PART III: POLICIES

CHAPTER 7: A STRATEGY FOR ECONOMIC AND SOCIAL DEVELOPMENT

CHAPTER 8: MACRO-ECONOMIC POLICY IN THE MEDIUM-TERM

CHAPTER 9: SOCIAL POLICY AND SOCIAL EXPENDITURE

CHAPTER 10: REFORMING THE TAX SYSTEM

CHAPTER 11: DEVELOPMENT POLICIES
A STRATEGY FOR ECONOMIC AND SOCIAL DEVELOPMENT

1. INTRODUCTION

The analysis in the first three chapters of this report paints a picture of the current state of the Irish economy which is almost unmittingly grim. The projections set out in Chapters 5 and 6, which are based on the assumption that the broad thrust of existing policies will remain unchanged, suggest little prospect of relief over the period to 1990. In particular these projections indicate that there is no self-correcting mechanism at work in the public finances, rather that the position of chronic imbalance is likely to continue. The projections also indicate that any reduction in unemployment which might be in prospect will be entirely attributable to the continuation of emigration on a large scale, unless there is a radical change in policy.

The seriousness of the economic problems currently facing the country cannot be emphasised too much. The gravity of the problem of unemployment is perhaps the most acutely evident, especially to those directly affected by it: the 230,000 people on the live register, those who have had to emigrate to find work, and the families and dependents of all such people.

The grave position of the public finances may not be as readily appreciated because it does not impinge as directly on people's daily lives. In part this reflects the fact that the accumulation of exchequer debt represents an attempt to escape from constraints and to defer to future generations a large portion of the cost of goods and services provided by the State. However, the rapidity with which debt has been accumulated in recent years means that in a very real sense the future has now arrived, with the National Debt approaching 140 per cent of GNP and the cost of servicing it 12 per cent of GNP.

Solutions to the twin problems of unemployment and the public finances must be found. The projections contained in Chapter 6 clearly indicate that the postponement of corrective measures is not a viable option. The question arises as to whether there is an inescapable trade-off between employment and fiscal policy objectives, that is, whether progress towards one must inevitably retard progress towards the other.

In the short-term this might be true. Cutbacks in government expenditure in themselves imply a reduction in domestic demand and, if unaccompanied
by other measures, could be expected to reduce employment in the short-
term. However, considerations about the medium-term must be set against
this, namely the stimulus which would be imparted to output and employment
in the internationally trading sectors of the economy because of the impact
on interest rates of reduced government borrowing.

Moreover, fiscal adjustment does not inevitably lead to a reduction in
employment, even in the short-term. The experience of Denmark since 1982
is a case in point. In 1982 the public sector finances were in deficit to the
extent of almost 10 per cent of GNP but are projected to be in modest surplus
in 1986. Notwithstanding the magnitude of this fiscal adjustment, employment
in Denmark increased by 110,000 between 1982 and 1985 while registered
unemployment in 1985 at 251,000, was 30,000 below its level of two years
previously.*

The three principles of consistency (pursuit of consistent fiscal, monetary
and exchange rate policies), continuity (steady adherence to a particular mix
of policies) and credibility (the widespread recognition that government is
committed to its economic strategy) form, at a policy level, the basis for the
success of a number of OECD countries in increasing employment while
correcting major imbalances in the public finances. The confidence that
adherence to these principles generates throughout an economy can lead to
a substantial fall in interest rates and a consequential increase in both private
consumption and investment.

Grounds for believing that the same possibility exists for Ireland are provided
by the recognition that the fundamental problem of the Irish economy at
present is not that the level of unemployment is so high or that the current
state of the public finances is unsustainable, but that the level of national
output is too low and that the rate of growth in output has for the last several
years been insufficient. It is the level of national output which determines
the level of sustainable employment. It is also the level of national output
which determines the level of public expenditure which can be sustained
by acceptable levels of taxation and prudent levels of borrowing. In large
measure, therefore, the existing problems of high unemployment and chronic
fiscal imbalance derive from the same source. An important contributory factor
to the low rate of output growth achieved in recent years (and expected to
persist over the medium term if present policies are continued) is the high
level of domestic interest rates associated with high levels of Exchequer
borrowing.

Two fundamental questions then arise. The first concerns the relationship
between the growth in GNP and the state of the public finances. That is

whether more rapid and sustained growth in GNP can be attained without
resolving the imbalances in the public finances or, whether tackling the
problem of the public finances is a necessary condition for more rapid and
sustained GNP growth. The second question concerns the relationship
between the evolution of employment and unemployment on the one hand
and GNP growth on the other. That is, whether, even with sustained rapid
growth in GNP (of for example 5-6 per cent per annum), employment would
expand strongly enough to significantly reduce the scale of unemployment.

2. THE ECONOMIC GROWTH PROCESS IN A SMALL OPEN
ECONOMY

To answer the first of the questions posed above it is useful to have some
simple conceptual model of how the economy operates. The model which
informs the analysis throughout this report is based on the distinction between
the exposed internationally trading sectors, and the rest of the economy. It
is the internationally trading sectors, embracing enterprises which compete
on overseas markets and those which compete with imports on the home
market, which comprise the locomotive of growth. These enterprises may
be located in either the public or private sectors.

The reason for this is that the Irish economy is too small for the domestic
market to provide the source of sustainable economic growth and that such
growth can only be secured by supplying the world market on an ever
increasing scale. It is only by means of securing output growth in the
internationally trading sectors that sustainable growth in employment, both
directly and indirectly through induced output and income increases elsewhere
in the economy, can take place.

Some important implications of this proposition are worth drawing out. Firstly,
those sectors of the economy which exclusively or predominantly serve the
domestic market cannot be regarded as an independent source of sustained
economic growth. Those sectors include the building and construction
industry, private non-traded service activities and most of the public sector.
These sectors provide goods and services which are vital to the smooth and
efficient functioning of the exposed sectors of the economy and, in the
case of the public sector, to the achievement of a just and humane society.
However, the demand for the goods and services produced by these sectors
is a derived demand and the output they produce and the level of employment
they provide are ultimately determined by the size of the exposed sector and
the strength of the economic linkages between the exposed sector and the
rest of the economy.

Secondly, domestic demand cannot be regarded as an independent source
of sustainable economic growth. In the short-term demand management
through fiscal policy may theoretically expand domestic demand at a faster
rate than otherwise but this is no longer a practicable option for fiscal policy for reasons that are made clear in the following chapter. In any event the demand management function of fiscal policy is one of stabilization and was never designed to generate economic growth in the medium term.

Similar remarks apply to the ability of increases in domestic demand brought about by factors, such as an improvement in the terms of trade, to generate sustainable economic growth in the medium-term. The discussion in Chapter 5 of the likely response of the Irish economy to the recent fall in oil prices makes this point clear. Indeed, going one stage further, greater buoyancy in the international economy such as that which is likely to follow the fall in oil prices, does not carry with it the guarantee of a sustained acceleration of economic growth in Ireland. Again, the discussion in Chapter 5 indicates why this is so.

