

## CHAPTER 9

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# THE INFLUENCE OF INSTITUTIONS

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### ABSTRACT

This chapter considers the role of institutions in shaping productivity and economic performance. It argues that some of the requirements for higher productivity on which all are agreed—innovation, training, infrastructure, and utilities—seem to require further institutional change. And some of the increasingly recognised supply-side factors—life long learning, childcare, eldercare, educational disadvantage, health services, urban planning and tailored social services—take us into domains in which Ireland's record of institutional innovation, reform and delivery is not strong.

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## 9.1 Introduction

This chapter considers the role of institutions in shaping productivity and economic performance. In Section 9.2, we survey the international literature on the role of institutions in productivity and economic development. While this strongly confirms the role of institutions, we suggest that there is no one compelling theory of economic development from which a comprehensive institutional design can be derived. Rather, the most convincing argument, and certainly the one most relevant to Ireland, is that development requires the successive removal of constraints, and good institutions are those that are good at learning how to identify and tackle constraints on productivity enhancement and business development. In Section 9.3, we discuss the role of institutions in Ireland. We draw attention to the role of institutional elements in Irish economic development, briefly characterise the evolution of institutions, and outline the argument that policy and institutional adaptation has been a key factor in Ireland's success over the past decade and a half.

If our analysis affirms Ireland's overall approach to institution building and reform, it does not warrant complacency. The chapter closes by arguing that some of the requirements for higher productivity on which all are agreed — innovation, training, infrastructure, and utilities — seem to require further institutional change. And some of the increasingly recognised supply-side factors — life long learning, childcare, eldercare, educational disadvantage, health services, urban planning and tailored social services — take us into domains in which Ireland's record of institutional innovation, reform and delivery is not strong.

In our discussion, institutions embrace organisations as well as rules, norms and behavioural constraints. Our primary concern is on the broad contextual factors that influence productivity, many of which are usually classified as institutional influences.

## 9.2 Perspectives on Institutions and Economic Performance

In this section, we review analytical approaches that inform thinking in the role of institutions in economic growth and productivity. While we begin with the economic theory of growth, it is necessary to consider ideas from economic development, industrial sociology and political science.

### 9.2.1 The Neoclassical Growth Model

The neoclassical theory of economic growth, developed by Solow in the 1950s, used standard assumptions of diminishing returns (adding more capital to a given stock of labour yields diminishing increments of output) and constant returns to scale (doubling all inputs will double all outputs). Diminishing returns means that productivity cannot grow indefinitely on the basis of higher inputs (Solow, 1956). How can such a model explain the sustained growth in productivity that has characterised many rich countries for over two hundred years? Solow's answer was technological progress: diminishing returns could be offset by the flow of new technology, an exogenous factor in the model. The *Economist's* comment on the model is

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telling: “what it illuminated did not ultimately matter; and what really mattered (technological progress), it did little to illuminate”.

## 9.2.2 Endogenous Growth Theory

In the 1980s, economists developed endogenous growth theory. While technological change was still seen as the key driver, it was incorporated in the theory, rather than treated as a gift of nature. This work was also motivated by the observation that national and regional growth patterns are correlated with a variety of economic, social and political variables, including many that are affected by government policies (Grossman and Helpman, 1994).

One set of models focused on the idea that investment in human or physical capital creates positive external benefits that increase the economy-wide productivity (Lucas, 1988). If these external effects are large enough they could offset diminishing returns on private investment and explain sustained productivity growth. The external benefits from physical investment mean that investment by one company reduces costs for another. The external effects of human capital mean one person’s human capital affects the productivity of other people. In support of an external human capital effect, Lucas cited the observation that we know from ordinary experience that there are group interactions that are central to individual productivity: “most of what we know we learn from other people” (Lucas, 1988: 38). He cited Jane Jacobs (1969) who provided many examples of how the exchange of ideas enhances productivity in urban environments. Lucas invoked the external effects of human capital to explain why the pressure for migration from poor to rich countries appears to be much stronger than the tendency of capital to move to poor countries.

Endogenous growth theory was welcomed as capturing some widely observed features of real-world development processes. Productivity growth is influenced by policy, particularly subsidies to education and research. Where technological progress derives from private investment, “the institutional, legal, and economic environments that determine these investments must surely affect the pace and direction of technological change” (Grossman and Helpman, 1994: 27).

