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TRADE AGREEMENTS AND TAX INCENTIVES: THE IRISH EXPERIENCE

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A. The Issues To Be Addressed

Thanks largely to a spurt of rapid growth since 1995, Ireland has gone from being one of the poorest three members of the European Union to the richest (after Luxembourg), as measured by GDP/capita in PPP terms.

Trade liberalization played an important role in the transformation of the Irish economy, starting in the early 1960s. Tax relief and industrial subsidies were also significant. This leads to two important questions:

1. **How did Ireland manage the fiscal effects of reducing tariff barriers? And**
2. **What were the fiscal implications of the system of industrial subsidies and favorable corporation taxation?**

In what follows we first make the case that the Irish case is relevant for Latin America; summarize the main explanations for Ireland's recent economic success; provide a chronology of Irish trade policy; explain how the loss of tariff revenue was handled; outline the subsidies and tax measures used to encourage investment, particularly from overseas; and discuss the fiscal implications of this industrial policy and the changes in taxation that have been made over time in the search for an efficient and high-yield tax system.

B. Why the Irish case is relevant

There are important parallels between the Irish case and those of most of the economies of Latin America. Three key similarities come to mind:

- As in Latin America, Ireland became highly protectionist during the 1930s, and kept high tariff barriers in place through the 1940s and 1950s. However, in the early 1960s it began to dismantle the tariff barriers, virtually eliminating them by the late 1970s. Ireland began the process of serious trade liberalization when its income level was similar to that of Costa Rica or Trinidad and Tobago today, as Figure 1 shows.

- The Irish economy is small. This makes protectionism particularly inefficient. With the removal of trade barriers the economy has become highly dependent on trade. Many Latin American economies are small (potentially) open economies like Ireland, including all the Caribbean island nations, most of Central America, and some countries in South America.

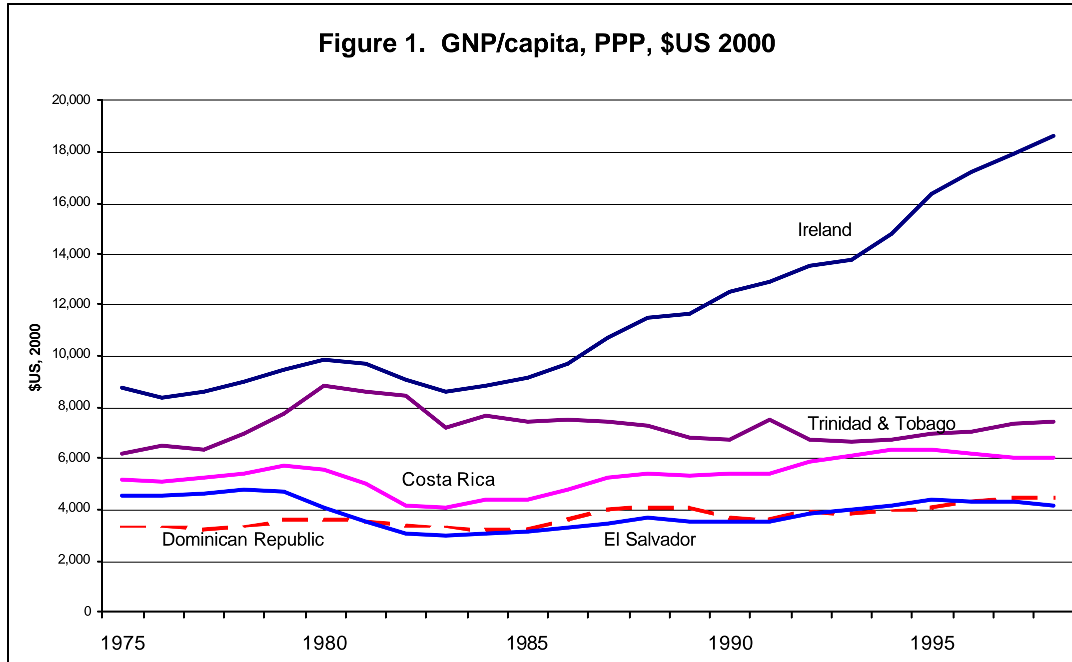
- Until recently, the bulk of Irish trade was with a single country (the UK); similarly, many small Latin American countries are highly dependent on trade with just one country (the US).

The Irish case is also relevant because policymakers appear to have dealt with the tax and fiscal problems successfully, to the point where Ireland's GDP/capita (in PPP terms) is second only to Luxembourg in the EU, and the third highest in the world. Just two decades ago, about two dozen countries were better off than Ireland.

