubtedly a favourable climate for FDI has been crucial, but other factors also have been important. The timing of the boom in the late 1980s points to the contribution of several policies put in place toward the end of the decade—the successful fiscal adjustment, the reversal of the upward trend in the tax burden, the competitive level of the exchange rate, and wage moderation achieved through

Figure 7 Tax Revenue as a Percentage of GDP, Ireland and the EU, 1979-1997

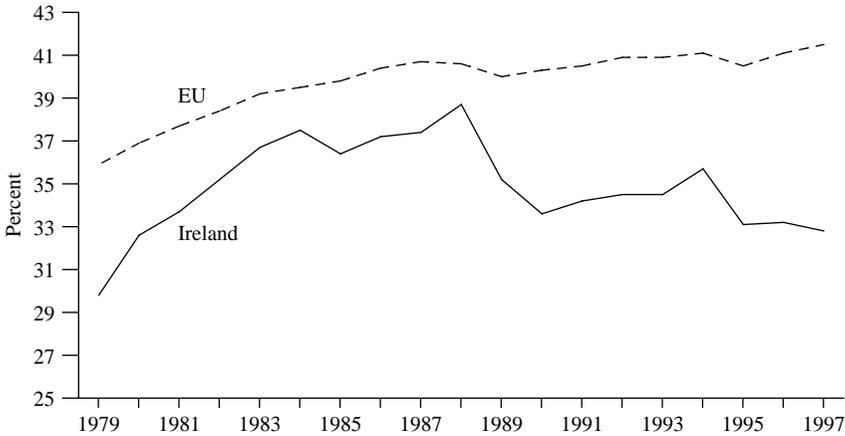
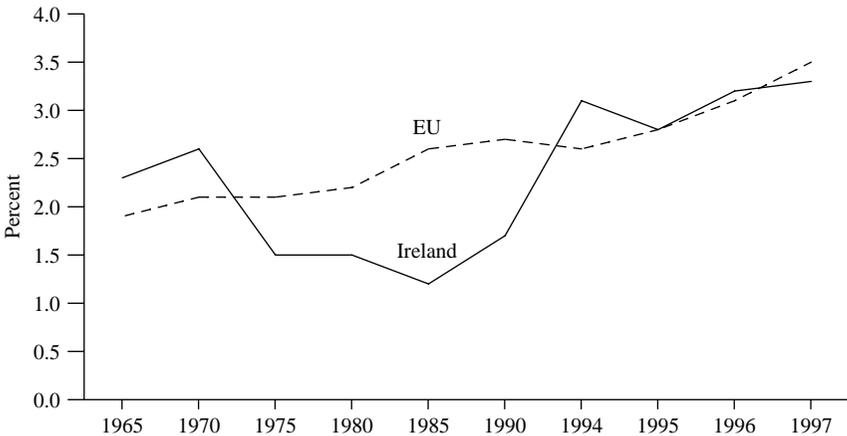


Figure 8 Taxes on Corporate Income as a Proportion of Total Tax Revenue, Ireland and the EU, 1965-1997



“social partnership.” Our commitment to the EU project, the ratification of the Single European Act (1986), and the adoption of the single European currency should also be remembered, while in the longer run Ireland’s location, use of the English language, familiar business culture, and general openness to US influences have been key factors in making the country an attractive location for FDI. Further comparative research is required to establish the importance of each of these elements.

The Irish tax system has evolved toward greater uniformity and now relies less on distortionary targeting than in the past. From the 1960s through the

1980s, a zero tax rate was targeted on export profits to promote “outward industrial orientation.” In the 1990s, in response to pressure for a less discriminatory tax regime, a 10 percent rate was applied to all profits from manufacturing and internationally traded services. The commitment now is to apply a 12.5 percent rate to all corporate profits. But while this adjustment will meet the non-distortionary requirements of the Treaty of Rome, the large gap between the tax rates applied to corporate and personal income is creating concern about the possible migration of the tax base from the high-tax personal to the low-tax corporate sector.

The basic lesson seems clear. A low corporate tax rate has formed an important component of Ireland's favourable environment for corporate investment and contributed significantly to raising the country's share of the flow of FDI into the EU. This inflow plays a very significant role in the country's current boom. Rapid growth allowed us to enter a virtuous circle in which tax cuts fuelled growth while the public finances improved dramatically. Under EU pressure, we have steadily widened the scope of the low corporate tax rate and reduced its distortionary features. This has been a welcome development. Our experience suggests that the soundest basis for the long-run development of the country is a non-distortionary, low-tax regime.