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Changing the Rules: How the Failures of the 1950s Forced a Transition in Economic Policy Making

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Ní don óige feasta
An sceirdoilean cúng úd

Máirtín Ó Direáin (Aran 1947)

INTRODUCTION

The rapid recovery and growth of the main economies of Western Europe after an initial period of post-war reconstruction cruelly exposed the poor performance of the Irish economy. The decision of the Fianna Fáil government of 1932 to attempt to build an Irish industrial base behind protective tariff barriers that had been initiated in the early 1930s, was continued well beyond its sell-by date into the post-WW2 era. While industrial output grew fairly rapidly in the early years of protection, demand for labour fell well short of what would have been needed to keep pace with the high natural increase in the population and growth in the labour force. But the most damning measure of the systemic failure of the Irish economy to generate sufficient attractive jobs to absorb the natural increase in population during the 1950s was the resumption of large-scale emigration. Some of the causes were undoubtedly home-grown.

The failures of the 1950s, as indeed the dramatic successes of the 1990s, lay in the changing external environment and how domestic policy mediated between it and the local economy. Policymakers in Ireland recognised and acknowledged these failures and attempted to address them to the best of their ability. Dramatic new policy initiatives were taken and implemented, and these initiatives eventually led to a step-change in performance during the 1960s .

Why should the 1950s continue to be of relevance to us today? Do we not now inhabit a brave new world characterised by globalisation and high technology? Have we not carved out a prosperous niche by dint of our home-spun cunning and intelligence? The explanation goes deep into how policy makers plan and implement long-term strategies. In the hurly-burly of daily life, one can live with a certain amount of lack of co-ordination; one can switch direction many times and experiment; one can even be inconsistent. Tactical policy mistakes and errors can usually be detected before too much damage is done, and revised policies implemented in a learning game of trial and error. However, this is only the case when the strategic thrust of policy has been set correctly. Getting the medium-term strategy right is vital mainly because change is difficult and errors are costly. When strategy is wrong, retribution usually follows. This is as relevant today as it was in the 1950s, for Ireland as for any other country or region.

We first examine the strategic setting for Irish economic policy as it was implemented in the early 1930s. The simple, unqualified and dogged embrace of protection by Irish policy makers had appeared to offer exactly what the country needed at that time, and was in tune with an unfolding political and economic drama being played out in the rest of the world. We are uniquely privileged to have an evaluation of that policy, written at the very time of its design and implementation, by the greatest economist of the twentieth century – John Maynard Keynes. We know from Robert Skidelsky's biography that when Keynes spoke, the world listened, even if – as in the case of post-war America – it did not always obey (Skidelsky, 2000). But why were Keynes's nuanced insights of 1933 neglected by his Irish policy-making contemporaries, who woke up too late in the 1950s to the peril of their position?

During the 1950s, economic failure forced a re-think of policy fundamentals and eventually appeared to produce a wellthought out alternative: trade liberalisation and access to foreign capital. The central document in this period was *Economic Development*, a report that motivated and justified a complete change in policy direction (Economic Development, 1958). With the benefit of hindsight, it is of interest to examine the extent to which the policy programmes that derived from *Economic Development* foresaw correctly the shape of the new and improved performance that would emerge during the 1960s.

We conclude by examining what we can learn from the process that led to the seismic shift in policy that took place during the 1950s. Professor Lee, in his magisterial *Ireland 1912-1985* has brooded on the causes of failure and reached fairly damning verdicts concerning the role played by contemporary economists and policy makers (Lee, 1989). Today, perhaps we need to beware of hubris, and ask ourselves whether such errors could be repeated.

BEFORE THE STORM

Ár n-aithreacha bhíodh,
Is a n-aithreacha siúd,
In achrann leis an saol
Ag coraíocht leis an gcarraig loim

Máirtín Ó Direáin (Stoite)

The seeds of the crisis of the 1950s were sown in 1932. The Cumann na nGaedheal governments of 1922 to 1932 had largely continued with pre-independence policy norms: a fixed link with sterling and free trade. Given the dominance of the UK as a destination for Ireland's mainly agricultural exports, few seriously challenged the link with sterling at that time. However, the efforts to restore the certainties of the pre-WW1 economy – based on free trade and the gold standard – had collapsed by the early 1930s, and the world moved into depression and fragmentation.