C. Background: The role of tax and trade policy in Ireland's recent economic boom

Ireland is a small country – just 3.8 million people and a GNP of E97bn in 2001. In this section we briefly provide the historical context needed for the subsequent discussion.

From 1800 to 1922, Ireland was part of the UK. It sent MPs directly to the House of Commons, used the pound as a currency, and was subject to the same laws. On the eve of World War I it was an open economy, with a GDP per capita that was similar to the Western European average (although only half the UK level), and twice the Japanese level.



When the Irish Republic (also frequently referred to as "the South") became independent in 1922 "it had an extensive system of communications, a developed banking system, a vigorous wholesale and retail network, an efficient and honest administration, universal literacy, a large stock of houses, schools and hospitals, and enormous external assets" (equivalent to one year's GDP).[1] There was no wartime destruction.

During the 1920s Ireland followed a policy of free trade and limited government. This changed in the 1930s, when it became highly protectionist; a tariff "war" with Britain disrupted trade, but was resolved when both sides lowered their punitive tariffs on cattle and coal, and the UK forgave significant amounts of debt. Ireland remained neutral during World War II, participated somewhat in the post-war rebound, and then (in the 1950s) experienced a period of very slow economic growth and high out-migration.

Economic growth speeded up in the 1960s, and the population grew for the first time since the early 1840s. This was a period of rapid trade liberalization, coupled with an aggressive (and expensive) drive to induce foreign investors to come to Ireland. The country joined the European Economic Community in 1973, and then tried to use Keynesian-style budget deficits to avoid unemployment in the wake of the oil crises of 1974 and 1979.[2] The effort eventually failed: gross national disposable income per capita fell between 1979 and 1986 and emigration resumed, while government debt spiraled from 52% of GDP in 1972 to 129% of GDP in 1987. The budgetary situation was unsustainable and capital was leaving the country.

In a dramatic move, the government cut spending radically in 1987 – far more sharply than was done by Thatcher governments in Britain – bringing the deficit down to 1.7% of GDP. Perhaps surprisingly, GDP began to grow more quickly – buoyed by exports (which were helped by an 11% devaluation in 1986) and investor confidence. Fiscal discipline has been maintained since then, and by 2001, government debt had fallen to 33% of GDP.

To the surprise of most analysts, a remarkable spurt of economic growth began in the mid 1990s. "It is hard to pinpoint specific events that caused the acceleration … The investment rate did not suddenly rise, the EU single market did not drop manna-like from heaven, EU subventions remained steady or even fell … there were no dramatic changes in taxes, or educational levels, or the age of the labor force."[3]

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[1] Haughton 2000.
[2] The budget deficit rose from 0.4% of GDP in 1973 to 6.8% in 1975.
[3] Haughton 2000.

"A more plausible view is that the economic planets all came into alignment at the same time." The key elements:

- The booming US economy provided firms with profits to invest abroad.
- The 10% tax on manufacturing profits, in place since 1981, attracted investors.
- A large pool of well educated workers with a good reputation for hard work.
- The Single European Market makes Ireland an attractive base for supplying the EU.
- An English speaking country, which facilitates communications.
- A credible and conservative macroeconomic stance.
- Wage restraint, from inertia in national agreements, reduced unit labor costs during the 1990s.

This list also shows that there was no single "magic bullet" that caused the growth spurt.

Once the boom began, Ireland found itself in a virtuous circle, as the demand for housing and construction rose, along with the need for a wide range of services such as restaurants, banks and accountants.

D. Trade Policy

The main events in Irish trade policy are summarized in Table 1. After a period of free trade in the 1920s – the average tariff rate was just 9% in 1931 – Ireland turned protectionist with a vengeance, pushing up its average tariff rate to 45% by 1936 (well above the level of the US, Japan, France or the UK). Industrial output rose rapidly at first, but by 1936 most of the import substituting possibilities had been exhausted, and the industrial sector remained introverted and sluggish for the next quarter of a century.

Protectionism remained in the place in the 1940s, but two innovations are worthy of note. First, in 1947 the Shannon Free Airport was established, although it only became a true export-processing zone in 1959. It was Ireland's first, and only, EPZ, and no longer enjoys a special tax status. Second, in 1949 the Industrial Development Authority was established. Again, it was slow to move into action, but in 1958 it was given more funding, and the power to grant tax holidays to corporations investing in Ireland.

Throughout the 1950s more than four fifths of Ireland's exports were agricultural, and even in 1960 three-quarters of all exports went to England. Trade liberalization started in the early 1960s, spurred by the prospect of joining the EEC and the realization that the slow growth of the 1950s was partly due to the high levels of trade protection. As late as 1966 the effective rate of protection in Irish manufacturing was 79%, compared to 28% in the UK and 19% in the EEC-6.[4]

In 1963 and 1964 Ireland unilaterally cut its tariffs by 10% (although the impact was small, since the tariffs remained very high). In 1965 it negotiated a free trade agreement with the UK, phasing in free trade (in all but a few items) over the subsequent decade. It became a GATT member in 1967.

