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PANEL RESPONSE: GROWTH POLICY

Reflecting on the Irish Growth Model

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I TRIBUTE

Along with the other panellists, I really appreciate being invited to participate in this celebration of Patrick's contribution to policymaking in Ireland. And I want to thank Philip, Alan and Augustin for their initiative that has created such an enjoyable and informative conference.

Unlike other panellists, who were Patrick's former work colleagues over his career in the ESRI, CBI and TCD, we did not overlap at any point in these three institutions. The only institution where we were daily colleagues was as undergraduates at UCD. However, we have maintained contact ever since and worked alongside each other in different capacities on boards and committees. My earliest recollections of Patrick as a fellow student in UCD were his endless curiosity and intense good humour, attributes mentioned by many others today.

By contrast with many others, Patrick has worked in an unusually large variety of organisations, both in Ireland and internationally, over the past 50 years. It is a real tribute to him that he maintained contact with so many of the people he has engaged with along the way. What made Patrick the perfect choice to take on the role of CBI Governor at such a very challenging time, was this exceptional variety of experiences, both in Ireland and in international institutions.

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1.1 Starting Point

In contributing to this Panel, I am taking as my starting point the paper by Patrick and the late Brendan Walsh, who were asked to explain Ireland's exceptional growth over the previous decade and a half. It was published by the Brookings Institution in 2002. In the paper, they documented the recent rapid convergence between Ireland and other long-standing EU Member States. In contrast with many individual research papers, which sought to look at Ireland through particularly focussed frameworks, such as peripherality, regional growth, dualism, etc., they looked across the whole range of possible factors that determined Ireland's growth performance. They concluded that what was particularly surprising was not so much Ireland's rapid performance in the 1990s but rather how long it has taken Ireland to catch up with other EU Member States. The paper then centred on the key drivers that they identified as having led to this late convergent story, and particularly, the role of multinational enterprises (MNEs).

The Honohan and Walsh (2002) paper demonstrates the importance, when trying to understand and explain economic growth, of looking at the multiple and interacting drivers that are at play. In replying to the paper, Olivier Blanchard gave two warnings: (i) "Beware of monocausal explanations" and (ii) "Beware of numbers, especially in a small economy with a large export–import sector, low taxation of profits, and transfer pricing".

The first caution is somewhat unexpected as most academic research papers tend to focus on one particular theory when exploring an issue. In reality, when dealing with sustainable economic growth over a period, various elements may reinforce or offset each other – a theme of the Honohan and Walsh paper. The second caution points to just how atypical the Irish economy is, a fact that has been reflected in recent conceptual and data developments (such as GNI*) in Ireland's National Accounts by the Central Statistics Office (CSO). While these accounting challenges undoubtedly reflect the complexity of activities by MNEs based in Ireland, they also arise because the global system of national accounting was developed over 70 years ago from the perspective of economies that: (a) were mostly large and closed (imports and exports were a relatively small fraction of national production); (b) had service sectors that were mostly non-traded; and (c) had international flows of capital and labour that were a fraction in scale compared with today's globalised world. It should be no surprise that small open economies like Ireland see limitations in GDP as an economic measure.

In the spirit of Blanchard's suggestions – and of the Honohan and Walsh approach – I will use a multicausal framework to look at the factors underlying past, current and future prospects for sustainable growth in Ireland. Figure 1 presents such a framework which was recently adopted by the National Competitiveness and Productivity Council to identify the drivers of sustainable growth and wellbeing in Ireland (NCPC, 2024).

Figure 1: Competitiveness and Productivity Framework

Source: National Competitiveness and Productivity Council (NCPC, 2024).

The two inner circles show productivity and competitiveness as intertwined and circular flows one to the other. In effect, these both reinforce each other in relation to sustainable growth and wellbeing. The outer ring shows six sets of drivers, which the remainder of the paper uses to comment on the Honohan and Walsh (2002) paper, the conference paper by Martina Lawless, and to consider Ireland's current and future prospects for achieving sustainable growth and wellbeing.

II DRIVERS OF SUSTAINABLE GROWTH AND WELLBEING

Macroeconomic Stability has been a key focus of many papers analysing Ireland's growth path since the 1960s. It is key to creating an investment climate that gives confidence to investors and for businesses to innovate, and covers indicators such as economic and fiscal performance, inflation, employment, debt stability, etc. The impact of macroeconomic stability on growth is at the heart of the Honohan and Walsh (2002) paper. It highlights the damage done by inappropriate procyclical fiscal policies, which added to the exceptional volatility in Irish growth rates, delaying Ireland's convergence to living standards in other EU countries until the 1990s. Honohan and Walsh also draw attention to the role played by Ireland's promoting itself as an export base for MNEs within the EU, and the influence of MNE activities, such as transfer pricing, on measures of aggregate productivity.