However, Nelson argued that while the theory formalises some observed realities, it omits other key insights from empirical research (Nelson, 2005). First, much research on technological advance has highlighted the inability of the actors involved to foresee the path of development, even in broad outline, and the surprises that occur along the way. Second, much research has pointed to the key influence of organisational and management practises on economic growth. Third, research suggests that a range of institutions — for example, financial systems, universities or institutions generally — are critical in explaining differences in national growth performance.

Nevertheless, the leading theorists of endogenous growth share Nelson’s views on the centrality of institutions. For example, Romer has stated that: “new growth theory describes what’s possible for us but says very explicitly that if you don’t have the right institutions in place, it won’t happen” (interview with *Reasononline*, December 2001). He suggests that in a developing country like the Philippines, the key question is: “what are the best institutional arrangements for gaining access to the knowledge that already exists in the rest of the world?”

A country like the US must ask “what are the best institutional arrangements for encouraging the production of new knowledge?” (Romer, 1994a: 21). Elsewhere, he says:

For the nation as a whole, an effective institutional arrangement for supporting technological advance must therefore support a high level of exploration and research in both private firms and in universities. Moreover, it must support a high degree of interaction between these two domains. Both people and ideas must move readily between them (Romer, 1994b:5).

While endogenous growth theory does not provide a formal theory of institutions, its approach strongly points to their significance.

It is of interest that Helpman’s recent survey of growth theory is entitled *The Mystery of Economic Growth*, and the mystery is, precisely, institutions:

Although it has been established that property rights institutions, the rule of law, and constraints on the executive are important for growth, the exact ways in which they affect income per capita are not well understood. And the roles played by a host of other economic and political institutions, such as the structure of labour relations and the regulation of interest groups, are even less well understood. Yet an understanding of these features of modern societies is extremely important for greater insight into modern economic growth. Without it, it is difficult to pinpoint reforms that can help achieve faster growth in both developed and developing countries... The study of institutions and their relation to economic growth is an enormous task on which only limited progress has been made so far (Helpman, 2004: 141-142).

While growth theory has clearly taken increasing account of institutional factors, it seems that other analytical and policy perspectives must be taken into account also.

### 9.2.3 The ‘Washington Consensus’

Economic doctrine has long had a certain affinity with the liberal theory of the minimal or ‘night-watchman’ state; from within these ideas, or for other reasons, in liberal societies, governments and other public institutions have persistently been active agents in the economy. Economists and others working in development have increasingly come to the view that access to international markets is a critical factor in facilitating the growth of less developed countries. The ‘Washington Consensus’ refers to a set of principles that shares something with both liberal thinking and development economics, but goes well beyond them. The term refers to a consensus view among the international institutions based in Washington (the World Bank, the IMF and others), particularly in their dealings with less-developed countries and transition economies in the past decade and a half. It holds that, in almost any circumstance, countries should adopt free trade, balanced budgets, privatisation, deregulation, tax reform and interest rate liberalisation.

Stiglitz and others have argued that the application of these principles has not had the positive effect on growth and prosperity which the doctrine would expect (Stiglitz, 2003). The limitations of the original Washington Consensus are widely accepted and a revised consensus has evolved, incorporating a number of institutional and social requirements for development. These include independent courts, flexible labour markets, central bank independence and adherence to

international financial codes and standards (Rodrik, 2005). But the basic tenet, that the only institutions that are necessary are those that prevent distortion of markets, remains.

## 9.2.4 National Systems of Innovation

Following the Second World War, a high priority was attached to increasing research and development (R&D) investment. League tables of R&D became influential. However, over time evidence accumulated that innovation and its associated productivity gains depends not just on formal R&D but a range of other factors:

In particular, incremental innovations came from production engineers, from technicians and from the shop floor. They were strongly related to different forms of work organisation. Furthermore, many improvements to products and services came from interaction with the market and with related firms, such as sub-contractors, suppliers and services... (Furthermore)... the external linkages within the narrower professional science-technology system were also shown to be decisive for innovative success with radical innovations (Freeman, 1995: 10-11).

From the research on these multiple sources of the innovation, the concept of a national system of innovation (NSI) emerged. Freeman defines it as “The network of institutions in the public and private sectors whose activities and interactions initiate, import, modify and diffuse new technologies” (Freeman, 1987). Lundvall highlights the role of relationships and the nation in his definition of the NSI: “The elements and relationships which interact in the production, diffusion and use of new and economically useful knowledge and are either located within or rooted within the borders of a nation state” (Lundvall, 1992). Nelson defines the NSI as “A set of institutions whose interactions determine the innovation of national firms” (Nelson, 1993).