On January 1, 1973, Ireland (along with the UK and Denmark) joined the EEC. It committed itself to phasing out tariffs on EEC goods over a period of five years, and by the end of 1977 Ireland had something close to free trade: tariff revenues constituted just 0.9% of the value of imports. In 1992 the Single European Act removed other barriers to trade, especially in services, although in practice the changes occurred over a period of several years.

The trade liberalization was associated with a significant rise in exports and imports (relative to GDP) from 1972 onwards; exports are now equivalent to 80% of GDP (up from 22% in 1960), making Ireland one of the most open countries in the world, as Figure 2 shows. The destination of exports also became more diverse: now just 20% of exports flow to the UK, with 45% going to other EU countries and 16% to the US.

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[4] The effective rate of protection measures the extent to which value-added in domestic firms is protected by the structure of tariffs. Source: McAleese.

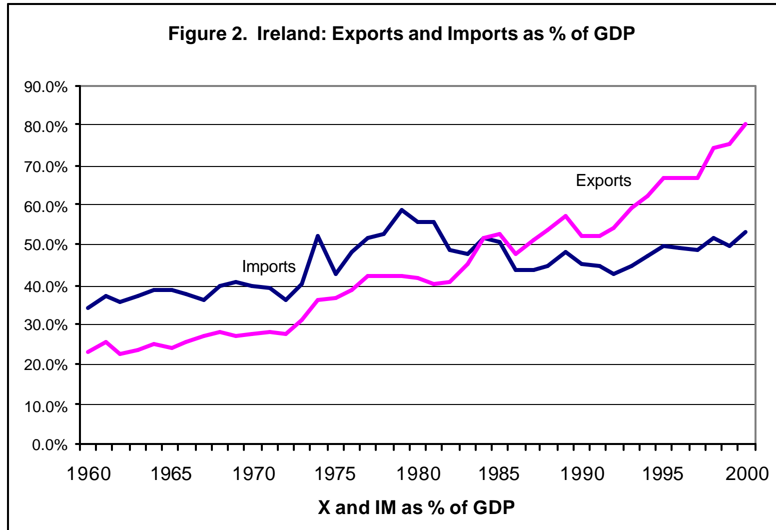


Figure 2. Ireland: Exports and Imports as % of GDP

Table 1: ***Highlights of Irish Trade Policy***	
1920s	**Free trade, low taxes and moderate government spending** 1921: independence.
1930s	**From free trade to protectionism** 1931: average tariff: 9% 1932-34: "Economic war" with Britain, ended with Coal-Cattle Act of 1935. 1936: average tariff 45% (2X level of US, Japan, Belgium France; 1.5X UK; 2/3 German level); industrial output rose 40% between 1931 and 1936, stagnated thereafter. 1938: average tariff 35%
1940s	**WWII and slow growth.** 1938-47: national income rose 14% (UK: 47%; N. Ireland: 84%) 1947: Customs Free Airport Act; Shannon Free Airport. 1949: Industrial Development Authority (IDA) established
1950s	**Decline or rebirth?** 1951-1958: GDP rose 1% p.a. 1956: export tax relief (from income and corporation profits tax on exports of certain manufactured goods) 1958: IDA given more funding, and power to grant tax holidays 1959: Shannon Free Airport Development Company (EPZ) set up. 25 years of profits tax exemption from 25/11/58 (extended to 5/4/90), on export sales, aircraft repair/servicing. 1958: *Economic Development* report sets optimistic tone
1960s	**Protectionism dismantled, tax base broadened** 1960-73: GDP rose 4.4% p.a., faster than UK, similar to W. Europe. 1960: 75% of exports go to UK. PAYE introduced. 1963: Turnover tax introduced, followed by wholesale tax in 1966. 1963 and 1964: unilateral tariff cuts of 10% each (but nominal effect, given tariffs were so high). 1965: Anglo-Irish Free Trade Agreement signed; in effect from mid-1966. Phased out tariffs on most industrial products over 10 years. 1966: ERP in manufacturing 79% (28% in UK, 19% in EEC-6.) (McAleese) 1967: GATT membership
1970s	**Into the EEC** 1972: VAT introduced. 1974: 60% of industrial output due to foreign-invested firms, induced by tax breaks and subsidies; rose to 68% by 1990 and 82% by 1998. 1972: 58% of exports go to UK. Manufactured exports: 20% of total (vs. 5% in 1952). 1.1.1973: Ireland enters EEC, along with UK and Denmark. 1977: All tariff barriers with EEC had been removed.
1980s	**EEC inflows; macroeconomic control regained** Significant net transfers from EU (CAP: 2-6% net inflow p.a., 1979-86) 1982: VAT at point of entry introduced. 1986: 11% devaluation relative to ecu. 1987: Sharp cuts in expenditure ended unsustainable budget deficits, and ushered in period of faster growth. 1988: Self-assessment introduced. Tax amnesty.
1990s	**Growth spurt and catch up.** 1992: Single European Market comes into effect 1999: 20% of exports go to UK; 45% to other EU; 16% to US.