What is crucial for the attainment of sustained economic growth in an economy such as Ireland's is the capacity of the internationally trading sectors to produce goods and services and to sell them competitively on export markets, or on the domestic market in the face of competition from imports. In the short term this can be achieved by securing the maximum degree of cost competitiveness and in the medium-term by defending competitive advantage while at the same time expanding the productive capacity of the economy.

3. IMPLICATIONS FOR POLICY
Given this simple model of how the process of economic growth takes place and the fundamental objective of strengthening the supply side of the economy, there are very clear policy implications.

As to the question of whether resolving the problem of the public finances is a necessary condition for generating more rapid and sustained growth in GNP a crucial factor in the answer must be the size of the National Debt-GNP ratio. It is argued in Chapter 8 that stabilising the National Debt-GNP ratio must be regarded as the over-riding but minimal objective of fiscal policy, given that by end-1985 it had reached 134 per cent, and that the debt-serving costs to which the level of national debt outstanding gives rise now pre-empt such a large proportion of overall Exchequer resources.

Failure to halt the increase in the National Debt-GNP ratio will inevitably lead to a situation whereby the problems of debt servicing become so acute that public spending cuts so deep as to curtail the provision of those services which are essential to the economy's continued operation will be required. Moreover, there is the danger that in such circumstances a rescheduling of Ireland's external debt repayments would be necessary, with discretion in the design of fiscal policy being moved from the Irish government to external agencies.

That the stabilisation of the National Debt-GNP ratio is a minimal requirement is because such a course is the only one which is viable. Accordingly in Chapter 8 this objective has been described as an imperative of fiscal policy. In effect the authorities have no option but to stabilise the ratio.

Achieving the minimal objective of stabilising the National Debt-GNP ratio will require a substantial reduction in public spending (capital and current taken together) and/or a significant increase in taxation as a proportion of GNP. The viability of the latter option is severely circumscribed by the size of the existing tax burden which is widely perceived as being unacceptably high. Accordingly, it would appear that adjustment will have to be effected principally through the medium of public expenditure cuts. At the same time it must be acknowledged that perceptions about the acceptability of the existing overall tax burden are related to the fact that total tax revenue is currently levied on a narrow base. The Council's views on tax reform are impelled by a recognition of this point and are detailed in Chapter 10.

The economic implications of a reduction in overall Government spending will depend on the distribution of that reduction across expenditure programmes. From the point of view of safeguarding as far as possible the medium-term prospects for output and employment growth throughout the economy it is important to distinguish between those elements of public spending which help to generate returns to the Exchequer (i.e. in terms of tax receipts and reduced levels of spending on unemployment compensation) and to the national economy (in terms of GNP growth) from those items which do not.

In general public capital spending projects which are rigorously evaluated in terms of future rates of return come within the former category. Those areas of government spending which involve the provision of signals for resource allocation may also do so if the grants, subsidies and tax expenditures concerned generate sustainable economic activity in the internationally trading sectors of the economy which would not otherwise have taken place. It is important that expenditure programmes which satisfy such criteria not be fettered in the pursuit of expenditure restraint.

In the short-term the performance of the exposed sectors of the economy is critically dependent on maintaining and improving their international competitiveness. Government policies in relation to taxation, incomes, interest rates and the exchange rate are of crucial importance in this regard. As pointed out in Chapter 8 the evolution of interest rates and the exchange rate are not independent of fiscal policy and more particularly the level and pattern of Exchequer borrowing. Unless the imbalances in the public finances are resolved it can be expected that the evolution of domestic interest rates and of the exchange rate will continue to exert pressures detrimental to the
competitiveness of the internationally trading sectors of the economy and injurious to the prospects for overall output and employment growth in the medium term. Accordingly the resolution of the public finance imbalances will become more intractable. The existing overall burden of taxation is clearly the consequence of substantial increases in the volume of public spending arising from both discretionary decisions on the part of successive Governments and the automatic response of certain components of public expenditure (for example, unemployment payments) to the depressed level of economic activity.

The burden of taxation has clear implications for international competitiveness: directly through, for example, its impact on the cost of industrial inputs and, indirectly, through the pressure which high rates of personal taxation have exerted on wages and salaries. It is pointed out in Chapter 10 that the present state of the public finances is such that across-the-board cuts in taxes cannot be regarded as a realistic option. But clearly this does not obviate the desirability or practicability of thoroughgoing reform of the tax system. Indeed it is suggested in Chapter 10 that tax reform may now be one of the most powerful instruments available to government for the promotion of faster growth in output and employment in the short-to-medium-term.

In the medium term the performance of the exposed sectors of the economy will depend not only on the maintenance of competitiveness but also on the expansion of productive capacity through investment, which will have the effect of:

(i) increasing the productive capacity of individual branches of activity and;
(ii) re-allocating resources away from sectors in which Ireland has no competitive advantage to those where such competitive advantage can be developed and sustained.

In this connection it should be emphasised that improvements in competitiveness in the short-term must be accompanied by structural change in the internationally trading sectors if they are to result in output and employment growth which is sustainable in the longer-term. The generality of government macro-economic policies in relation to taxation, incomes, the exchange rate, interest rates and other costs of production, if properly designed, will play a crucial role in providing an environment conducive to sustained growth in the internationally trading sectors in the medium-term. However, in Chapter 11 the argument is advanced that it will not be sufficient for the achievement of the long-term objectives of agricultural and industrial development to simply get the cost environment right. There are several reasons to suppose that even with a favourable cost environment the pace of agricultural and industrial growth would be considerably slower than is needed to realise national aspirations for higher employment and increased living standards. Accordingly there is a compelling case for the continued pursuit of active state development policies in relation to both manufacturing industry and agriculture.

There will be a continuing need to deploy policy instruments in such a way as to increase the allocation of resources towards these sectors. Central to the design of such policies must be the recognition that the effectiveness of incentives is in inverse proportion to their number and degree of dispersion. The greater the number of incentives and the greater their degree of dispersion the less effective they will be. The more it is that incentives are directed towards economic activity in the sheltered sectors the more national resources will be concentrated there at the expense of internationally trading activities and sustainable overall economic growth.

4. EMPLOYMENT AND SOCIAL POLICY OBJECTIVES

We now turn to the second question posed earlier, namely the relationship between the evolution of employment and unemployment on the one hand and GNP growth on the other. The expansion of employment may be achieved by securing sufficiently rapid growth in output or by redistributing work or by a combination of both. In the five years to 1985 GDP increased at an annual average rate of 1.8 per cent while total employment declined by 1.5 per cent annually on average. Accordingly, economy-wide productivity grew by about 3.3 per cent per annum on average. Productivity growth in the 1975-1980 period was of a similar order: GDP grew at an annual average rate of 4.6 per cent while employment expanded at an annual average rate of 1.5 per cent.