Work on the NSI has evolved over time. It initially focussed on the institutions most directly involved in technological innovation (as in the Freeman definition above), but later research encompasses a wider range of institutions, including social and regional policy (see Lundvall and Tomlinson, 2000). Comparative studies led Freeman (1995) to argue that a variety of national institutions have powerfully affected the relative rates of technical change and economic growth in many countries.

The concept of the national system of innovation was used by Mjoset in his 1992 report for NESO, *The Irish Economy in a Comparative Institutional Perspective* (Mjoset, 1992). He traced Ireland’s long-run development problem to the interaction between a weak national system of innovation and population decline through emigration. Other countries with similar structural characteristics, such as Denmark, had institutional arrangements that allowed them to build manufacturing industry on the base of grassland commodity production. Mjoset’s analysis suggested a range of policy and institutional measures—including a strong emphasis on Porter’s clusters — that would allow Ireland to build an effective NSI. The Government’s recently published *Strategy for Science, Technology and Innovation 2006-2013* is a programme to strengthen Ireland’s national system of innovation.

The proposition that a range of institutions influence learning and hence growth is now widely shared. However, the concept of the *national* system of innovation has been criticised by those who emphasise influences at levels other than the nation state, such as the regional level, the transnational corporation or the global market (Ohmae, 1990; and for a discussion of different levels of analysis, see O’Donnell, 1997). While all these levels are worth considering in the

Irish context, we focus here on multinational enterprises. They have been able to achieve high productivity operating in countries with different institutional environments. This suggests that the national institutional environment is not always a binding constraint on high productivity.

Teece sought to explain why enterprises operate internationally, when they could sell their knowledge, licence it, or exploit it solely in their home base. His answer is that firms' knowledge often cannot be codified. "Such know-how is tacit and is extremely difficult to transfer without intimate personal contact" (Teece, 1985: 29). In this situation, the establishment of a foreign subsidiary may be optimal. This is particularly the case if ongoing transfers are likely:

If repeated transfers of technology are contemplated, intra-firm transfer to a foreign subsidiary (which avoids the need for repeated negotiations, contract specification, monitoring and enforcement) has advantages on how contractual difficulties arise. Better disclosure, easier agreement, better enforcement and more efficient transfer result. Here lies the incentive for developing the assets and investing in the creation of organisational infrastructure associated with horizontal direct foreign investment (Teece, 1985: 30).

This perspective, in conjunction with endogenous growth theory, provides a possible explanation for uneven distribution of technological and other know-how across the global economy. Achieving a return on R&D investment requires the establishment of a network of international subsidiaries. Hence, we have a world in which knowledge is transferred globally within multinationals, but it is not a world of perfect information or perfect competition.

## 9.2.5 Institutional Perspectives from Industrial Sociology and Comparative Politics

Not surprisingly, institutions are a major focus of study in sociology and political science. An influential study by the industrial sociologist, Peter Evans, explored the role of public institutions in promoting industrial development in Brazil, India and Korea (Evans, 1995). He distinguished between predatory and developmental states and argued that the developmental role of the state in the newly industrialising countries of East Asia could be traced to the structural characteristics of those states — their internal organisation and relation to society. Those states that most successfully promoted industrial transformation displayed what Evans called 'embedded autonomy'. Their corporate coherence gave them sufficient autonomy from vested business interests to pursue genuine national economic goals; at the same time they were embedded in dense networks with both business and civil society, which provided rich information and institutional channels for continual negotiation and renegotiation of goals and policies. The concept of the developmental state has been applied to a range of other countries and contexts (see Woo-Cummings, 1999).

Within comparative political science there is great interest in the institutions by which various countries address the pressures of international economic competition and mediate internal conflict. An example is Weiss's analysis of the way in which globalisation changes the nature of state capacity and puts various national institutional models under different kinds of pressure (Weiss, 1988). Her analysis is interesting from an Irish perspective — not so much for its substantive argument (it dates from 1988) but because of the categories she uses may have a certain relevance to Ireland's current institutional challenges. She distinguishes between the developmental states of East Asia and the 'distributive state' of Sweden. The former have great capacity for industrial transformation, but face pressures of social development and distribution.