E. The fiscal implications of trade liberalization

In 1960, taxes on trade (essentially imports) were equivalent to 6.6% of GDP, amounting to 41% of all tax revenue. This represents a higher dependence on import revenue than is found in most Latin American countries today (see Table 2).

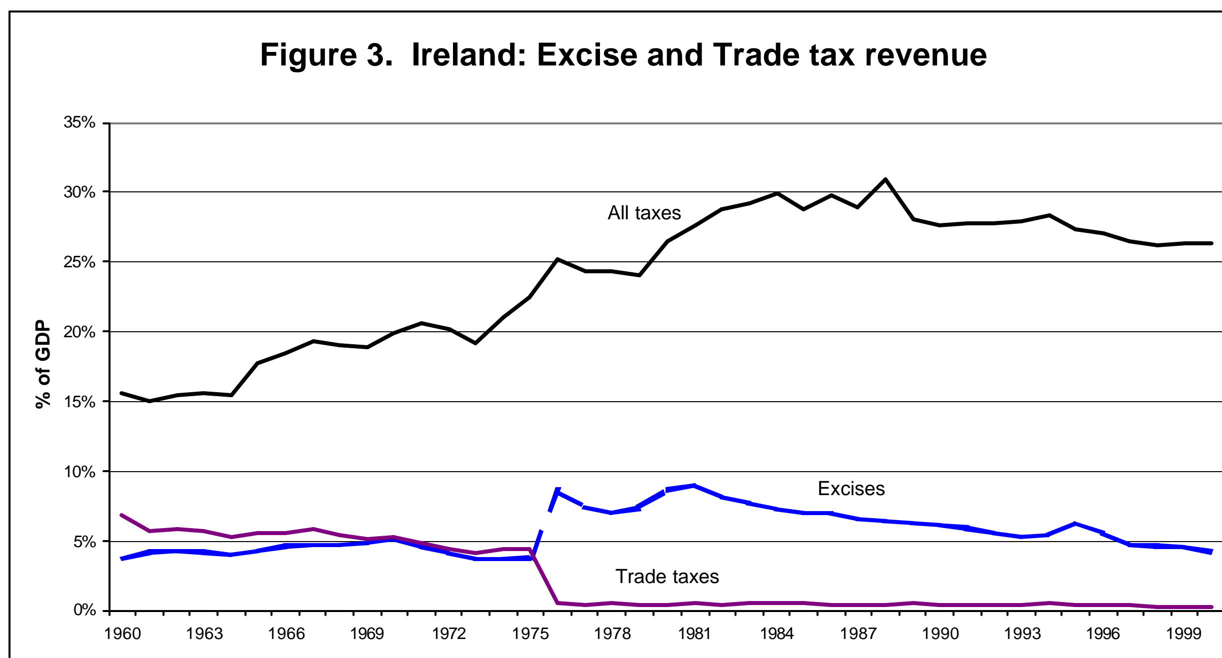
Table 2. ***Import Duty Collections (as % of GDP)***

	Total import duties		% imports from rest of FTAA	Loss of duties via FTAA
	1990	1999	1999	% of GDP, 1999
MERCOSUR	1.7	1.0	36	0.4
CAN	1.7	1.8	61	1.1
MCCA	3.1	3.6	66	2.4
CARICOM	6.3	6.2	69	4.3
Ireland	6.6 (1960)	0.2		

Source: DOTS/IMF (2001) for Latin American figures, collected by J.L. Machinea.

By 1976 trade taxes made up just 0.5% of GDP, or 2.1% of all tax revenue. Since then the figures have shriveled to a mere 0.2% of GDP and 0.8% of tax revenue, and almost all of this is directly remitted to Brussels to cover the costs of running the EU.

The key information is graphed in Figure 3. From 1960 to 1975 there was a steady decline in relative trade tax revenue, from 6.6% to 4.5% of GDP. This was also a time of rising tax revenue overall, except during the period just after the first oil crisis (1974).