Simple forward extrapolation of these economy-wide productivity figures would suggest that in order to do no more than stabilise employment at its 1985 level an annual rate of growth of GDP of about 3 per cent over the next five years would be required. This growth rate would be almost twice that achieved over the 1980-1985 period. If GDP were to grow at an annual average rate of 5 per cent in the five years to 1991, a rate broadly comparable to that achieved during the previous most buoyant five-year period in the Irish economy (1965-1970), an expansion of the order of 100,000 in employment might be expected on the basis of recent economy-wide productivity trends.

Such a level of economic growth would represent an outstanding performance and would require the conjunction of a major improvement in competitiveness and the other elements in the climate for enterprise as well as favourable international market conditions. An increase of 100,000 in employment in five years would make a substantial contribution to reducing unemployment.

The only way in which such an outcome can be achieved is by embarking on a credible strategy for resolving the fiscal imbalances, by pursuing monetary and exchange rate policies consistent with that strategy, by improving the competitiveness of the internationally trading sectors of the economy and by restructuring agriculture and industry to ensure that short-term gains
in competitiveness are converted into sustainable output and employment growth in the medium-term.

Even assuming that annual average growth in national output of 5 percent could be achieved in the medium term the scale of unemployment is still likely to be such, given the present organisation of work, that policies to redistribute work may have a role to play in reducing unemployment. Indeed such policies might be pursued as part of an overall strategy to reduce unemployment. In such a strategy the achievement of employment growth through a more rapid expansion in output, and the redistribution of work would be seen as complementary processes in the attainment of a reduction in joblessness.

There is a wide range of methods whereby work might be redistributed. These include reducing working hours, early retirement, increasing the school-leaving age, job or work-sharing, curtailing overtime and increasing part-time at the expense of full-time employment.

Some of these changes are already taking place as a spontaneous response to existing social and economic conditions. The incidence of part-time working, for instance, has increased significantly in recent years in tandem with the growth of service sector employment. Other changes (e.g. job-sharing) are being facilitated by government policy or have been attempted with little conspicuous success (e.g. restrictions on overtime).

In general, policies explicitly designed to effect the redistribution of work by such means as these may be viewed as a response to the social problem of joblessness rather than an attempt to counteract the economic problem of unemployment of underemployed or underemployed human resources. It is here that the fundamental shortcoming may reside. To the extent that such policies result in no net addition to the nation’s wealth their success will depend principally on the willingness of people who are at present fully employed to accept lower standards of living. For this reason the decision whether to pursue and win acceptance for such policies is essentially, though not exclusively, a political one.

A second way in which the numbers recorded as unemployed might be reduced in circumstances where GDP growth was not sufficiently rapid to generate the required level of employment would be to simply create additional posts in the public sector as distinct from generating sustainable employment increases in productive public sector enterprises. Given the present state of the public finances this could only be financed through tax increases. This too amounts to a policy of redistribution. The principal difference between such a policy and work-sharing would be that whereas, under the latter, those currently employed would be expected to do less work for proportionately lower incomes, under the former taxpayers would be expected to perform the same amount of work for lower incomes after tax. Given that the existing burden of taxation is perceived as being already too high an increase in that burden is likely to represent an unviable option, even for the purposes of direct job creation in the public sector. But again it should be stressed that to the extent that what would be involved in successfully pursuing such a policy is the acceptance of a greater degree of redistribution, it is largely a matter of political choice.

An important element in any medium-term strategy for economic and social development must be the attainment of progress towards social policy objectives. Objectives of social policy include (i) the securing of an adequate minimum standard of living for the most disadvantaged sectors of the community, embracing not only income transfers under the various social welfare programmes but also the provision of housing, health and educational services and, (ii) the more equitable distribution of opportunities and life chances.

Social policy objectives cannot be ignored even at a time when economic policy objectives prove difficult to achieve since the preservation and pursuit of social justice is vital to a cohesive society. The reductions in public expenditure necessary to correct the serious imbalances in the public finances must have regard to protecting the disadvantaged groups in society. What is important in circumstances where fiscal stringency is necessary is to ensure that the net benefits flowing from public expenditure are concentrated to the maximum extent possible on those most in need. Much of the analysis in Chapter 9 represents an attempt to identify the extent to which the net benefits from public expenditure accrue to the intended target groups and the extent to which expenditure reductions could be effected while safeguarding the position of such groups and strengthening the redistributive role of social policy.

Moreover, it is important to recognize that economic and social policy objectives are not mutually antagonistic. Unemployment is now the single most important contributory factor to inequality. The provision of sustainable employment to those currently out of work and those seeking work in the future would, accordingly, make a major contribution to securing a more equitable distribution of income and opportunities.
MACRO-ECONOMIC POLICY IN THE MEDIUM-TERM

1. INTRODUCTION

The principal purpose of the medium-term projections contained in Chapters 5 and 6 was to assess the extent to which the two most pressing problems facing the Irish economy, namely the scale of unemployment and the serious imbalances in the public finances, might be expected to be ameliorated over the next five years assuming that the broad thrust of existing government policies, both macro-economic and sectoral, would remain unchanged.

The principal conclusions of this exercise were that, even in the face of a modest upturn in the world economy, the evolution of national output would be insufficient to reduce unemployment or to generate a significant improvement in the public finances. Indeed, under the more pessimistic scenario for output growth both unemployment and fiscal imbalances could deteriorate appreciably.

In this and the following three chapters the policy response to these medium-term prospects is discussed and analysed, and policy options are presented where they exist. The policy response should be viewed as a four-pronged strategy designed to simultaneously address the twin problems of unemployment and the public finances. The four chapters in this part of the report broadly correspond to the four parts of the strategy. The concept of an integrated strategy is fully developed in Chapter 12. The present chapter addresses issues in macro-economic policy: fiscal and monetary policy; exchange-rate policy; incomes policy and competition policy. Chapter 9 examines issues which arise in the area of public expenditure with particular reference to social expenditure. Chapter 10 is devoted entirely to the question of reforming the taxation system. Chapter 11 discusses development policies, principally in relation to agriculture and manufacturing industry.

2. FISCAL AND MONETARY POLICY

(i) The Importance of the National Debt-GNP Ratio

In Chapter 6 the conditions required to stabilise the National Debt-GNP ratio were discussed and it was indicated that these conditions were unlikely
to be realised over the next five years under existing policies. It is worth elaborating this discussion further because the debt-GNP ratio is the critical indicator of the imperatives which must govern fiscal policy and also because this ratio is a very useful and convenient tool for medium-term policy analysis. Moreover, certain targets in relation to this ratio were set out in the Government's economic plan Building on Reality.

