Memorandum

To: Kathryn Dominguez  
From: Katherine Brady, Dana Hopings, Lyndsay Huot  
RE: Status of Ireland's Macroeconomy

Executive Summary

Over the past decade, Ireland has experienced tremendous economic growth and high levels of general economic welfare. Since joining the European Monetary Union (EMU), Ireland has outpaced many of its fellow European countries in measures of economic progress and welfare, such as GDP growth rates, unemployment levels, debt and deficit/surplus levels, and global competitiveness. With all this good news for Ireland, it would seem that it has nothing to worry about. However, there are a number of current issues facing Ireland as it strives to continue this level of progress. In particular, Ireland must address the threat that foot-and-mouth disease poses to its tourism industry, the effects that labor force changes will have on its economy, and the implications of recent fiscal policy.

Key Economic Indicators: 1995-2000

Ireland has maintained very high GDP growth over a relatively long period of time. The GDP growth rate was 10.1% in 1995, with GDP at 41.409 billion Irish Pounds, and 9.8% in 1999, when GDP had reached 69.052 billion. Growth reached a high point of 10.7% in 97, and estimates suggest that it came close to hitting this mark again with 10.5% in 2000. This gives Ireland a 6 year average yearly growth rate of 9.6% for the period 1995-2000. Over this same period, GDP per capita has increased at an even faster rate. In 1999, the growth rate of GDP per capita was 12.8%.

During this tremendous period of prosperity, Ireland has seen several other key economic indicators improve. Irish unemployment levels were quite high early in this period, with an 11.5% unemployment rate in 1996. The unemployment rate has steadily fallen since then, and it was at 4.1% in 2000.

Both imports and exports have increased substantially over the period. Total import growth was nearly 67% for the period 1995-1999, and total export growth for the same period was nearly 88%. Since export growth has outpaced import growth, the balance of trade has grown from 7.2 billion in 1995 to 17.8 billion in 1999, an increase of approximately 47%.

In the face of falling unemployment and high growth, inflation remained low for most of the period, but took off last year. Inflation, measured by the annual percentage change in the CPI, averaged just 1.92% over the period 1995-1999. This win-win situation of low unemployment and inflation ended in 2000 when inflation rose to 5.6%, which was partially fueled by steeply rising housing costs.

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1 GDP figures are taken from or calculated with data from the Central Statistics Office of Ireland and the Ireland Department of Finance. http://www.cso.ie and http://www.irlgov.ie/finance.
3 Remaining key economic indicator statistics are taken from or calculated with data from the Central Statistics Office of Ireland and can be found at http://www.cso.ie.
Potential Problems for Continuing Economic Performance

Foot-and-mouth Threat to Tourist Industry

Tourism is a key part of the Irish economy. The Irish countryside is world renowned for its beauty, and, as a tourist attraction, it drew over 6 million visitors to Ireland in 1999. The rate of growth in the tourism industry, in terms of numbers of visitors, was 6.2% in 1999, and the yearly number of visitors has more than doubled since 1994. The tourism industry generated over 2.5 billion Irish Pounds in 1999, which constituted 3.6% of GDP. The earnings growth of the tourism industry was 8.9% in 1999, and the total yearly income to Ireland from tourism has grown 67% since 1994. Not only have more people been visiting Ireland, but they are spending more money there.

As the major tourist season approaches, Ireland is faced with the possibility of a significant decrease in levels of tourist activity due to the negative publicity surrounding the foot-and-mouth outbreak in Europe. In light of the amount of income that the industry provides to the economy, Ireland must consider the potential effects of a drop in tourism. These effects can be understood using the tools of the IS-LM model of economic fluctuations.

The tourist industry brings income into the economy just as an export does. Tourism is purchased by foreigners, but it is sold on domestic soil. If concern about foot-and-mouth disease discourages people from traveling to Ireland, revenues from this export will decline. This will result in an inward shift of the IS curve. Ceteris paribus, this will reduce income in the economy since the new IS curve will intersect with the LM curve at a lower level of output. The amount of the drop in GDP will depend on the slope of the LM curve.

This type of shock to the economy can be dealt with in a number of ways. If it is the case that the shock takes the economy away from full output, the economy can either be left alone to recover itself, or fiscal policy can be used to hasten the recovery (monetary policy is not an option for an EMU member). Fiscal policy may target the tourist industry directly, or it may act in general on the components of GDP through increased expenditures or tax cuts. It is possible that the economy has been above full output with its many years of incredible growth. In this case, a decrease in output may be slowing the economy down to a more reasonable level of output.