As countries were confronted by depression, there was an aversion to international economic interdependence (Kenwood and Lougheed, 1992). Nations turned inward, fell back on their own resources, and there was a proliferation of exchange controls, tariffs, import quotas, and the like. Even in the UK – the spiritual home of free trade – the Import Duties Act of 1932 imposed

tariffs on a wide range of non-Empire goods. That the incoming Fianna Fáil government was committed to a policy of protection was hardly surprising. One might speculate that if the world trading system had not been experiencing a breakdown, the avowedly 'Sinn Féin' policies of the new government might have not been given such a free rein.

The driving motivation for the new policies of protection was the need to create an Irish manufacturing sector from almost a zero base. The partition of the island in 1922 had split off the one heavily industrialised region that was centred on Belfast, leaving the Free State with the modest remainder. The lurch to protection by Fianna Fáil must have appalled the pro-free trade politicians of the previous administration. It is said that the invitation to Keynes to deliver the first Finlay lecture in UCD on 19 April, 1933 had been on the expectation that the speaker – a well-known advocate of the benefits of free trade – might bring an end to what some felt to be madness (Keynes, 1933). We can imagine the horror of the ranks of pro-free trade politicians and academics when Keynes declared – in the most often quoted extract from his lecture:

> Ideas, knowledge, science, hospitality, travel – these are the things which should by their nature be international. But let goods be homespun whenever it is reasonably and conveniently possible, and, above all, let finance be primarily national.

and concluded:

> If I were an Irishman, I should find much to attract me in the economic outlook of your present government towards greater self-sufficiency.

What is seldom quoted is what immediately followed these remarks, and heavily qualified them.

> But as a practical man and as one who considers poverty and insecurity to be great evils, I should wish to be first satisfied on (some) matters. ... I should ask if Ireland is a large enough unit geographically, with sufficiently diversified natural resources, for more than a very modest measure of national self-sufficiency to be feasible without a disastrous reduction in a standard of life which is already none too high.

Keynes went on to suggest in the longer term an economic arrangement with England (sic) that resembled nothing so much as the Anglo-Irish Free Trade Agreement that was eventually concluded over thirty years later in 1965. But what is even more interesting are the reasons why Keynes had become disillusioned with free trade and international interdependence. Remember, Keynes was the author of *The Economic Consequences of the Peace*, a man who, at the time of the negotiation of the Treaty of Versailles in 1919, foresaw exactly where the vindictive treatment of a fallen Germany would lead. Keynes's Finlay lecture on 19 April, 1933 was given one month after Adolf Hitler was appointed German Chancellor, and three weeks before the burning of books in the square of Unter den Linden in Berlin on 10 May. Keynes's worst nightmare had come to pass.

It is little wonder that Keynes declared that:

> It does not today seem obvious that a great concentration of national effort on the capture of foreign trade, that the penetration of a country's economic structure by the resources and the influence of foreign capitalists, that a close dependence of our own economic life on the fluctuating economic policies of foreign countries are safeguards and assurances of international peace.

Keynes's was the wider vision that may not have struck much resonance in a country preoccupied with its own internal development problems. He had abandoned the liberal economic agenda for reasons associated with the deterioration in the world political climate, but was to work diligently during and after the coming war to restore this agenda and to avoid repeating the errors of Versailles. The new Fianna Fáil government, on the other hand, had domestic objectives of industrialisation and needed to erect protective barriers to shield the infant industries. However, the policy of tariff protection that was put in place in 1933 endured through WW2 (a time when access to vital imports was a more pressing problem than protection) and continued through the period of postwar recovery into the late 1950s. The relative successes of the immediate postwar period – when Ireland had captive British markets for its agricultural and food

products – served to conceal the underlying problems that the resumption of more normal conditions brought during the 1950s

More fundamentally, the political incorporation of Ireland into the United Kingdom between 1801 and 1922 had generated forces that led to comprehensive economic and trade integration as well. The full extent of this integration after more than one hundred years of Union is demonstrated by the UK-Irish trade position from just after independence in 1922 to the year 1950. The proportion of Irish exports going to the UK showed only a very small reduction from 99 per cent in 1924 to 93 per cent by 1950.