It was intended in Building on Reality that the National Debt would be stabilised at 132 per cent of GNP by 1987, and that this would be achieved by securing a position in which the surplus on the non-interest account of the current and capital budgets taken together would be 1 per cent of GNP. These targets are unlikely to be achieved. By December 1985 the National Debt already amounted to 134 per cent of GNP. Moreover, present trends indicate that a deficit on a non-interest account of about 2 per cent of GNP will emerge for 1986. Accordingly, the achievement of a 1 per cent of GNP surplus in 1987 on this balance would require a significant measure of revenue buoyancy and/or real expenditure reductions.

It is of vital importance that the debt-GNP ratio be stabilised as quickly as possible. A number of compelling reasons may be adduced for this objective.

In the first place, there is the simple arithmetic of the relationship between the stock of debt outstanding and the cost of servicing it. A rising stock of debt implies an increase in servicing costs. Accordingly, a rising debt-GNP ratio means that interest payments also rise as a proportion of GNP. Quite apart from the fact that such a situation is unsustainable, it seriously impairs budgetary flexibility as interest payments pre-empt an ever-increasing proportion of Exchequer resources. That this is the case is amply testified to by recent Irish experience. It has already been pointed out in Chapter 3 that although the overall current budget deficit increased from 7.6 to 8.4 per cent of GNP between 1981 and 1985, the non-interest balance on current account was in significant surplus by the end of this period having increased from 0.2 per cent of GNP in 1981 to 3.6 per cent of GNP in 1985. Thus, because of increasing debt servicing costs, the sharp increase in tax revenue which took place over these years, combined with modest expenditure restraint in respect of supply services from 1983, was insufficient to prevent the current budget deficit from rising.

Secondly, the budgetary implications of the relationship between the National Debt and the cost of servicing it are the more serious and the associated degree of budgetary inflexibility all the greater the higher is the debt-GNP ratio.

Given that a rising debt-GNP ratio is unsustainable in the long term there necessarily comes a time when its growth must be stopped. At that stage the amount of tax revenue required to stabilise the debt ratio while simultaneously financing necessary non-interest spending will be determined by the size of that ratio: the greater the ratio the heavier the tax burden required. The alternative would be a cut in government spending on essential public services and social welfare programmes.

Thirdly, there is the probability that an increasing debt-GNP ratio would exert upward pressure on interest rates leading in turn to lower private investment, a smaller capital stock, and diminished growth potential for the economy. In this connection it is worth referring to the view which has been expressed by a number of commentators that there is an incremental stock effect associated with the accumulation of debt in addition to the crowding out which arises from deficit flows. Two principal reasons have been cited in support of this argument:

(i) a 'portfolio effect' whereby higher interest rates are required to induce the private sector to hold an increased share of government stock in their portfolios;

(ii) pressure on interest rates arising from the expectation of higher inflation: if government debt is high savers may fear that the authorities will be tempted to reduce the real burden of National Debt by generating inflation.

In a small and open economy such as Ireland's other considerations apply including the fact that the pool of domestic savings from which increases in the National Debt might be funded is limited in size. As the debt-GNP ratio increases, domestic sources of funding may become exhausted and increasing resort had to foreign borrowing which at some stage may require premium interest rates to be paid to international lending institutions and, at a later stage may provoke resistance on the part of foreign lenders to making any further credit available. In the meantime the capital inflows which are the counterpart to Exchequer foreign borrowing will generate increasing upward pressure on the exchange rate leading to a deterioration in the competitiveness of the exposed sectors of the economy and losses in output and employment.

(ii) Implications for Fiscal Policy in the Medium-Term

Stabilisation of the National Debt-GNP ratio must be reaffirmed as the overriding objective of fiscal policy. Indeed, for reasons which are spelled out below this can only be regarded as the minimum requirement of a sound financial policy.

Under all the specified combinations of interest rates and GNP growth rates, a surplus on non-interest account for the 1986-1990 period would be required to stabilise the debt ratio. The most benign scenario is one in which the required surplus would be less than 0.5 per cent of GNP. This represents a position of considerable optimism about the future evolution of interest rates and about medium-term growth prospects for the economy. It is predicated therefore on an extremely unlikely conjunction of events. The most pessimistic scenario — the high interest rate, low growth case — implies that the required surplus on non-interest account to stabilise the debt ratio would amount to almost 5 per cent of GNP.

The scenario which arguably represents most judicious balance between optimism and pessimism, calls for a surplus on non-interest account of 2.7 per cent of GNP to stabilise the debt ratio. Under this scenario there is some allowance for a fall in interest rates over the period 1990 and a projected growth in nominal GNP of 5.5 per cent which, given an inflation rate of 3 per cent, would translate into a real growth rate of 2.5 per cent per annum.

Present trends indicate that the Exchequer non-interest account will record a deficit amounting to about 2 per cent of GNP in 1986. On the basis of the illustrative projections documented in Chapter 6 it was deemed improbable that this deficit would be significantly reduced in the period to 1990 assuming the continuation of existing policies in relation to expenditure and taxation. Indeed, although the more optimistic output and employment outlook envisaged a movement to a very modest surplus on non-interest account, the more pessimistic scenario generated a significant increase in the non-interest deficit. On balance therefore it seems reasonable to expect that the balance on non-interest account on the basis of existing policies would in 1990 be broadly equivalent to the 1986 outturn, yielding a deficit of the order of 2 per cent of GNP. The requirement that a non-interest surplus of 2.7 per cent of GNP be secured to stabilise the debt-GNP ratio translates therefore into the requirement that fiscal policy bring about a shift in the non-interest balance of some 4.5 to 5 per cent of GNP.

The required shift in the non-interest balance could be secured by cuts in net expenditure* (current and/or capital) and/or an increase in taxation relative to GNP. The considerations which should inform the mix of expenditure-reducing and tax-increasing measures are discussed in the following paragraphs.

Table 8.1

<table>
<thead>
<tr>
<th>Nominal Interest Rate</th>
<th>8.5%</th>
<th>7.5%</th>
<th>6.5%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nominal</td>
<td>6.25%</td>
<td>5.5%</td>
<td>5.0%</td>
</tr>
<tr>
<td>GNP</td>
<td>5.0%</td>
<td>4.7%</td>
<td>4.4%</td>
</tr>
<tr>
<td>Growth</td>
<td>5.0%</td>
<td>4.7%</td>
<td>4.4%</td>
</tr>
</tbody>
</table>

Notes:
1. The entries under what surplus on non-interest account (interest plus capital) was in percentage of GNP, would be required to stabilise the national debt-GNP ratio at an end-1985 level of 150 per cent, under the various combinations of nominal interest rates and rates of growth in nominal GNP. The non-interest surplus required is obtained by multiplying the current national debt-GNP ratio by the difference between the interest rate and the nominal GNP growth rate.
2. The figures in the table are computed on the assumption that a reduction in national rates would impact on interest payments in respect of the entire stock of national debt outstanding. In practice this would not happen immediately but within a few years some 50 per cent of existing Exchequer debt is denominated in terms of fixed interest rates. Moreover bond interest rates are fixed over and beyond pressures on the borrowing proportion of the debt to benefit from lower interest rate reductions.