The latter has achieved a high level of equality, but is somewhat threatened by globalisation (though not all would agree with this now). Her interest is in the possibility of institutional arrangements that could promote both industrial transformation and social cohesion. Writing in 1988, she argued that both Germany and Japan were ‘dual states’ — combining the capacity to promote both equity and industrial growth and transformation. Allowing for the structural and substantive differences between these countries and Ireland, and the fate of Germany and Japan since 1988, we argue in our closing section that there is a sense in which Ireland now faces the task of linking more adequately its institutions for economic and social development.

## 9.2.6 Context-Specific Institutions and Development Constraints

An interesting perspective on the institutions and policies that foster development has been developed by Dani Rodrik, a development economist at Harvard. Rodrik argues that certain first order economic principles that can be derived from neoclassical economics — protection of property rights, contract enforcement, market-based competition, appropriate incentives, sound money, debt sustainability — do not map into unique policy packages: “Good institutions are those that deliver these first order principles effectively. There is no unique correspondence between the functions that good institutions perform and the form that such institutions take” (Rodrik, 2005: 973).

Rodrik develops this argument with a thought experiment. Looking at countries’ adherence to the policies of the Washington Consensus, can we predict which have achieved the best economic development? He argues that the East Asian countries of Taiwan and Korea, while benefiting from linkages with the global economy, departed significantly from the policy menu of the Washington Consensus. Neither country engaged in significant deregulation or liberalisation of their trade and financial systems until well into the 1980s. Both countries used more interventionist industrial policies than would be recommended by the Washington Consensus. China has gradually embraced market reforms but managed to initiate growth with initially quite modest reforms that introduced incentives within a planned economy. In the developing countries that most systematically embraced the Washington consensus agenda — Argentina, Brazil, Bolivia and Peru — growth in the past two decades has remained below its pre-1980 levels. In surveying cases of high growth, Rodrik contends that it is difficult to find cases where unorthodox policies have not played some role, with the possible exception of Hong Kong.

In explaining the relationship between tailored policies and growth Rodrik argues that the constraints on growth and capabilities vary across countries and over time. Countries can initiate growth if they can relax the most binding constraints, even if they do not undertake wholesale institutional reform. Growth itself can facilitate further institutional reform and reduce constraints on continuing growth. This argument for institutions tailored to circumstances does not imply that any institutions will work. Rodrik argues that there is a wide range of evidence across countries to support the view that “institutions that provide dependable property rights, manage conflict, maintain law and order, and align economic incentives with social costs and benefits are the foundation of long term growth” (Rodrik, 2003: 10).

In terms of industrial policy, like Evans, Rodrik argues that the key to developing growth-friendly policies is achieving the right balance between autonomy and embeddedness. The need for autonomy is straightforward. As economists frequently point out, industrial policy can easily lead to rent seeking or corrupt behaviour. A public system capable of acting in the

country's interests is an essential requirement of industrial policy. However, embeddedness is also needed. If public officials are to understand the constraints on growth, they need to understand the concerns and constraints as seen by the business community:

Too much autonomy for the bureaucrats and you have a system that minimizes corruption but fails to provide the incentives that the private sector really needs. Too much embeddedness for the business bureaucrats, and they end up in bed with (and in the pockets of) business interests. Moreover, we would like the process to be democratically accountable and to carry public legitimacy. Getting this balance right is so important that it overshadows, in my view, all other elements of policy design (Rodrik, 2004: 17).

Extending this argument, Sabel suggests that development policy is a social learning process (Sabel, 2005). It can be viewed as process of addressing successive constraints on development. An important type of constraint is the absence of certain public goods: for example, support institutions that help potential exporters determine where they should direct their efforts, training, quality certification, physical infrastructure and various stages of venture capital that new entrants are unlikely to be able to provide themselves (Sabel, 2005: 5). He says "The focus on relaxing successive constraints corresponds to a re-interpretation of the kinds of institutions that favour growth; and this re-interpretation in turn undermines the claim that growth depends on institutional endowments in the familiar sense of a single, well defined set of mutually supportive institutions" (ibid).