How did Ireland deal with the fiscal impact? The simple answer is that it improved and extended its other taxes. This was fairly easy to do (technically, at least), given the relatively low tax burden (16% in 1960) at the start of the period. Among the main tax changes:

- 1960 Pay As You Earn (PAYE) introduced for personal income tax
- 1963 Turnover tax introduced

- 1966 Wholesale tax introduced
- 1972 A VAT, with a standard rate of 16.37%, replaced turnover and wholesale taxes; VAT rates were raised in subsequent years, to 19.5% in 1973 and 20% in 1994; after peaking at 35% in 1983-84, the standard VAT rate now stands at 21%.

There appears to be similar potential, in many Latin American countries, for raising tax revenue from sources other than trade, both because the tax burden is relatively modest overall, and because rates of VAT are likely to be well below their revenue-maximizing levels. Table 3 provides some support for these contentions. For instance, although the Dominican Republic derives 37% of its tax revenue from trade taxes, the burden of other taxes (9% of GDP) is low, and the standard VAT rate is a modest 8%; the situation is very similar to that faced by Ireland in 1960.

Table 3: ***The Burden of Taxation, Ireland and Selected Countries in the Americas***

	Tax rev/GDP	Trade tax rev/tax rev	Non-trade tax rev/GDP	Standard VAT rate (current)
Ireland 1960	16	41.2	9	N/A
Ireland 1974	22*	20.2	18	19.5
Ireland 2001	26	0.8	26	21
Costa Rica 1996	23	8.4	21	13
Dominican Republic 1997	16	36.8	9	8
El Salvador				13
Trinidad & Tobago 1995	23	5.7	22	15

* 27% if social insurance contributions are included.
Sources: World Bank, *World Development Indicators*, for tax data; World Bank (www.worldbank.org) for VAT rates.

In 1976 Ireland removed almost all tariffs on trade, and reclassified them as excise (i.e. specific) taxes. The effect appears clearly in Figure 3, where trade taxes drop from 4.5% to 0.5% of GDP overnight, while excise tax collections show an equivalent rise. The change was required as part of Ireland's obligations under the terms of its accession to the EEC. The reclassification of "customs fiscal duties" into excises raises an interesting technical issue: in some cases, the reported revenue from "trade taxes" may be overstated.

In the Irish case, prior to 1976, locally produced goods such as beer, cigarettes, motor vehicles, and petroleum products were subject to excise duties; however, imported goods were not subject to excise duties, but instead had to pay "customs fiscal duties," which may be thought of as part excise tax and part protective tariff. The non-protective duties can be renamed with the stroke of a pen. For many of the smaller Latin American countries, it may frequently not matter whether a tax is labeled "import duty" or "excise tax," because if the good is not produced domestically then the two taxes are equivalent for all practical purposes. Some of the major excisable items, including motor vehicles and refined petroleum products, probably fall into this category.

F. The Cost of Industrial Policy

Since the late 1950s, Ireland has actively sought foreign investment. In this section we outline what measures were used, discuss the fiscal implications, and comment on the possible effects of tax harmonization.

Tax incentives

Beginning in the later 1950s, the government offered a wide range of tax incentives to encourage foreign investment and exports. Among the key elements:

- Until the end of 1980, profits derived from manufactured exports were tax exempt for 15 years.
- Firms operating in the Shannon Free Trade Area were exempt from most tax on profits.
- There was a generous system of accelerated depreciation allowances.

Under EEC rules, the policy of tax exemption on export-generated profits was considered to be discriminatory. In response, in 1981 Ireland replaced it with

- a 10% tax on the profits of manufacturing firms. This was later extended to certain financial services.

The cost of these "tax expenditures" has been substantial, as Table 4 shows, amounting to 12% of tax revenue in 1989 (= 3.2% of GDP) and 16% of revenue in 1998 (= 4.3% of GDP), although these probably overstate the effects somewhat, since some of the revenue would not have been gained in the absence of the tax relief.

Under EU rules, Ireland has also had to adjust the tax system to remove the discrimination in favor of manufacturing. It has chosen a low-tax solution: as of 2003 the corporation profits tax will be a uniform 12.5%.