*It has been assumed for simplicity here that GNP and GDP will grow at the same rate over the period.

*See Chapter 6 for an explanation of the weighting system used.

**See Chapter 6 for an explanation of the weighting system used.
(iii) Achieving a Surplus on Non-Interest Account

Tax Increases or Expenditure Cuts

In the circumstances which exist in the aftermath of the recent oil price fall the grounds upon which an increase in the tax burden could be defended are developed in section (vii) below. The options which are identified there as feasible however are specific, and would involve the highly selective application of tax increases to particular areas. These options are advanced for consideration as a response to a specific set of circumstances and not as a strategy for correcting the fiscal imbalances in the medium term.

Whether further tax increases should be relied upon as a means of stabilising the debt-GNP ratio in the medium-term depends on what judgement is reached about the impact which the existing burden of taxation has on the efficient functioning of the economy. More particularly, whether fiscal balance should be attained by means of tax increases or expenditure cuts depends on which of these strategies is more likely to improve the prospects for economic growth in the medium term. In addition there is the question of the acceptability to the public at large of increasing the burden of taxation and the relative acceptability of such a strategy compared with cutting public expenditure.

There is little by way of conclusive research evidence on the economic effects of an increasing tax burden relative to a reduction in public spending. The choice between the two strategies cannot, however, be deferred until such evidence becomes available. There is a widespread perception that the existing burden of taxation has reached the limit of acceptability and that it has substantial adverse effects on economic activity. This perception has been incorporated in the economic plans of successive governments in recent years. The Way Forward, published in 1982, commended the then government to reducing the total burden of taxation relative to GNP on the grounds that "the growth in the burden of taxation in recent years... has had adverse effects on the enterprise of the individual and on the competitiveness of the economy." The present government's Economic Plan states as an objective of policy in the medium-term that there will be no increase in the overall level of taxation over the period of the Plan.

Moreover, the social partners have in successive NESC reports** expressed concern about the economic effects of the high burden of taxation and its rapid increase in the period up to 1984, and have recommended that the reduction in the EBR be concentrated in appropriate expenditure restraint.

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**The Way Forward, 1982, p.11

**See NESC Reports Mem. 76, 75 and 74

The factors which impelled the NESC towards this recommendation in Report No. 75 have not essentially changed. Accordingly the conclusion must remain that the burden of fiscal adjustment should be borne by reductions in expenditure. This is not to imply that taxation should be ignored as an instrument of policy. Reform of the tax system can play a powerful role in stimulating economic recovery and thereby contributing to the restoration of balance to the public finances. Reform of the tax system is the subject of Chapter 10.

Cuts in Current or Capital Expenditure

The perspective of the National Debt-GNP ratio is a useful one for assessing medium-term fiscal policy because, inter alia, it focuses not only on the magnitude of the National Debt but also on GNP. Accordingly it points up the fact that stabilisation of the ratio - the minimal requirement of fiscal policy - can be effected not only by means of actions which reduce the rate of growth in National Debt but also by policies which foster a higher growth rate in GNP. This fact emphasises the importance of viewing fiscal policy, other macro-economic policies, such as policy in relation to the evolution of incomes and the exchange rate and, sectoral development policies, as comprising essential components of an integrated medium-term economic strategy. It also provides a framework against which the relative merits of current and capital expenditure cuts can be evaluated.

Although it cannot be presupposed that all public capital projects increase the productive capacity of the economy and that no elements of current government expenditure have this effect (part of current spending on education being a case in point) a general distinction between current and capital spending along these lines provides a useful point of departure. If public capital expenditure is rigorously evaluated in terms of future returns there is a clear difference between the capacity of the economy to service the debt contracted to finance capital expenditure and the borrowings used to fund the generality of current spending.

The interest payments attaching to debt financing of productive capital spending will not, in general, increase as a proportion of GNP because such spending fosters the growth in GNP through the provision of improved infrastructure and the enlargement of the industrial base and the productive capacity of the agricultural and services sectors. Indeed it can reasonably be expected that with vigorous evaluation of the capital projects concerned, such interest payments as a proportion of GNP will decline as the rate of return on the investment exceeds the cost of servicing the corresponding debt. If the capital projects are located in the tradable goods producing sectors of the economy, or support the activity of the exposed sectors, this result will in general obtain irrespective of broad trends in exchange rates. The debt
may be denominated in foreign currencies but so will the foreign exchange earnings generated as a result of the capital projects in question.

The generality of current spending in contrast does not expand the productive base of the economy. Accordingly it does not increase the economy's debt servicing capacity. There are exceptions to this general observation and again as noted above elements of current spending on education are an important example.

The reduction of three points in the EBR as a proportion of GNP between 1981 and 1985 was achieved entirely on foot of a fall in Exchequer borrowing for capital purposes. This was facilitated by a large reduction in the Public Capital Programme which declined in volume terms at an annual average rate of almost 6 per cent over the period. Within the overall PCP it is notable that, whereas substantial volume falls occurred in respect of sectoral economic investment and investment in productive infrastructure, the volume of investment in social infrastructure increased between 1981 and 1985. Although the reduction in the PCP may be attributed in part to the completion of large investment projects and to this extent may have been inevitable, and in part to the influence of the recession on industrial and agricultural investment, it would appear that Government policy has in recent years exercised an amount of discretion in using the PCP as an instrument of fiscal adjustment. On balance it would have been more desirable if the burden of fiscal adjustment had been borne by current spending. As noted in Chapter 6 one of the factors which is likely to inhibit the recovery of the economy in the medium term is the low level of overall physical capital formation recorded in recent years.

By way of contrast with trends in public capital spending, current expenditure increased in volume terms between 1981 and 1985. The volume of supply service expenditure rose at an annual average rate of 2.6 per cent within which aggregate there was a modest decline in real spending on pay and pensions (0.8 per cent annum) which was more than counterbalanced by volume growth in spending on transfer payments (4.6 per cent) and other non-pay elements (4.3 per cent).* Within the category of transfer payments substantial real increases in rates of payment occurred under all the major schemes between 1981 and 1985.

Given the differential impact of productive capital spending and the generality of current expenditure on the productive capacity of the economy, and on its capacity to service debt, and given the sharp reduction in the PCP which has occurred in recent years, cuts in public spending in future years must be effected primarily on the current account of the budget. Great care should be taken in the design of fiscal policy to ensure that productive capital projects are not jeopardised in the process of restoring order to the public finances.

Reductions in Current Expenditure

For the purposes of identifying where reductions in current expenditure might be made, spending on supply services may be subdivided on a functional basis, or by means of a more detailed programme-by-programme classification. In Chapter 9 relevant aspects of current spending on the latter basis are highlighted. In this section the prospects for current expenditure restraint on the more general functional classification are assessed, that is, on the basis of the distinction between pay and pensions, transfer payments, and other non-pay spending.