Growth requires continuing social learning. "The goal therefore is to create institutions that can learn to identify and mitigate different, successive constraints on growth, including of course such constraints that arise from defects in the current organisation of the learning institutions themselves" (Sabel, 2005: 6). Where these institutional interventions aim to shape entrepreneurial behaviour, they resemble traditional industrial policy, picking winners. But, says Sabel, that is as far as the similarity between industrial policy in the traditional sense and the process view goes. "Traditional industrial policy assumes that the state has a panoramic view of the economy, enabling it to reliably provide incentives, information and services that less knowledgeable actors cannot". There are no actors in the process or bootstrapping view with that kind of overarching vision. All vantage points are partial. "So just as private actors typically need public help in overcoming information limits and coordination problems, the public actors who provide that help themselves routinely need assistance in overcoming limits of their own".

International experience suggests that there is not one best set of institutions. Across currently rich countries in Europe, the US and Japan, there is comparatively little difference in productivity levels. In many respects, there are similarities in the roles played by institutions in protecting property rights and regulating product, labour and financial markets. However, there are also significant institutional differences between Europe, Japan and the US, as well as (smaller) differences in institutional arrangements between European countries. These differences are most evident in labour market institutions.

## 9.2.7 Regional Institutions and Quality of Life

Since the Irish economy has many of the characteristics of a regional economy, the determinants of regional growth are of interest (Krugman, 1997). Regional economies are often viewed as being driven by their export base — an incomplete theory, but one that captures



some of the dynamics of regional growth. Regions that have, or develop, an export base in activities with favourable characteristics (strong demand, high level of skilled employment) will tend to enjoy strong income and employment growth. The shift in Ireland's export base from agriculture and related industries to one based on high-technology, software, financial and other internationally tradable services has had a profound effect on the Irish economy. The ability to reposition the economy in this way has been based on a wide range of factors.

A related perspective has been developed by Florida (2002). He sees 'creative activities' and creativity as the driving force in regional economic growth. His theory is consistent with endogenous growth theory, which places new knowledge creation at the heart of economic growth. Florida's focus is on the geography of creativity, in particular the role of urban regions in fostering it. He argues that regional prosperity depends on achieving a combination of what he terms the three Ts: technology (presence of high-tech companies), talent (employment of people in creative occupations) and tolerance (an attractive quality of life for the 'creative class', who seek culture, diversity, racial integration). Regions that have all three Ts are most successful in attracting new talent and generating new ideas, new enterprises and regional economic growth. Florida's analysis is mostly based on US regions and cities, but he cites Dublin as a city that is achieving the three Ts and, hence, dynamic growth.

If Florida's argument is convincing, his institutional recommendations remain somewhat general: "Building broad creative ecosystems that mobilize the creative talents of many is a complex, multifaceted activity". We are, he says, only beginning to understand how to do it. "It will take a long time and many local experiments" (Florida, 2002: xxiii). But it underlines the potential importance of quality of life in securing not only an adequate social dividend from Ireland's economic growth, but in sustaining growth potential itself.

## 9.3 Irish Institutions: Past, Present and Future

### 9.3.1 The Characteristics and Evolution of Ireland's Institutions

Without offering a comprehensive interpretation of the role of institutions in Irish development, a number of observations can be made. First, the institutions that shaped Ireland's outward-oriented economic development were significantly state-created or state-led, especially in the 1960s, 1970s and 1980s. In contrast to continental European countries, in earlier decades there were relatively few and weak associations in civil society in Ireland devoted to technical, scientific or business development. There were undoubtedly some strong religious and professional associations, but these were not particularly concerned with economic development or productivity enhancement. Their purposes and methods reflected the context in which they had developed — a protected economy and a closed society — in which the representation of interests and the provision of services was presumed to occur in a stable environment and to focus on the division of a roughly fixed national product.

Second, if some civic associations were too inwardly looking, another important nexus of institutions were insufficiently tailored to Irish realities. Because of the link with sterling and other historical connections, the monetary, financial and industrial relations systems bore the marks of the British regime. Indeed, in the 1960s and 1970s, reflecting the British experience, they became increasingly conflictual and inflation-prone.

Third, there was a very significant evolution of Irish institutions over the decades. Within a stable basic industrial policy, there were many institutional changes. Some organisations which were seen as important in the early days, such as the Institute for Industrial Research and Standards (IIRS), were no longer necessary as technical standards became increasingly international. Other functions were met by creation of new programmes and bodies. The European Monetary System (EMS), and eventually European Monetary Union (EMU), represented an historical shift in the institutional framework of monetary management and wage bargaining. Social partnership was a major institutional development that gave rise to behavioural changes in wage bargaining, industrial relations and public policy. The European internal market — by addressing non-tariff barriers to trade in goods and extending the common market to key services — prompted the creation of new regulatory institutions at both European and national level. In Ireland and elsewhere, there were deep changes in business organisation and technology as Japanese production techniques proved feasible in Western firms and new high-performance work practices were adopted by the, mostly American, IT and pharmaceutical firms investing in Ireland in the late 1980 and the 1990s.