In addition to other problems, the failure of Ireland to diversify its economy away from an almost total dependence on the UK had serious consequences for its economic performance when compared to a range of other small European countries. The reluctance of post-independence Irish public administration to deviate too much from British policy norms has been well documented (Fanning, 1978). It was hardly surprising that Ireland and Britain formed a particularly strong web of dependency, continuing from independence well into the 1960s. While policies and policy makers in Ireland may have been less assertive and innovative than might have been desired, in the absence of a competitive and export-oriented industrial sector there is probably very little that could have been achieved to accelerate an earlier economic decoupling from the UK. The consequences followed inexorably. In the words of Lars Mjøset:

> Ireland became a free rider on Britain's decline, while Austria and Switzerland were free riders on Germany's economic miracle. (Mjøset, 1992, p.9)

DURING THE STORM

Cár imigh an aoibh,
An gáire is an gnaoi,
An t-aiteas úrchruthach naíonda?

Máirtín Ó Direáin (Ár Ré Dhearóil)

Even while the war was in progress, and before it was clear that the Allies would be the victors, Keynes and others worked to ensure that postwar barriers to trade and currency exchange would not disrupt the proper functioning of the international economy as it had after WW1. Robert Skidelsky notes that Keynes claimed, ironically, that he used the calm of war to reflect on the turmoil of the coming peace (Skidelsky, 2000)! The international institutions that emerged from the Anglo-American negotiations – the IMF, the IBRD (or World Bank), and the GATT – were heavily influenced by Keynes, even if the detailed implementations carried the imprint of the now immensely powerful USA. The European scene was further transformed by the European Recovery Programme (Marshall Aid) from April 1948 and the major devaluations against the dollar of September 1949. In addition, the Schuman Plan of 1950 set up the European Coal and Steel Community, and led eventually to the signing of the Treaty of Rome in March 1957. This was the international context that was to test the robustness of the inward-looking Irish policies and cruelly expose their weaknesses.

The early part of the 1950s was characterised by a series of balance of payments crises that were handled in the conventional way by imposing higher taxes and cuts in expenditure to reduce demand drastically. Tentative efforts were made to run an independent Irish lower interest rate policy, but this was soon abandoned. But these problems were simply the *consequences* of the uncompetitiveness of the manufacturing sector, and not the primary *causes*. Not only had protection failed to produce self-sufficiency – since the protected industries still needed to import materials and capital goods – but any increase in consumption also quickly ran into the sands of the balance of payments constraint. In other words, this was exactly what Keynes had warned about back in 1933! Ireland was simply too small to be a producer of goods where it had no comparative advantage. In his book *Planning in Ireland*, Garrett FitzGerald summarised the dilemma as follows:

> (Ireland) thus drifted into the 1950s unconscious of the difficulties it was creating for itself, or of the urgency of tackling them if stagnation of output and a decline in population were to be avoided. (By 1955) the basic disequilibrium between competitive Irish exports, and the imports demanded by an Irish public increasingly conscious of the disparity between its living standards and those of the British public, was dangerously exposed. (FitzGerald, 1968)

The Control of Manufactures Act – which had been used to prevent foreign ownership of Irish industry – was relaxed, but was not to be formally abolished until the 1960s. By 1956, the Fine Gael-led Coalition government had started to use industrial grants to attract foreign activity into Ireland, rather than merely to divert domestic industries to particularly deserving locations. Also, an export tax relief scheme – exempting profits earned from new or increased exports – was put in place.

The disparate policy changes that evolved during the 1950s were consolidated in *Economic Development* and codified in the *First Programme for Economic Expansion*. An extraordinary and diverse range of ideas and proposals were advanced, mainly in the areas of agriculture and the agri-food sector. But with the benefit of hindsight, we can now recognise *Economic Development* as a transition between old and new perspectives, and not a whole-hearted embrace of a modern view of the economy. For example, we now appreciate better that the zero rate of corporation profits tax, combined with the liberalisation of trade and foreign investment as well as the freedom to repatriate profits, were absolutely central factors in a process that would inexorably lead to the decline of the indigenous manufacturing sector and the rise and eventual dominance of a new foreign-owned sector. Yet the tax initiative lies buried in Appendix 2 of *Economic Development* (measures designed to encourage investment in Irish enterprises) on page 232 and is not mentioned in the main text.