The assumptions underlying the expenditure elements of the projections of the public finances position to 1990, discussed in Chapter 6, may be recalled as follows:

(i) that expenditure on pay and pensions would increase from 1986 at an annual average rate of 4.75 per cent comprising, inter alia, an annual 3 per cent increase to reflect projected inflation and 1 per cent per annum in respect of incremental scales;
(ii) that rates of social welfare transfer payments would increase by 3 per cent per annum, again reflecting the projected inflation rate and,
(iii) that expenditure on the remaining non-pay elements of supply service spending would expand at an annual average rate of 4.5 per cent per annum comprising 1.5 per cent volume growth and also reflecting the projected annual inflation rate of 3 per cent.

As regards pay and pensions, expenditure on which currently accounts for 46 per cent of total supply service spending, it has been assumed that no change in numbers employed in the public service will take place in the 1987-1990 period. Nor has allowance been made for the cost of any special pay claims in the future over and above those which have already been conceded and incorporated in the budgetary arithmetic for 1986. On these grounds the projections may be biased downwards somewhat. It has effectively been assumed that rates of pay in the public service will remain unchanged in real terms over the 1987-1990 period although average per capita incomes are projected to increase by 1 per cent in real terms because of the impact of incremental scales.

The options for reducing the public sector pay bill below the levels projected reduce to two in effect: a reduction in the numbers employed and/or the granting of pay increases below the rate of inflation.

Gross expenditure on transfer payments is determined by rates of payment and the number of beneficiaries. Given projected levels of unemployment and the impact of demographic factors on the change in numbers covered by other existing beneficiary categories, the evolution of gross transfer payments spending is fully determined if the real value of rates of payment
is maintained. Gross expenditure reductions under this heading can therefore be effected only if the real value of social welfare benefits is reduced and/or eligibility conditions are made more restrictive.

Net Exchequer spending on transfer payments is determined by an additional factor namely, social insurance contributions. Such contributions are currently levied on a narrow base — a base narrower than that on which personal income tax is levied — because of the existence of an income ceiling and because of the exemption of certain categories of income from liability. Moreover a reduced rate of PRSI applies in respect of certain categories of employment. Accordingly scope exists for reducing net spending on transfer payments through broadening the base for PRSI contributions and instituting a single rate structure. The options available here are analysed further in Chapter 9.

As regards the third category of supply service spending — expenditure on non-pay non-transfer items — volume restraint has apparently been remarkably difficult to effect in recent years. Such spending increased in volume terms at an annual average rate of 3.5 per cent between 1981 and 1985 although a small volume reduction may have taken place in 1985. For the projections to 1990 it has been assumed that volume growth of 1.5 per cent per annum will take place under this heading in the absence of policy changes. This expenditure aggregate is very heterogeneous and this may help explain the difficulties which have been experienced in controlling it. Moreover, net expenditure under this heading is affected not only by gross disbursements but also by receipts in the form of appropriations-in-aid which comprise in the main, charges for services, and transfers from the European Community. To achieve control over the growth of net spending under this category scope may exist for increasing the range of services for which charges are made. If there was no volume growth in real expenditure on non-pay non-transfer items over the next four years, total supply service spending would be some £100m less in 1990 than projected in Chapter 6.

(iv) The Current Budget Deficit and the Exchequer Borrowing Requirement

The state of the public finances has conventionally been measured with reference to the magnitude of the current budget deficit and the Exchequer Borrowing Requirement (EBR). The analysis in this chapter has been based on, and the imperatives for fiscal policy derived from, a consideration of the National Debt-GNP ratio and the concept of the non-interest balance on the Exchequer accounts. One reason for adopting this different perspective is the suitability of the debt-GNP ratio for medium term analysis. Another reason has to do with the way in which the public finances have in recent years been increasingly dominated by interest payments on the National Debt. Interest payments are susceptible to very large fluctuations from year to year because of movements in interest and exchange rates, the future course of which is extremely uncertain. In order to plan the adjustment of the public finances in a consistent and credible way it is accordingly necessary to adopt the non-interest balance as the planning framework while making realistic assumptions about the future course of interest and exchange rates.

Given that interest payments are recorded as an item of current expenditure and enter into the current budget deficit and the EBR as conventionally measured, it might be argued that the pursuit of targets in respect of these magnitudes is inappropriate and may induce an unwarranted loss of confidence in fiscal policy when the achievement of declared targets is undermined by, perhaps short-term, interest and exchange rate movements.

Although we believe that the current budget deficit and the EBR do not provide a satisfactory framework for the pursuit of a credible and coherent fiscal policy it is useful to make a few remarks about how these conventional measures fit into the framework adopted here.

The adoption of the objective of stabilising the National Debt-GNP ratio does not imply any particular magnitude for the current budget deficit. The current budget deficit is comprised of (i) interest payments and, (ii) the balance between non-interest current spending and current revenue. If the National Debt-GNP ratio is stabilised the first element is determined by the interest rate applicable to the stock of debt.* The magnitude of the second element — the non-interest current balance — depends upon how the adjustment necessary to secure stabilisation of the debt-GNP ratio is effected. More specifically it depends on whether and to what extent that adjustment is made through cuts in current or capital spending or through increases in taxation.

The considerations which should inform the choice of adjustment strategy have been outlined in the preceding sections. The principal economic rationale for informing that choice is the strategy most likely to safeguard and promote the expansion of the economy’s productive capacity and thereby GNP growth and the economy’s ability to service the National Debt. In this regard as far as expenditure cuts are concerned there is not a clear cut choice between current and capital spending programmes, but a clear distinction can be made between the generality of current expenditure and, productive capital spending rigorously evaluated in terms of future rates of return.

If the entire burden of adjustment required to stabilise the debt-GNP ratio were to be borne by the non-interest current balance (i.e. with no adjustment of Exchequer borrowing for capital purposes relative to GNP), the resultant current budget deficit would amount to about 3 per cent of GNP, comprising

*Interest payments are equal to the stock of debt outstanding multiplied by the average interest rate attaching to that stock of debt.
a National Debt interest element equivalent to some 10 per cent of GNP and a surplus on the non-interest account of about 7 per cent of GNP. The EBR under these circumstances would be about 7.5 per cent of GNP. Obviously, the smaller the adjustment to the non-interest current balance, the greater would be the corresponding current budget deficit.

(v) The Speed of Adjustment

On the basis of present trends in the public finances it seems likely that non-interest current spending in 1986 will amount to the equivalent of 38 per cent of GNP, significantly higher than provided for in the budget. It has already been indicated that the stabilisation of the National Debt-GNP ratio would require a shift in the non-interest budget balance of up to 5 per cent of GNP. Were this burden to be entirely borne by non-interest current expenditure it would require that this aggregate be reduced from 38 to 33 per cent of GNP. What this would mean in terms of real expenditure reductions* depends on: (a) the rate of growth in real GNP and, (b) the time span over which the reductions were to take place.