It is notable that this evolution contains at least three strands: an EU-informed institutional framework for the regulation of markets, an American influence on business organisation and technology and the gradual creation of Irish institutions more suited to modern Irish realities. All three strands are supportive of Ireland's success in the international economy; they can be seen as creating the conditions in which Ireland's outward-looking strategy, which had mixed success in the decades after 1960, can really work.

The development of institutions tailored to Irish circumstances, and designed to address identified constraints, is particularly notable in two areas, industrial policy and social partnership.

### 9.3.2 Institutional Factors in Ireland's Industrial and Economic Development

Economic and social change in Ireland has been so profound, and institutional changes so multiple, that they lend themselves to various interpretations. Indeed, among those interpretations is the view that Ireland's experience, especially since the mid-1980s, reflects adherence to liberal or neo-liberal policies and institutions (Kirby, 2002). It is clear that several aspects of Irish policy and economic development are consistent with a liberal or Washington consensus view of the economy — the importance of free trade, the adoption of stable macroeconomic policies, the lowering of personal taxes, the independent regulation of utilities and privatisation of state enterprises.

In our view, the development of the Irish economy can be better understood as an example of what Rodrik and Sabel refer to as 'heterodox success'; this does, indeed, involve adopting a range of market-conforming policies, but combines these with institutions and policies that go beyond the minimalist prescription of neo-liberalism or the Washington consensus.

For a start, the Irish experience would appear to support Rodrik's view that *initiating* growth is easier than implied by the all-or-nothing institutional prescription of the Washington consensus. At the start of the 1960s Ireland still had high tariffs, capital controls, an inefficient industrial base built up under protection, weak domestic competition and state monopolies in transport and all of the network industries. Labour mobility between Ireland and the UK limited the extent to which Ireland's disadvantages could be offset by lower wages. Yet, there

was a marked acceleration in Irish economic growth. Some key constraints on Irish growth were indeed released in the early 1960s — particularly lack of confidence and the balance of payments constraint — a process assisted by inward FDI by American companies.

Although highly reliant on the extension of free trade, and closely aligned to the strategies of transnational corporations, Ireland's industrial policy has been much more pro-active than implied by a purely liberal reading. Since the late 1950s, an important part of Irish public policy has been industrial and development policy. The policy aimed to re-orient indigenous enterprises to export and attract inward investment to Ireland. It had varying success in each of these tasks and there was ongoing debate on the rationale, feasibility and best method of state action to promote economic development (NESC, 1981, 1982, 1986; 1998; O'Malley, 1989; Mjoset, 1992, Industrial Policy Review Group, 2002). The experience since the late 1980s and recent research help us to see more clearly what role the state has played, and can play, in the Irish context. O'Riain distinguishes between the Asian 'bureaucratic developmental state' and what he calls the flexible or 'networked developmental state' (O'Riain, 2004). Ireland's flexible developmental State has developed the Irish economy by creating connections with the most modern networks of production and innovation. It does this by attracting high-tech firms to Ireland and fostering related indigenous networks of innovation, and encouraging them to internationalise.

This perspective allows us to see that the Irish state — through a complex and flexible set of agencies and policies — has played a key role in the economic progress of the past decade and a half. Under a fairly invariant industrial 'policy', the agencies have flexibly reconfigured the package of services that they offer, in dialogue with their client firms. The agencies and the firms seem to be jointly exploring the latest organisational and technical possibilities and teasing out how they can be applied in Ireland. The development agencies are in a complex form of interdependence — with Government Departments, universities and the social partners — which constitutes a form of external accountability. NESC argues that the idea of the networked developmental state "allows us to retain our focus on the challenge of developing a small peripheral economy that constituted the major task of independent Ireland, and remains relevant, while letting go of the overly statist outlook that sometimes goes with that focus, but which is no longer effective in an age of global information networks" (NESC, 2002: 7).