Table 4. ***Revenue loss from tax relief, £IRm, 1989/90 tax year***		
	1989/90	**1998/99**
Capital allowances: accelerated	170	1,061
Capital allowances: other	115	48
Export sales relief	378	0
"Shannon" relief	29	0
Stock relief	2	
Manufacturing relief (10% tax rate)	124	1,837
"Section 84" loans	64	8
Double taxation relief	0	81
Total:	**882**	**3,035**
Memoranda:		
Total tax revenue	7,617	18,467
Tax relief as % of total tax revenue	11.6	16.4
GDP, £IRm	27,525	70,116
Tax relief as % of GDP	**3.2**	**4.3**
Exchange rate (US$/£IR)	1.42	1.42
Sources: OECD 1991 and World Bank, *World Development Indicators.*		

Grants and Subsidies

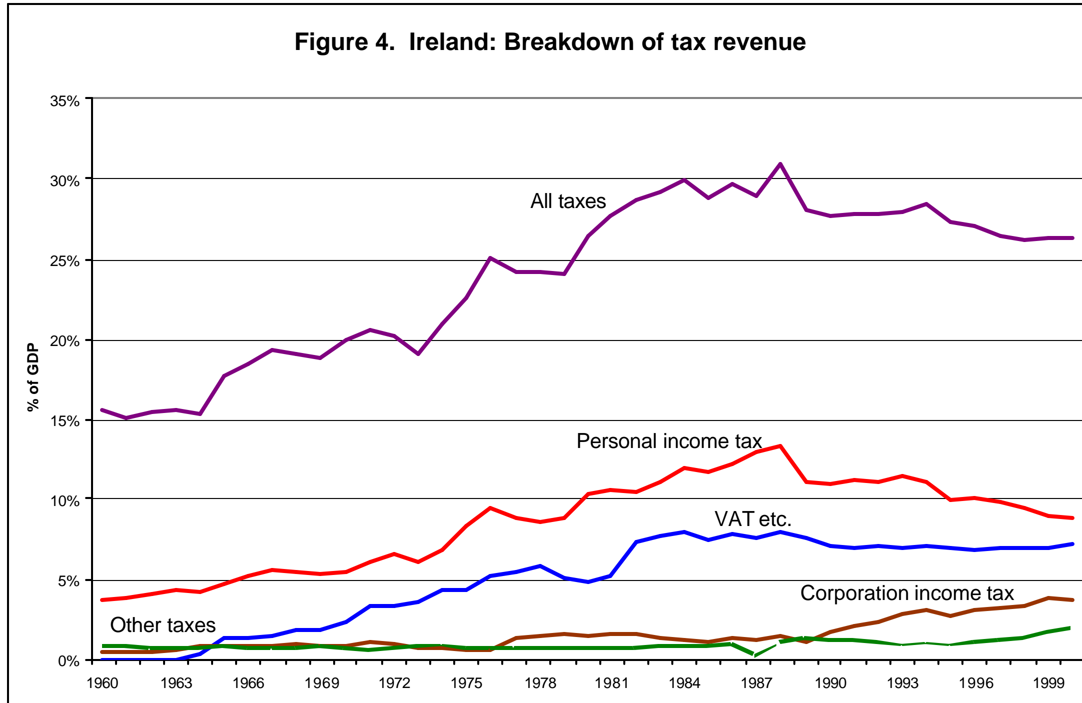
Ireland has also provided large grants to firms willing to set up, or expand, in the country. Until recently, the government would pay 45-60% of the cost of buildings, machinery and equipment; it subsidized interest costs, supported marketing costs, provided labor training; and provided grants of up to 50% of the cost of research and development. The direct cost was estimated at £IR433 million in 1983 – a typical year – equivalent to 4.4% of GDP; roughly half of this total was channelled through the Industrial Development Authority. Institutionally, *IDA Ireland* is now the body responsible for attracting foreign industry. *Enterprise Ireland* is charged with promoting training, encouraging the development of indigenous industry, and fostering research and development; increasingly it takes an equity stake in the businesses it supports.

The point here is not that the structure of grants and subsidies was necessarily appropriate – it had a strong bias against employment creation, and a bias against domestic (and especially small domestic) firms – but rather that the policy was expensive and had to be paid for. The direct and indirect costs in 1982 were estimated at £IR750 million, compared to manufacturing value added of £IR2,800 million. The important message is that the cost of replacing tariff revenue was modest when set against the full cost of industrial policy.

G. Improving the Tax System Through Trial and Error

In this last section we return to the original questions: how did Ireland find an alternative to trade taxes, and how did it pay for the expensive system of industrial subsidies and tax concessions?

The story may be told with the help of Figures 3 and 4. Overall tax revenue rose from about 15% of GDP in the early 1960s to 20% by 1970, 25% by 1975 and 30% by the early 1980s, before dipping in the 1990s. The figures shown here do not include social security/payroll taxes. Ireland's overall tax burden exceeded the OECD average in the 1980s, but is now somewhat below the OCED mean, as Table 5 shows.



As argued above, trade taxes steadily fell in importance between 1960 and 1975, and were largely replaced by excise duties (mainly on alcohol, tobacco, and petroleum products) thereafter. Since then, excise taxes have fallen in relative importance, as the base of these items has shrunk relative to GDP.