If the adjustment were to be completed within one year a real reduction in non-interest current spending of 10 per cent would be required in 1987. The debt-GNP ratio would be stabilised at its present level and interest payments at about 10 per cent relative to GNP. If adjustment were to take place over a longer period a somewhat lower real reduction in non-interest current spending would need to be made in 1987 but this reduction would have to be repeated in each subsequent year until the debt-GNP ratio was stabilised. In the intervening period the debt-GNP would continue to rise as would the proportion of GNP absorbed by interest payments.

For example, if 1988 were adopted as the target year for stabilising the debt-GNP ratio, real cuts in non-interest spending of 4.1 per cent would be required in each of the years 1987 and 1988, and the national debt would in the meantime have risen as a proportion of GNP**.

In general the longer the period of adjustment the smaller the required annual volume cuts in expenditure but the larger would be the ultimate levels at which the debt-GNP ratio and the ratio of interest payments to GNP were stabilised. The longer the period of adjustment therefore the greater the proportion of national output pre-empted by debt servicing costs and the greater the vulnerability of the public finances to interest rate and exchange rate fluctuations. Moreover, the more distant the target year for stabilising the debt-GNP ratio, the greater will be the Exchequer’s borrowing requirement in the adjustment period and the stronger the pressures on interest rates. If a longer period of adjustment translates into upward pressure on domestic interest rates the resultant depressing effect on domestic economic activity, especially investment, will weaken the medium-term prospects for economic growth.

On the other hand the process of adjustment must recognise the need to (i) avoid excessive economic dislocation and, (ii) command confidence that the targets can be achieved. The volume reduction of 10.4 per cent in non-interest expenditure (£650m in 1986 prices) which would be required to stabilise the debt-GNP ratio in one year seems outside the range of what is feasible or credible given particularly that commitments relating to very large components of current spending covering much of 1987 have already been entered into.

Given the medium-term outlook for interest rates and GNP growth, stabilising the debt-GNP ratio will be a difficult task requiring many tough decisions on the part of government. Even so it can only be regarded as the minimal objective for fiscal policy and cannot be regarded as an achievement beyond which there will be no further problems to resolve in the public finances.

Stabilised at its present level relative to GNP the National Debt would still be extremely high: unparalleled in the history of the state and considerably higher than the corresponding ratio for any other OECD country. Moreover a National Debt of this size would still leave the public finances highly vulnerable to adverse movements in interest and exchange rates, a factor which renders economic planning a more than usually difficult task.

The interest payments to which such a stock of debt would give rise even at interest rates somewhat lower than currently prevail would amount to over 10 per cent of GNP and would accordingly continue to pre-empt a large proportion of national resources. A fortiori would they continue to drain a very large proportion of Exchequer resources and thereby severely circumscribe the ability of the State to deploy resources in ways which would foster output and employment growth throughout the economy, or to release resources to private firms and individuals in the form of tax reductions.

The stabilisation of the debt-GNP ratio is the first step on the road towards reducing it. Unless interest rates and exchange rates evolve in a direction significantly more favourable than that currently in prospect, the only way in which reductions in the debt-GNP ratio can be achieved is by continuing to effect reductions in the non-interest balance relative to GNP beyond those

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* Real expenditure reductions are defined here to mean the fall in expenditure outlays as compared with the level they would reach if indexed to price rises.

** The estimates provided in this paragraph are based on the assumption of an average interest rate of 2.5 per cent and nominal GNP growth of 4.5 per cent in 1983 and 1984.
required to attain the minimal objective of debt stabilisation. It is only when substantial reductions in the debt-GNP ratio have been secured that significant cuts in the overall tax burden can be seriously contemplated.

(vi) Financing the Exchequer Borrowing Requirement

Fiscal and monetary policy cannot be viewed in isolation from each other. The magnitude of the Exchequer Borrowing Requirement has implications for key monetary aggregates such as the rate of domestic credit expansion. Moreover, the way in which the EBR is financed, and more particularly the distribution of that financing between monetary and non-monetary instruments and between foreign and domestic sources, can be expected to have a differential impact on the exchange rate and domestic interest rates respectively. Thus, the magnitude of the EBR and the pattern of its financing may transmit pressures to the exposed sectors of the economy.

If the world were characterised by perfect capital mobility, if all financial assets were perfectly interchangeable, and if there was certainty about future movements in exchange rates, interest rates in Ireland would be the same as those obtaining internationally and this relationship would exist independently of the pattern of funding of the EBR.

However, the conditions necessary for the establishment and maintenance of one-for-one parity between domestic and foreign interest rates do not exist: all financial assets are not perfectly interchangeable, in particular, government bonds are not regarded as being perfect substitutes for other assets; there is no certainty about the future evolution of exchange rates so that exchange rate risk characterises borrowing and lending in foreign currencies and, exchange control regulations restrict capital mobility. The conjunction of these factors means that interest rates in Ireland may diverge significantly from those obtaining internationally and that there may be a differential effect on domestic interest rates arising from domestic as against external financing of the EBR.

The greater the proportion of the EBR financed from domestic sources, all other things equal, the greater will be the pressure on domestic interest rates. Moreover, the cumulative effect of financing the EBR from domestic sources over time may provide an additional source of upward pressure to domestic interest rates as the share of government debt in the portfolio of financial institutions increases, leading private savers to demand higher rates of return on government debt.

The existence of a differential between domestic and foreign interest rates need not necessarily generate private capital inflows. Evidence in support of this is provided by the experience of Denmark in 1982 when large private capital outflows occurred despite the fact that Danish interest rates were substantially higher than those obtaining in the US and in most other EMS countries, especially Germany. The outflow of private capital from the Danish economy was reversed in the period to 1985 even in the face of a marked reduction in interest rate differentials.

The likelihood of a private capital inflow taking place when Irish interest rates exceed those generally prevailing overseas depends in part on expectations about future movements in the exchange rate. If the domestic currency is perceived as being susceptible to depreciation or devaluation, prospective foreign investors in financial assets whose rates of return are denominated in Irish pounds will require a risk premium. Where a firm and credible commitment to a fixed exchange rate regime is being pursued however, no such risk premium will be demanded. Where a firm and credible commitment to a quasi-fixed exchange rate regime, such as the EMS, is in place the magnitude of the potential risk premium will be related to the extent to which the value of the currency can decline while still remaining within the parameters of the quasi-fixed regime. In the context of Ireland’s membership of the EMS the relevant parameters are set by the narrow band.

In contrast to domestic financing, external financing of the EBR has a direct effect on the balance of payments, through the associated official capital inflow which takes place. Because of this, external financing directly affects the exchange rate by exerting upward pressure on the currency’s value. External financing may result in the maintenance of an exchange rate for the domestic currency which would otherwise be unsustainable. Moreover, just as there may be a ‘portfolio’ effect on domestic interest rates arising from an accumulating stock of foreign government debt, there may be an analogous effect on the exchange rate associated with an accumulating stock of exchangeable foreign debt. The prevention of capital losses on the stock of foreign debt outstanding is one of the considerations informing the government’s resistance to currency depreciation or devaluation.