Lawless points to the further growth in complexity of MNE activities since 2002, thereby creating additional challenges for measuring productivity. Lawless benefits from recent developments in Irish National Accounts data, and from having greater access to more disaggregated data, not available to Honohan and Walsh. While her paper's title refers to Irish domestic firms, much of it involves comparisons between domestic small and medium sized enterprises (SMEs) and MNEs, and in particular the continuing and widening differences between the productivity levels in MNEs and SMEs. While such differences are to be expected, given the differences in age, scale, and complexity of both types of enterprises, it is striking (and disappointing from a policy perspective) that the differentials are showing no sign of narrowing.

Lawless uses two datasets produced by the CSO to look at the productivity growth of MNEs and SMEs. The first is a data series where enterprises are aggregated according to whether they are in Foreign Direct Investment (FDI)-dominated sectors, which in turn corresponds approximately to those sectors dominated by MNEs. Her indicators contrast the performance and structure of these two sectoral groups over the past two decades and show a marked difference between the productivity levels in both. The second dataset uses market enterprise data which allows her to demonstrate the heterogeneity of enterprise productivity in both sectors – SMEs lag MNEs in terms of productivity even in sectors that are not traditionally FDI dominated. She points out that this is consistent with literature on Ireland finds little evidence of FDI spillover effects. However, this issue needs further exploration with analysis at NACE four-digit level, to explore the within-sector drivers of growth and productivity.

Lawless' analysis of productivity by ownership shows that it is not meaningful to ignore ownership and simply aggregate. In effect, the average is meaningless and uninformative when seeking to understand the development of Ireland's macroeconomy over recent years. But her analysis also points to the value of looking in more detail at the productivity performance of SMEs, which has been the focus of Government policy for many decades, and which she notes has not seen much improvement. She draws on data from Eurostat to make some international comparisons between the sizes of both FDI and non-FDI enterprises (Table 4) noting the exceptionally high gap between labour productivity levels in foreign and domestic enterprises in the ICT and Manufacturing sectors in Ireland (Table 5). This points to a potentially fertile strand of future analysis but, to ensure that the comparisons are valid, will require sectoral aggregation to be at four- rather than two-digit NACE levels.

Lawless charts the growth in the share of GVA accounted for by the foreign-dominated sectors since the early 2000s, and the resilience of these sectors in the face of both the financial crisis and the COVID-19 pandemic.[1] Despite the current

[1] While the pharma sector results were very positive during COVID-19, there was a major downturn readjustment in the year following.

concern with the high concentration of ownership within the MNEs operating in Ireland, and the associated concentration of sources of Corporate Taxation, these sectors actually added to the stability of Ireland's economic performance in the face of these two major global challenges.[2] Lawless notes that metrics for GVA and employment give different signals, and that the latter is not distorted by the strategic behaviour of multinationals. This finding is noteworthy given the strong emphasis on employment as an indicator of progress by the IDA over the past 40 years.

Lawless builds on the discussion in Honohan and Walsh on the distortionary impact of multinational activity on measures such as GDP, and references the increased use of adjusted Gross National Income (GNI*) and Modified Domestic Demand as more reliable indicators to measure Ireland's real economic performance. She also cites the recent paper by Honohan (2021) which suggests that, using such metrics, Ireland's relative position in the EU lies between 8th and 12th rather than among the top five performers.

It is clear that macroeconomic stability is important for growth, justifying concerns about the level of recurrent expenditure in the 2025 Budget. In contrast with Keynesian models which are often linked to maximising the impact of stimulus, at this stage of the economic cycle Ireland would benefit from those expenditures being devoted to capital imports (such as trains, electric cars, wind turbines, prefabricated housing, etc.), rather than local domestic demand to avoid further overheating the economy.

Business Environment and ***Infrastructure*** drivers do not feature strongly in the Honohan and Walsh (2002) analysis, which has more a macroeconomic focus. Honohan and Walsh do, however, point to the fact that the available data in 2002 may not capture the impact of major infrastructure investments (particularly on roads) facilitated by the EU structural funds. These funds came at a vital time, allowing the government to fill major infrastructure investment gaps when fiscal retrenchment was needed to rebuild macroeconomic stability.