### 9.3.3 Social Partnership and the Institutions of Interest Mediation

Irish experience also seems to confirm the observation that initiating growth is easier than sustaining it. In reviewing Ireland's long-run economic development, NESC pointed out that although the Irish economy achieved significant economic growth, adjustment, modernisation and inward investment after 1960, these successes were qualified in important ways. Growth was not handled well, giving rise to inconsistent claims on the Irish economy. Awareness of the international environment was incomplete. The adjustment of indigenous enterprises to international competition failed more often than it succeeded. Job creation was insufficient, old jobs were lost at a remarkable rate and unemployment increased. High levels of savings and corporate profits were not matched by investment in the Irish economy. Inevitable adversities were allowed to become divisive and produced delayed and insufficient responses. Overall, there was an insufficient appreciation of the interdependence in the economy — between the public and the private sectors, between the indigenous economy and the international economy, and between the economic and the political (NESC, 1996: 21).

Social partnership seems to have had a significant influence on the Irish economy through a number of channels (NESC, 2002; 2003). First, the partnership approach has supported wage moderation, predictability and enhanced profitability. Second, partnership was an important element in Ireland's transition from a high-inflation, volatile and conflictual economy to a low-inflation, stable economy. Third, there was a supply side influence. By settling macroeconomic and distributional issues, partnership freed management, trade union, voluntary sector and government energies to focus on real issues affecting competitiveness and social cohesion, such as training, work practises, commercialisation of state enterprises, active labour market policy and many other supply-side issues.

### 9.3.4 The Role of Institutional Adaptation in Ireland's Recent Success

The role of institutions is seen by NESC as central in understanding Ireland's experience since the late 1980s. In its 2003 Strategy report, NESC argued that a critical aspect of vision is clear sight of how public policy, the social partners and others have influenced the economy and society, and how they can influence it in future. It noted that over recent decades NESC and others had developed a particular view of what a successful economy would look like, what role public policy has in promoting economic and social development, the nature and role of social partnership, the desirable and likely pattern of enterprise-level partnership, the contribution that EU membership can make and the social patterns and social policies that would be evident in a prosperous economy. "Our view on these issues was, in large measure, derived from study of the patterns of economic and social life, and public policy, found in the richer states that we aspired to catch up with, and was often described as a superior 'model'" (NESC, 2002: 36).

Now that a significant degree of economic and social catch up has been achieved, a more successful economy, society and public system looks significantly different from the model that was envisaged. Taken together, the slight deviation from the expected model or goal on many fronts—the role of the state, business development, social partnership, industrial relations, the EU and social policy and patterns—amounts to a significant deviation on all taken together. Ireland's experience, NESC argued, suggests that:

1. Ireland does not fit neatly into any existing model or category of socio-economic development;
2. Much greater economic and social progress occurred than was deemed possible within the models that informed earlier analysis;
3. Ireland has succeeded with an eclectic approach, that seeks to adopt the best features of different socio-economic models;
4. Many of the new economic and social possibilities were discovered by experimental problem-solving action involving government, the social partners and others; and
5. Changes in many parts of the economy, society and the state can amount to significant change in the whole.

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Because of this, NESC rejects any one-dimensional view, that the changes in the past decade are due to a single factor, whether it be fiscal correction, tax reduction, inward investment, educational attainment, market liberalisation, high technology, European integration, labour supply, changes in social policy or indeed, social partnership itself:

In contrast, the Council believes that the changes since the late 1980s—in the economy, business, public policy, enterprises, the EU and society — have been the product of widespread policy and institutional adaptation and experimentation. Although not derived from a preconceived plan or model, each change has been deliberate.

It is the willingness and ability to change policies, arrangements and institutions that ultimately underlies Ireland's success. This is confirmed by the fact that Ireland continues to achieve less in precisely those areas where we have not adapted institutions, policies and arrangements (NESC, 2002: 37-38).

If this perspective is accepted, it poses the question: what policy and institutional adaptations are most important in securing Ireland's prosperity in the early decades of the 21<sup>st</sup> century?