Table 5. ***Composition of Tax Revenues, Ireland and OECD***

	1965		1990		1997	
	Ireland	OECD	Ireland	OECD	Ireland	OECD
Income taxes	25.7	35.3	36.5	39.8	41.4	35.4
Personal	*16.7*	*26.3*	*32.0*	*32.7*	*31.4*	*26.6*
Corporate	*9.1*	*9.2*	*4.5*	*7.7*	*10.0*	*8.8*
Social Security	6.5	18.2	14.3	24.2	14.0	25.8
Property tax	15.1	8.0	5.3	5.2	0.02	5.7e
Goods & services	52.6	37.1	43.7	29.1	37.9	30.4
Consumption tax	*5.7*	*11.7*	*14.8*	*13.2*	*21.8*	*18.0*
Specific goods & services	*43.4*	*23.2*	*28.3*	*14.2*	*16.1*	*12.4*
Others		1.4	0.2	1.7	6.7	2.3e
Memo:						
All tax as % of GDP	**26.0**	**26.7**	**34.0**	**34.9**	**33.4***	**36.2*e**

Source: OECD 1991, p.64. Madden 2000. * = 1999. e = estimated.

The increase in overall revenue through 1988 came from two sources:

1. the increase in income tax rates, and
2. the introduction of a turnover tax, its subsequent replacement by a VAT, and increases in the VAT rates.

During this period the corporation income tax, although levied at high rates, played a minor role in revenue mobilization – mainly because of tax relief, including the exemption of profits on exports from tax (up to 1981), and the low tax rate on manufacturing profits (since 1982).

By the mid 1980s it became clear that the tax system, although it mobilized substantial revenue, was not conducive to rapid economic growth. The government set about simplifying the tax rates and lowering them. Among the important changes:

1. The top personal income tax rate was lowered from 60% to 48%, at which point it was merged with the "standard" rate; the low tax rate was reduced gradually from 35%, and now stands at 22% (Figure 5a).
2. The top corporation tax rate was gradually cut from 50% to 40% (in 1991), when it was merged with the standard rate; subsequently the standard rate was reduced, to 24% by 2000, and it is due to fall to 12.5% in 2003 (Figure 5b).
3. The standard VAT rate reached 35% in 1985, but was cut to 25% and now stands at 21%; the number of rates was reduced, and the lower rate now stands at 12.5% (Figure 5c).

The cut in the personal income tax rate was associated with a significant reduction in revenue as a proportion of GDP, but reduced unemployment (because it helped remove an anomaly whereby some unemployed people would have been worse off if they started working) and boosted GDP. The lower VAT rates had little effect on actual collections, suggesting that the high rates of the early 1980s had reached, or gone beyond, the revenue-maximizing levels. And somewhat unexpectedly, revenues from the corporation income tax, which had been low prior to 1990 (by OECD standards – see Table 5), rose steadily in the 1990s, as the share of taxable profit in GDP rose sharply.

Ireland has also tried a variety of other taxes, including:

a. *Estate duties*. Somewhat important in the 1970s, but now phased out.
b. *Wealth tax.* Somewhat important briefly in the 1970s, but now phased out.
c. *Capital acquisitions tax.* A gift and inheritance tax, which replaced estate duties, but is of relatively minor significance.
d. *Capital gains tax*. Applied to realized capital gains. Moderately important.
e. *Resource tax.* Applied in 1980 and 1981, but of minor importance.
f. *Residential Property Tax.* Introduced in 1983 and abolished in 1997, this tax applied to large residential properties owned by high-income households. Ireland is unusual in how lightly it taxes property.
g. *Stamp duties.* Essentially a tax on the transfer of assets, including land and housing, stocks, checks, credit cards, and insurance policies. In 2000, accounted for over 10% of all tax revenue, largely on the strength of higher prices for property and for stocks.
h. *Turnover tax.* Operated from 1964 – 1971, but was replaced in 1972 by the more efficient VAT.
i. *Wholesale tax.* Operated from 1967 – 1971, but was replaced in 1972 by the more efficient VAT.
j. *Agricultural levies.* Introduced in 1973, the rates have been reduced over time and the revenue yield has always been trivial.

The purpose of this list is to indicate that considerable thought, even creativity, has gone into finding ways to raise tax revenue in Ireland. Irish experience shows that when revenue is really needed, the best performers by far are the personal income tax, VAT, and excise duties, with corporation income tax playing a supporting role in recent years. Moreover, these taxes can yield enough revenue with relatively moderate tax rates, provided they are collected efficiently and applied to a wide base. These are not new lessons, but they are supported by the Irish case.