Assuming that the shock is undesirable, the best policy would be to prevent it from occurring. Even though the threat of foot-and-mouth disease looms large over the Irish economy, the disease has not significantly affected Ireland. There is only one confirmed case, livestock slaughters have been limited, and there are few restrictions on travel in the countryside. At this point, foot-and-mouth disease is more a public relations threat than an agricultural one. Ireland can manage this potential threat if it can assure the world that foot-and-mouth disease is of no concern to visitors. A marketing campaign to bolster Ireland’s image abroad may encourage tourists to keep or make their travel plans, thus preventing the IS curve shift and the income drop.

Labor Market

In the past decade, Ireland has enjoyed record lows in unemployment and fairly steady in-migration above the 2000 level of 1.1%. The number of asylum applications in Ireland in 2000

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4 All tourism figures are calculated with data from the Central Statistics Office of Ireland and can be found at http://www.cso.ie.
5 Population and Migration figures all come from CSO of Ireland’s April 2000 report.
was proportionately the second highest in the EU, yet the number of deportations from the
country was the lowest. This number, however, was only 2.4% of all who applied for asylum in
Europe. Ireland’s population in 1961 was at an all-time low of 2.8 million; now, it’s up to 3.8
million. Despite this growth in population, unemployment has reached a remarkable low, falling
to an annual average of 4% in 2000. International firms with major operations in Ireland are
recruiting outside of Ireland to fill their high-tech programming jobs.

In March of 2000, in response to labor shortages, Ireland adopted a skill based immigration
policy, hoping to attract labor in areas of identified shortage. There are three pieces to consider in
looking at a policy like this: 1. How will the increase in population affect the country’s growth?
2. Does the increased investment/savings that Ireland will enjoy by continuing to meet the
market’s need for labor off-set these changes from population increase? 3. Is there a human
capital story here?

The Solow growth model predicts that an increase in population will lead to a reduction in a
country’s GDP. This happens because the depreciation curve becomes steeper with the addition
of \( n \), creating a lower steady-state level of capital per worker. We would expect to see some of
these effects in Ireland, if its population continues to grow by the same percentage, but the size of
\( n \) will not cause a major shift in. If population growth is fueled by immigration policies targeted
towards sectors with an undersupply of labor, increased investment should result. This increase
will offset the decrease in capital that occurs from population growth. Thus, a carefully managed
immigration policy should enhance Ireland’s economic future.

Indeed, the huge increases in Ireland’s GDP and other economic indicators have a lot to do with
foreign investment in the late 1990’s. With high unemployment and low wage rates, Ireland
attracted many firms. Therefore, it makes sense to compare the effects of population with trend
growth in investment. GDP growth in 2000 is estimated at 10.5 percent\(^6\), which would shift up
the savings curve, bringing a new steady state. Since this growth is fairly large, we would expect
that in the short run it would more than offset the drop in capital due to population growth,
assuming our curve somewhat resembles the one used here. As we know, this will be a one-off
increase in income because the economy will move to a new steady state. So, long term success
of this policy will ensure that population does not continue to increase at the same rate if
savings/investment in Ireland drops off.

As mentioned above, Ireland’s available labor supply serves as a limit or ceiling to growth. As
the classical model predicts, output is constrained by the amount of labor supplied. The long run
model serves here since unemployment is low, and could be explained here by a mismatch of
skills since so many new employers in Ireland are looking for special technical training. In order
for the economy to grow, the supply of labor will need to grow.

The type of population growth is also an important consideration. Since Ireland is targeting high
skilled workers with particular skill sets for visas, we can think of this policy as affecting the
amount of human capital. As workers with more education immigrate to Ireland, we should see
increased returns to scale from labor, due to higher worker efficiency. At the higher rates of
capital that now exist in Ireland, we should see even higher levels of output in the future. This
growth in human capital amounts to an increase in \( g \), which will counteract growth in \( n \).

\(^6\) Growth estimates from Ireland’s CSO March 2001 quarterly predictors report.
Fiscal Policy

Tax Policy

Since 1990, Ireland has made substantial changes to its tax regime, both for personal income and corporate income taxes. The personal income tax schedule has become flatter; the highest rate is eight percentage points lower than it was ten years ago. The government also plans to eventually remove from the tax rolls all those earning the minimum wage. The Value Added Tax (VAT), essentially a consumption tax, has also been significantly reduced over this period. The corporate tax has also been greatly reduced, from 43% in 1991 to 24% in 2000.