Lawless presents data showing that investment per person employed in Ireland is relatively low for Irish-owned firms but much higher for foreign enterprises in Ireland, when compared with EU reference points. This muted level of investment was linked to the financial crisis, but has persisted long after it, and despite several government schemes established specifically to provide finance for Irish SMEs. She suggests that this may be due to a low level of growth ambition, associated with risk aversion following the financial crisis. This is of concern in a context where employment in SMEs is high, but productivity levels are low. A related concern is that unit labour costs in the domestic sector of the economy are continuing to rise steadily. Setting these factors in the context of the recent analysis by the OECD, which shows that Ireland has exceptionally low entry and exit rates

[2] There was also a step change increase share of GVA accounted for by MNEs following the onshoring of IP in 2015.

in its business sectors compared to other EU countries, there are no strong grounds for being optimistic about productivity growth in the domestic-owned sector.

In the current policy climate, the business environment and infrastructure are identified as major areas of concern for both foreign-owned and domestic businesses operating in Ireland. For the SMEs, the business concerns are the higher costs they have to pay for services (energy, insurance, etc.) compared with their competitors in the EU, while MNEs warn that these costs impact negatively on their ability to win reinvestment funds from the parent company. Both complain that the planning system generates massive uncertainty and is a major drain on managerial resources.

The major infrastructure deficits are a result of the reduced capital budgets following the financial crisis, and the failure to plan for, design and deliver public infrastructure to address the faster than expected recovery from the crisis. While much of the public focus is currently on housing, there is a major shortfall in basic infrastructure (water/wastewater/electricity) which is a prerequisite for building both houses and business premises. Many of these concerns interact with the macroeconomic stability factors – the infrastructure deficit is very visible, but addressing it speedily puts a strain on the fiscal balances and risks adding to inflationary pressures. Government has recently identified the AIB and the Apple revenues as sources to finance major infrastructure, but as of now there does not appear to be the capacity to prioritise or deliver these over an identified planned time period. This represents the biggest challenge to sustainable growth in the next decade.

Education and Skills are key to productivity growth. Honohan and Walsh (2002) emphasise the role that investment in education from the mid-1960s has had on Ireland's economic development. Honohan and Walsh also comment on the additional investment in higher education from the 1980s and 1990s and emphasise the decision for focused investment in the skills related to the ICT and pharma sectors. These new graduates, along with the build-up of managerial skills within the workforce, allowed Ireland to move from attracting MNEs to undertake quite low-level activities in the so-called High-Tech sectors, to attracting MNEs to undertake high level activities in those same sectors over the turn of the millennium. This direction of change was signalled by the establishment of Science Foundation Ireland at the end of the 1990s and reflected in the introduction of R&D tax credits for business in the early 2000s. The impact of this change is manifest in the significant establishment of R&D capacity in MNEs located in Ireland, particularly in the pharma and ICT sectors.

Lawless shows that the education levels in all sectors continued to increase in the period since the financial crisis, but that the share of workers with a degree or higher is almost 50 per cent higher for those employed by MNEs compared with domestic enterprises. She points to the pressure that this growth in skilled employment in the MNE sectors is putting on wage levels, and in a full employment situation suggests that this creates the potential for 'crowding-out'. Undoubtedly the ability of MNEs to hire skilled labour is contributing to the tightness of the current labour market.

While investment in education and skills has contributed to Ireland's growth performance over the past two decades, the current demands for individuals with new skills (digital/green/advanced manufacturing/construction) cannot be met without a significant increase in lifelong learning.[3] This has been the weak link in the skills chain in Ireland, as the increase in higher-level skills at entry into the labour force resulted in less emphasis on lifelong learning compared with other EU countries. Ireland faces significant challenges to deal with the very particular changes in technology and skills requirements, and in particular ensuring that the quality of life-long learning is appropriate to our needs. This has implications for the Higher and Further Education sectors.

Technology and Innovation did not feature particularly strongly in Honohan and Walsh (2002), although technology is emphasised in the context of Ireland's decision to prioritise the ICT and pharma sectors in the 1980s, and indirectly in the discussion about MNEs and their impact on growth. Data on R&D spend and innovation have improved significantly in the past two decades, reflecting the importance of this driver of growth, and Lawless draws on these data in her paper. She finds that that scale of R&D spending in domestic-owned enterprises is about one-third of the level in foreign-owned enterprises, and that this has not changed in the past 15 years.