### 9.3.5 What Now?

Our short review of international thinking strongly confirms the role of institutions in supporting productivity and prosperity. But it also suggests that there is no one compelling theory of economic development from which a comprehensive institutional design can be derived. Rather, the most convincing argument is that development requires the successive removal of constraints and good institutions are those that are good at learning how to identify and tackle constraints on productivity enhancement and business development. Our brief discussion of Irish institutions meshes with that analysis. The Irish economy performed poorly up to the late 1950s and it is widely accepted that institutional factors were critical in the subsequent success — but also in the intermittent failure — of Ireland's outward-looking strategy. Institutions played a role in identifying and mitigating constraints on economic development. Some of them evolved pragmatically in response to emerging problems. But other institutions — of political decision making, interest mediation, wage bargaining and macroeconomic management — considerably damaged economic performance, until they were recast around a shared understanding of Ireland's particular economic structure and position in the international system. Here also, there is no compelling international theory or model of social concertation, and our institutions work well when they are tailored and focused on learning.

This discussion suggests that Ireland must continue to create institutional arrangements that can identify and address constraints. We must continue close observation of international developments. We must continue to adapt institutions in a way that responds to changing conditions and suits Ireland's context. What is new is the range of factors that influence productivity and prosperity and, therefore, the spectrum of institutions that are relevant to the productivity challenge. If this argument affirms Ireland's overall approach to institution building and reform, it does not warrant complacency, for reasons we outline now.

## *Economic Constraints*

There is considerable agreement on some of the economic constraints that need to be addressed to facilitate continued prosperity and increased productivity:

1. Innovation, on which the Government has recently published its *Strategy for Science, Technology and Innovation 2006-2013*;
2. A truly effective national training system that meets the needs of people at work and of enterprises;
3. Investment in infrastructure;
4. Stronger competition in several areas of the Irish economy to stimulate productivity and innovation among enterprises and reduce prices; and
5. Enhanced performance in the utility industries.

Some of the key requirements for productivity on which all are agreed — innovation, training, infrastructure and utilities — seem to require significant further institutional change if they are to be effectively delivered. The issue of productivity in the non-traded sector has received relatively little attention until recently in public policy. Productivity is below average in many parts of the non-traded sector and there is scope for public policy and industry bodies to promote innovation and best international practise.<sup>1</sup>

## *Social Constraints on Economic Performance*

We are moving towards a new shared understanding of the Irish economy and a new view of the relationship between economic performance and social policy. While there was a real sense that the economic reality set limits to the social possibilities, it seems that the long-term strength of the economy now depends on effective social policy. The medium and long term strength of the economy seems to depend critically not only on the recently increased investment in physical infrastructure and scientific research, but also on a deepening of capabilities, even greater participation, internal as well as external connectivity, more social mobility and successful handling of diversity, including immigration. In short, social realities now set limits to economic possibilities.

The NESc is convinced that the development of a dynamic, knowledge-based economy has inherent social implications that can serve social justice and a more egalitarian society, and that the development of Ireland's welfare state—as outlined in its recent report, *The Developmental Welfare State*—is integral to sustaining the dynamism and flexibility of its economy. In a globalised world, the strength of Ireland's economy and the attractiveness of its society will rest on the same foundation – the human qualities of those who participate in them.

The wider set of supply-side factors which are critical to economy-wide productivity and prosperity include:

1. life long learning;
2. public transport;
3. childcare;
4. eldercare;
5. educational disadvantage;

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6. health service;
  7. urban planning; and
  8. tailored social services.

Addressing this wide set of issues poses profound institutional challenges. These policies take us into domains in which Ireland's record of innovation, reform and delivery is not particularly strong (NESC, 2005b, Chapter 11).

Ireland is now confronted with the challenge of transforming its developmental state into a 'dual state' — a set of public institutions that achieve not only high productivity and competitiveness but also social solidarity and participation. Experience and analysis confirm that the exact institutional route to this is something we must work out for ourselves. Ireland's economy and 'networked developmental state' differ from even the most relevant comparators; its social situation and, yet to be created, 'developmental welfare state' will differ from that in the best performing countries, like Denmark. But experience and analysis — not least Ireland's surprising break-through — also suggest that we must now benchmark our businesses, technology and social outcomes against the best in the world. Benchmarking works best when combined with root-cause-analysis. So NESC's call to 'trust ourselves' and 'revise means and goals in the light of experience' is also a suggestion that we see ourselves as part of the worldwide quest for public institutions that achieve continuous improvement. Ireland will, almost certainly, not be on its own in discovering that a 'networked developmental state' and a 'developmental welfare state' are merely supportive of, and also dependent on, a 'developmental society'.

## Notes

- 1 The recently published Forfás report on the construction sector provides an example of what could be done to address productivity in a non-traded area.

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