We also now understand better that when a mainly agricultural country attempts to modernise, the primary requirement is for the farming sector to shrink in size as a proportion of the overall economy, and for the manufacturing sector (and elements of services) to expand and develop in a way that drives export growth through improvement in cost competitiveness. In the post-war period, this involved attracting direct investment from America. Yet the vision of *Economic Development* was mainly one of agriculture-led export growth, with a continuing mainly indigenous base.

The crucial policy changes made in the 1950s, that were brought together in the strategy of *Economic Development* in 1958, were a heady and novel mix of a commitment to trade liberalisation, a range of direct and indirect grant aid to private firms, and the singular incentive of zero corporation profits tax on exports. This policy mix was precisely what was needed to ride the future wave of American foreign direct investment, in contrast to the declared policy aim of growing on the back of an expanding indigenous agri-industrial base. The policy thrust was uniquely appropriate to Ireland's development challenge, but the outcome eventually produced by these policies turned out to be very different from that originally envisaged by the policy makers!

AFTER THE STORM

Ach mas éigean an cumann a chur i gcrích
Agraim thú a shearc na bhFiann,
Gan ceangal leo gan raidhse dollar.

Máirtín Ó Direáin (Éire ina bhFuil Romhainn)

The Irish economy emerged from the 1950s still in a weak state, but at least was now equipped with a policy strategy that happened to be uniquely in tune with the changed times. Furthermore, Ireland was no longer alone in having difficulty in coping in a new European and international environment. American investment into Europe at that time was so dynamic and threatening that it presented the major European economies with what Jean-Jacques Servan-Schreiber characterised as *The American Challenge*. In his book, Servan-Schreiber wrote:

> While French, German, or Italian firms are still groping around in the new open spaces provided by the Treaty of Rome, afraid to emerge from the dilapidated shelter of their old habits, American industry has gauged the terrain and is now rolling from Naples to Amsterdam with the ease and speed of Israeli tanks in the Sinai desert. (Servan-Schreiber, 1968)

The best explanation for the rise of American inward investment into Europe, and eventually into Ireland, was provided by the late Raymond Vernon (Vernon, 1966 and 1971). Vernon's main insight was to link the product life cycle with international trade and foreign direct investment, at a time when US foreign direct investment had come to dominate the post-war European economy. Vernon suggested that for technologically innovative products, at the early stage of their product life cycle, producers need great freedom and flexibility to modify, improve and test new processes at a time when the technology has not yet stabilised. Also, demand for innovative products tends to be relatively insensitive to price, so there is less pressure to seek lowest cost production locations. Communications between producers, suppliers and final customers must be facilitated, and this also argues for a home location.

But as products mature, a certain degree of standardisation takes place, the need for production flexibility declines, and there is now a greater need for lower production costs. As economic and political pressures build up, eventually some production moves abroad, initially into larger more developed economies like the UK, France, Germany, but soon even to smaller and less developed economies like Ireland. Eventually, as the product fully matures and perhaps enters a declining phase, low cost considerations become paramount, production ceases in the US, declines in other developed economies, and concentrates in low cost, under-developed economies. In essence, this was the dynamic behind Ireland's opportunity to capture inward investment, starting in the early 1960s.

The strong web of dependency between Ireland and the UK, that had endured relatively unchanged from independence until the late 1950s, only began to weaken after the shift to foreign direct investment and export-led growth that followed the various French-style *Programmes for Economic Expansion* in the late 1950s and during the 1960s. Starting from a point in the 1950s when about 90 per cent of Irish exports went to the UK, the share declined steadily thereafter, and stabilised at about 20 per cent by the mid-1990s.