These reductions in corporate and personal taxes will decrease private and public saving, which will reduce the amount of domestic capital available for investment. This puts more pressure on Irish firms to attract foreign investment. Given the slowing economy in the United States, which supplies significant capital to the Irish economy, this could make it difficult for Irish firms to maintain their operations and to expand. The drop in saving will also reduce the trade surplus and could cause a trade deficit in the future, if the possible drop in foreign investment occurs.

National income/output will also be effected by the reduction in taxes; income will rise, assuming that the marginal propensity to consume remains the same. The effect of the tax cut will have a multiplier effect in the economy over time, as the extra income provided to citizens is spent throughout the economy and used for investment and other uses.

Debt Reduction

Over the past decade, Ireland has made reduction of national debt a priority for fiscal policy. At the start of this period, little progress was made in paying down the debt, as the government struggled to keep expenditures below revenues. Ireland went from the tremendous debt of 120% of GDP in 1986 to 74% of GDP in 1996. The last part of the 1990's saw even further reductions, spurred on by huge growth in Ireland’s economy. The government has been in surplus since 1996, attributable in large part to the huge increase in GDP during that period.

This increase in GDP meant a near tripling of government revenue during those 4 years. This made it very easy for the government to work on not only spending down the debt, but insuring that new deficits were not created to add to national balance due. At the end of 1999, Ireland’s debt was down to 52% of GDP, which is quite manageable and right on target.

Government Reform

In 2000, the Irish Government, together with employers, trade unions, farming interests and the voluntary and community sector, negotiated an agreement called the Programme for Prosperity and Fairness (PPF) that lays out a number of Ireland’s social policy goals. The central component of the PPF is an incremental 33-month pay agreement that involves a minimum 15% pay raise for all employees in both the private and public sectors. The Irish government is very interested in increasing the standard of living for their citizens and creating a more hospitable work environment, in terms of family-friendly policies, more employee participation (including becoming financial stakeholders in the companies where they work), etc.

Wage rigidity policies such as government-mandated pay scales reduce the demand for labor, because companies know they will have to provide generous salaries and benefits; this pay
increase policy will likely reduce the work force, thereby increasing unemployment. This could be prevented if the new wage rates, combined with the increased demand for labor discussed earlier, offset one another so that the supply of and demand for labor are equal at this new wage. If, however, the wage rate causes the demand for labor to drop, this will have negative effects on output as the economy moves away from full employment.

**Recommendations**

1) **Encourage tourist activity.** A negative shock to the economy can be prevented if Ireland maintains a positive image abroad. An advertising campaign targeting countries with high rates of visitation to Ireland should emphasize the minimal impact that foot-and-mouth disease has had on the beautiful Irish countryside. Also, Ireland could enact pro-tourism policies such as reduced taxes on tourist activities.

2) **Build human capital.** Since increased investment in Ireland by international firms is constrained both by amount of labor and skills available, Ireland may want to focus on building the human capital in its work force. Government investment in education, particularly for high demand skills will have multiple positive effects. It will help Ireland to continue to attract international firms, while making the current labor force more efficient.

3) **Stop worrying about inflation.** Inflation in 2000 was at 5.6%, which was higher than in previous years, leading to Ireland's reprimand from the European Commission. These levels of inflation are in reality quite low and are predicted to drop to 4.2% in 2001 and go even lower in 2002. This suggests that Ireland's inflation does not merit the concern it has garnered.

4) **Continue to reduce the national debt.** Ireland should continue to capitalize on its current economic growth to pay down the debt, because it will reduce the overall tax burden to citizens in the long run, assuring continued growth by stimulating consumption as well as investment.

5) **Delay wage increases.** Implementing the pay raises included in the Programme for Prosperity and Fairness under the current economic conditions may make a tenuous future bleak. Given the current slowdown in the US, which provides a significant amount of capital to the Irish economy, mandatory wage increases will deter the US and other nations from investing in Ireland. Since the goal of the PPF is to increase quality of life for Irish citizens, the government should weigh the relative merits of wage increases vs. the widespread unemployment that may result from this wage rigidity policy.

6) **Encourage private saving.** In order to maintain and improve the level of capital available for investment in Irish firms, the government should encourage citizens to save the extra income they receive due to lower taxes. The government could provide matching funds to citizens who maintain savings above a certain level annually, or allow taxpayers to deduct interest earnings on savings accounts.