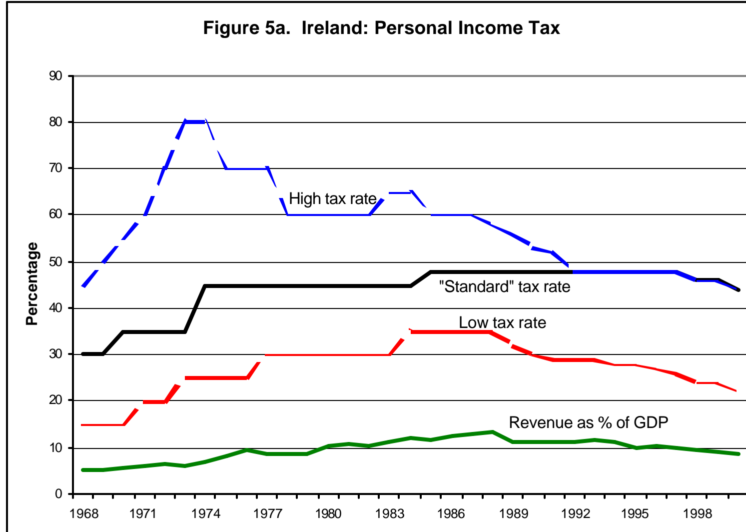


Figure 5a. Ireland: Personal Income Tax
Percentage
0
10
20
30
40
50
60
70
80
90
1968
1971
1974
1977
1980
1983
1986
1989
1992
1995
1998
High tax rate
"Standard" tax rate
Low tax rate
Revenue as % of GDP

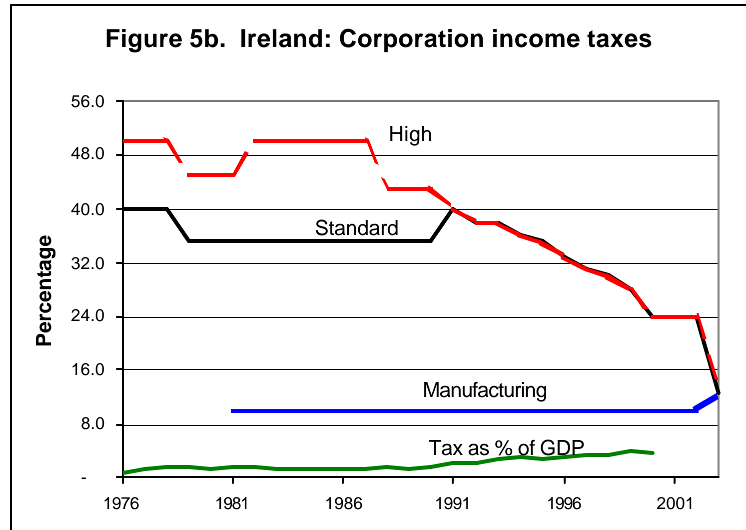


Figure 5b. Ireland: Corporation income taxes
Percentage
-
8.0
16.0
24.0
32.0
40.0
48.0
56.0
1976
1981
1986
1991
1996
2001
High
Standard
Manufacturing
Tax as % of GDP

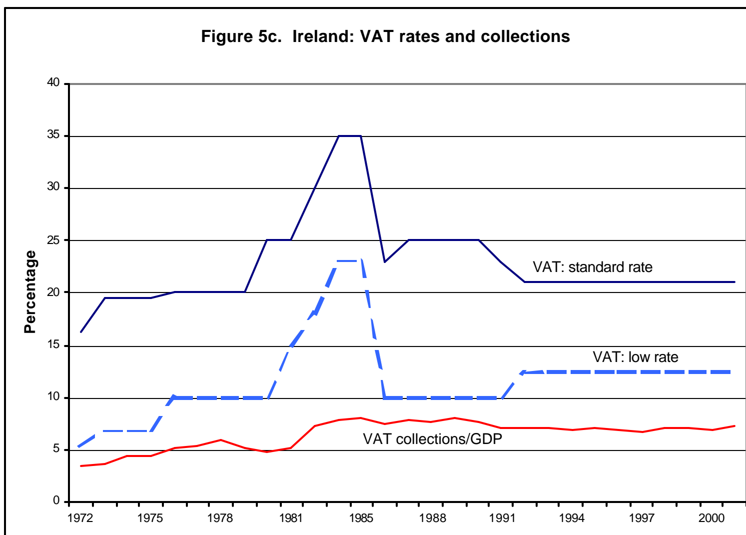


Figure 5c. Ireland: VAT rates and collections
Percentage
0
5
10
15
20
25
30
35
40
1972
1975
1978
1981
1985
1988
1991
1994
1997
2000
VAT: standard rate
VAT: low rate
VAT collections/GDP