The opening of the economy and the removal of tariff barriers were necessary policy changes to kick-start from stagnation. Free trade with the UK – our main trading partner – happened in the mid-1960s. This initiative of Taoiseach Seán Lemass provided a very useful opportunity of 'testing the water' of outward orientation. Free trade with Europe came later when Ireland joined the then EEC in 1973. The strategic orientation of Irish economic policymaking since the 1950s has always emphasised the need to face the consequences of extreme openness, to encourage export orientation towards fast growing markets and products, and to be aligned with all European initiatives. Thus, we joined the European Monetary System in 1979, breaking a long link with sterling and its deep economic and psychological dependency. We embraced the Single Market of 1992, the Social Chapter of the Maastricht Treaty, and most recently, Economic and Monetary Union from January 1999. Perhaps this is the main legacy bequeathed to us by the prescient policy makers of the time of Seán Lemass. The enthusiastic embrace of openness provided the strong and enduring strategic backbone of our economic planning.

But Ireland was still not a very attractive place in which to invest in the early 1960s. It was remote and unknown, had little by way of natural resources, and had no industrial heritage. The main inducement provided to inward investors was initially a zero rate of corporation tax on exports of manufactured goods. Under pressure from the EU, this was later replaced by a low rate of 10 per cent on all manufacturing profits. This tax policy, combined with aggressive and sophisticated initiatives designed by the IDA to attract and aid inward investors, provided the main driving force for the modernisation of the economy through export-led growth.

However, an attractive corporation tax rate and the absence of tariffs were only a start. They would not in themselves have made Ireland a major host for high quality foreign direct investment. Other factors came together to reinforce Ireland's success and interacted to create a virtuous circle of superior performance that replaced the previous vicious circle of decades of under performance that had culminated in the failures of the 1950s. Educational standards in the Irish work force had lagged behind the world. Policies were urgently needed to bring about a steady build-up of the quality, quantity and relevance of education and training, and this had been initiated by far-seeing educational reforms starting in the 1960s. These reforms were extended by the emphasis given to scientific and technical skill formation through the use of EU Structural Funds from the late 1980s. Although issues of social inequality are still of concern, the general level of educational attainment in Ireland rivals that of many other wealthier European states.

Perhaps the most striking consequence of foreign investment inflows was that it hastened the de-coupling of the Irish economy from its almost total dependence on the United Kingdom. Ireland's development dilemma had always been that it could either stick closely to UK economic policy and institutional norms and be constrained by the erratic UK growth performance, with little prospect of rapid convergence to a higher standard of living; or implement a politically acceptable degree of local policy innovation that offered hope of a faster rate of growth than its dominant trading partner. The Irish economic policy-making

environment during this period can be characterised as having shifted from one appropriate to a dependent state on the periphery of the UK to that of a region more fully integrated into an encompassing European economy. Foreign direct investment renovated and boosted Irish productive capacity. The Single Market provided the primary source of demand. All that remained was for a big push on improvement in physical infrastructure, education and training, and this arrived in the form of a dramatic innovation in regional policy at the EU level, with the advent of Structural Fund aid from the late 1980s.

REFLECTING ON THE EXPERIENCE

Murar i gCionn tSáile an léin
A cuireadh ár gcleacht ó rath,
Arbh iad na cinnirí críonna
Nó cléirigh an tréis a d'fheall?

Máirtín Ó Direáin (Mar Chaitheamar an Choinneal)

We have come a long way from the failures of the 1950s. For example, in a remarkable comment on the state of the Irish economy today, Intel president Craig Barrett recently reflected on why his firm had come to Ireland. Speaking to Thomas Friedman, author of *The Lexus and the Olive Tree*, Barrett said:

> We are there because Ireland is very pro-business, they have a very strong educational infrastructure, it is incredibly easy to move things in and out of the country, and it is incredibly easy to work with the government. I would invest in Ireland before Germany or France. (Friedman, 1999)

Policy actions initiated in the 1950s launched the economy on a development path that differed radically from that pursued before and after independence. The core policy dilemma was not about whether the Irish economy should be open to trade and investment flows with the wider world economy, since Ireland – in spite of almost three decades of protection – already had a relatively open economy when compared to the other small European states in the late 1950s. Rather, the issue was the nature of this involvement and whether there was to be a break with an almost total dependence on the British market as the destination for exports of a very restricted variety of mainly agricultural products.