In relation to innovation, Lawless' evidence demonstrates that the scale of innovative activities in large Irish-owned enterprises is very similar to that of foreign-owned enterprises, while for smaller enterprises, the scales are significantly lower. Her finding of greatest concern from a policy perspective is that so many Irish and foreign-owned enterprises identify "Different priorities" as reasons for not engaging in innovative activities, with "lack of qualified personnel" being the second most contributory factor. Irish enterprises also name "innovation costs as being too high" as the third most important deterrent to innovation. This may reflect the need to review and redesign the fiscal and financial supports for innovation for SMEs.

Since the 1990s, innovation has become increasingly mainstreamed – in fact today it might be time to replace *Business as Usual* with *Innovation as Usual* if enterprises are to survive and thrive. Creating a more innovative culture is key to raising productivity levels, and one area where Ireland lags its EU neighbours is in the development of modern methods of construction which, by increasing productivity in construction, could contribute to a more sustainable model of

[3] The only alternative would be a further increase in the use of employment permits, which would put further pressure on the demand for housing.

housing delivery if building regulations on allowable building heights were changed. At the same time there needs to be recognition that some essential sectors will continue to be labour intensive and have low labour productivity by their nature (e.g. nursing, social care), and this will give rise to pressures if these services are to be supplied at competitive wage rates.

International Environment covers all of the factors outside Ireland's control which have a bearing on its sustainable growth and wellbeing. Like all small open economies in the EU, Ireland has benefited hugely from the creation of the Single European Market, and arguably more so because it hosts major international enterprises that produce products and services (ICT, pharma and medical devices) which were disadvantaged by the previous non-tariff barriers. Since the end of its protectionist phase, Ireland has always been conscious of external factors, both in the EU and with the UK. Honohan and Walsh analyse the highly interconnected relationship between Ireland and the UK and how this shaped the Irish economy. They could not have anticipated Brexit, which today continues to shape the development of the SME sector, as well as trade on the island of Ireland.

Honohan and Walsh were writing at a time when globalisation was in full flight and trade agreements were to the fore in geopolitical discussions. Looking at this now, we see how much recent geopolitical events have brought about a new reflection on global supply chains, natural resources and energy independence and transition. Recent developments in the EU also paint a picture of a world that is quite different from that of 2002. In contrast to the Letta Report (Letta, 2024), which strongly endorses the importance of the Single Market (in terms of State-Aid Rules and level playing-field competition generally), the Draghi Report (Draghi, 2024) signals a move in the opposite direction towards more EU-wide strategic investments. Draghi's recommendations promoting EU champions echo the industrial policy regimes of the 1970s and 1980s, and could be seen as potentially undermining the model of cooperation that has been an important part of how the EU operates. If his recommendations were fully implemented, they would create an entirely new landscape in the EU and could lead to a centralisation of the investments in the two large countries at the centre of the Europe, with the risk of a new peripherality for countries like Ireland.

III FINAL OBSERVATIONS

Rereading the Honohan and Walsh (2002) paper and reviewing Martina Lawless' new paper is a reminder of the importance of research that canvases large questions through a wide lens and over a lengthy period. FitzGerald and Honohan (2023) follows in this tradition. We have come through a period of change until recently that was for the most part unidirectional. The future does not appear to guarantee that this will continue, and economic policy needs to reflect the new reality. As well as following Blanchard's advice and avoiding mono-causality, we need to harness the value of existing datasets that can explore enterprise dynamics in greater depth so we can understand the development potential of the Irish SME sector. We also need to collect new data from administrative sources that can inform whether policy is operating as intended, and whether individual policy instruments are properly aligned.

The analysis in Martina Lawless' paper underlines the need to separate the analysis of MNEs and SMEs. While the comparisons are informative, and the search for spillovers should continue, the real concern lies with the continuing low levels of productivity in Irish SMEs. Improved policy design is necessary to ensure government supports for SMEs are effective and efficient. Analysis is now needed to determine where Irish based MNEs can benefit rather than suffer from policy development in Brussels.

Irish enterprise policy has had the virtue of consistency over many decades and this stability creates a very positive environment for both SMEs and MNEs and for society at large. The approach adopted should broadly continue but should vary in intensity to reflect domestic conditions. Greater use should be made of extant and new datasets to glean a more granular understanding of how policy incentives combine to promote innovation and growth, and, at a systems level, longstanding weaknesses at the business / higher-education interface need attention.

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