It is clear that there were some special circumstances surrounding the Irish switch to trade liberalisation and active encouragement of inward FDI. First, the manifest failure of the previous protectionist policies had been so dramatic that almost no domestic group favoured their retention (Kennedy, 1998). Second, the range of abilities and expertise available within the Irish public sector was considerable, and there was a willingness to learn from the indicative planning experiences of continental Europe (Chubb and Lynch (eds.), 1969). Third, the completion of European reconstruction, and the growth in importance of the EEC, provided the opportunity to capture some of the rapidly expanding flow of American investment into Western Europe (Vernon, 1971). Fourth, rapid advances in technology and declining transport and communications costs during the 1960s facilitated the process of foreign investment by multinational corporations (Krugman, 1995).

However, the Irish path of economic development followed since the 1950s is not without its risks. The most dynamic part of manufacturing is almost completely foreign owned and is concentrated in a narrow range of technologies that are fast moving towards maturity. In this arena, the policy initiatives that provided Ireland with an advantageous head start in the early 1960s may not be sufficient to facilitate the inevitable switches to newer technologies since other countries and regions have been learning by watching Ireland doing. Until recently, we could rely on an abundant supply of highly trained Irish workers. But birth rates fell rapidly in the 1980s, and if growth is to continue, we may have to rely on inward migration to supply the labour.

In general, if a country or region faces major policy challenges, but either has an inadequate stock of research-based knowledge or fails to draw comprehensively from its available research, then policy prescriptions are very unlikely to be soundly based. A singular exception that proves this rule was the case of *Economic Development*, a policy review that heralded major changes in the strategic orientation of policy and led eventually – and in ways that were not accurately predicted – to a step-change in economic performance. The stock of research and knowledge about the functioning of the Irish economy was woefully inadequate, and the analysis and research contained in *Economic Development*, that initiated a subsequent series of three

Programmes for Economic Expansion running into the early 1970s, actually came from within the civil service. However, initiatives were quickly put in place that led eventually to a significant expansion of capacity for academic research, including the founding of the Economic and Social Research Institute in 1960 and the expansion of university and other institutional-based research.

Today, on the global economic map, the lines that now matter are those defining 'natural economic zones', where the defining issue is that each such zone possesses, in one or other combination, the key ingredients for successful participation in the international economy. With falling transportation and telecommunication costs, national economies were destined to become increasingly interdependent, and in the words of former US Labour Secretary, Robert Reich:

> ... the real economic challenge ... [of the nation] ... is to increase the potential value of what its citizens can add to the global economy, by enhancing their skills and capacities and by improving their means of linking those skills and capacities to the world market. (Reich, 1991)

This process of global competition is organised today mainly by multinational firms and not by governments. Production tends to be modularised, with individual modules spread across the globe so as to exploit the comparative advantages of different regions. Hence, individual small nations and regions have less power to influence their destinies than in previous periods of industrialisation, other than by refocusing their economic policies on location factors, especially those which are relatively immobile between regions: the quality of labour, infrastructure and economic governance, and the efficient functioning of labour markets.

As to the future of inward investment into Ireland, the fact that foreign ownership of the manufacturing sector is already at a very high level makes it less likely that it can rise much further. The Southern European periphery, as well as the acceding states of Central and Eastern Europe, have cost advantages, good human and physical capital infrastructures, geographical proximity to the core markets of Europe, and stabilising macroeconomic, fiscal and monetary environments. The future for Ireland is more likely to involve both a shift towards greater complexity (new products, emerging technologies) as well as a more active reliance on the rapidly modernising indigenous sector. Indeed, the product cycle model still fits the stylised Irish facts rather well: early inward investment in simple standardised products ('screw-driver' operations), recent shifts to maturing products (e.g., the Intel pentium chips) and a potential for attracting more R&D activity in the area of new products.

Perhaps the most sobering lesson of the 1950s is that the true significance of the internal elements of a national strategy – even when it is very successful – are not always fully understood at the time of its inception. In the 1950s the Irish tax system was used creatively to underpin our ability to stimulate exports. Had policy makers been less radical, and corporate tax rates been only reduced marginally rather than slashed to zero, the Irish economy today would probably look more like that of Northern Ireland than like Silicon Valley! But strategic planners today must look to a future where Irish international competitive advantage will rest more on the quality of our infrastructure, the excellence of our education system, our ability to innovate, and the wider benefits of living and working in Ireland, than mainly on a low corporate tax rate and inward investment. These challenges may seem less urgent than the challenges faced by policy makers in the 1950s. But they are no less real.

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