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At the risk of excessive simplification the options available to government in financing its borrowing requirement and the consequences of pursuing the respective options may be summarised as follows. The EBR may be financed primarily from domestic sources as was increasingly the case between 1983 and 1985. The availability of domestic funds for financing the EBR in 1986 however, has been severely circumscribed because domestic liquidity has been sharply reduced by a large outflow of funds from the economy, recorded as a residual item in the balance of payments accounts. This outflow totalled £1.5bn in the 9 months to June 1986. The precise composition of this outflow is unknown and the factors responsible for it are the subject of considerable uncertainty. However, it is evident that its existence has significantly altered the balance between the demand for and supply of credit in the economy with considerable upward pressure on domestic interest rates resulting.
Alternatively the EBR may be financed primarily by means of foreign borrowing which was the case in the late 1970s and early 1980s, in which case, although upward pressure on domestic interest rates may be avoided, there is likely to be upward pressure on the exchange rate. This pressure comes directly via the balance of payments and may come indirectly because of the heightened resistance of government to devaluing the currency in order to prevent the avoidable capital losses on foreign debt which this would give rise to.

Either strategy may lead to a crowding-out of private sector economic activity. Increased domestic interest rates will significantly reduce the profitability of firms which are heavily borrowed, but, more importantly, by changing the relative rates of return on financial and physical assets in favour of the former, will reduce the level of physical capital formation and thereby reduce the economy's potential for growth in the medium-term. The maintenance of an overvalued exchange rate will, in the absence of compensating cost adjustments, erode the competitiveness of the exposed sectors of the economy and will lead to the reduction of output and employment and the scrapping of productive capacity, especially in price-sensitive industries and in firms where profit margins were already small.

(vii) The Fiscal Policy Response to the Oil Price Fall

Independently of the need to restore balance to the public finances a question relevant to the conduct of policy at the present time concerns the response of fiscal policy to the fall in oil prices. In this section the considerations which should inform that response are set out.

In Chapter 5 some general observations were made about the impact effect of an oil price fall on the Irish economy. It was estimated that the transfer of income to the domestic economy arising from crude oil prices averaging $16.50 per barrel in 1986 and an average Irish pound-dollar exchange rate of about 1.35, would amount to about two and a half percent of GNP. It was stated that this transfer of income to the domestic economy can be apportioned between the household sector through a reduction in the consumer price index, the corporate sector through a reduction in costs of production, and the Government sector through a fall in the cost of goods and services which it purchases.

The impact effect on the Government sector could be transmitted through two general channels: (i) the fall in oil prices per se would reduce Government expenditure to the extent that the Government sector is a direct consumer of oil and oil-related products and, (ii) the reduction in inflation induced by falling oil prices could allow a reduction in nominal public spending on goods and services, including wages and salaries, and transfer payments, while leaving the real value of such spending unchanged. As regards the first channel, data on fuel costs as a proportion of total costs are not available for the public sector but they are likely to be relatively small. As regards the second channel, it has already been indicated that the gains accruing to the household sector from the oil price fall will be the greater and the gains to the Government sector the smaller, the weaker is the tendency for nominal wage trends in the public sector and nominal rates of increase in social welfare payments to adjust downwards to the lower rate of inflation.

In this context it is worth referring to the circumstances surrounding the most recent increase in Social Welfare transfer payments and public sector pay rates. The increase in transfer payments of 4.4.5 per cent to take effect from mid-July 1986 to mid-1987, was determined at a time when the inflation rate for 1986 was projected at 4.5 per cent. Similar forecasts of inflation underpinned the current Public Sector Pay Agreement, negotiated towards the end of 1985, which provided for a cumulative increase in pay rates of 7.2 per cent over the period to mid 1987. Since both sets of commitments were entered into inflation projections have been revised substantially downwards: inflation in 1986 is now forecast at 3 — 3.5 per cent and for 1987 inflation is expected to about 2.5 per cent.

As a result of these commitments the possibility of current expenditure reductions being effected on foot of the fall in oil prices and the associated fall in inflation has been sharply circumscribed. Reductions in nominal spending which might have been facilitated because of lower inflation have effectively been pre-empted to the middle of 1987 in respect of transfer payments, net expenditure on which accounts for 25 per cent of total supply service spending and, in respect of the Exchequer pay bill which accounts for 46 per cent of supply service expenditure. Given that the balance of supply service spending in respect of which nominal reductions might be effected on foot of decelerating inflation is small — at most 28 per cent of the total — it is worth considering whether the government sector might attempt to retrieve, by means of tax increases, some portion of the windfall gains which would otherwise be conferred on the household sector by the fall in oil prices. Such a strategy might be justified on the grounds of reducing the public sector deficit but could also be justified on more general macro-economic grounds if it were felt that a boom in consumer spending were to result in nothing more than an increase in the volume of imports with no permanent benefits resulting for the economy as a whole. It is worth noting that a number of European Governments have responded in such a way to the oil price fall.

The Danish government in April 1986 taxed away the full amount of the fall in the price of oil imported into Denmark.

See EBR Quarterly Economic Commentary, August 1986.
There are a number of options in regard to increasing taxes:

(i) the gain from the oil price fall could be taxed at source by imposing higher taxes on oil and oil-related products;
(ii) taxes on personal income could be increased or,
(iii) taxes on non-oil expenditure could be raised.

The macro-economic effects would differ significantly as between these broad options. The second option would erode the competitiveness of the exposed sectors of the economy if increased income taxes were simply passed on in higher wage demands rather than accepted as a measure the purpose of which was to tax windfall gains accruing to employees in the aftermath of the oil price fall. Moreover, this option may also be deemed undesirable on the grounds that the existing rates of personal income tax, given the structure of the income tax system and the narrowness of the tax base, are already too high and a source of serious distortions in the labour market.

The first option is inherently more attractive on the grounds that preventing the benefits of the oil price fall from being passed on in full to oil consumers would encourage continued energy conservation at a time when the future course of oil prices is extremely uncertain. Such a strategy could have the effect of obviating the possible dislocation of economic activity following the large fall in oil prices and future dislocations which would ensue in the event that oil prices moved sharply upwards again. Within this broad option it would be possible and desirable to differentiate the tax treatment of oil products consumed by the household and corporate sectors respectively: to pass on the full benefit of the oil price fall to industry and agriculture in order to secure the competitive position of these sectors, while taxing in full or in part the benefits which would otherwise accrue to personal consumers.

A disadvantage attaching to this option would be that the inflation rate would not decelerate as much as would otherwise be the case. This might exert upward pressure on wage settlements. However, given the margin by which increases in wage rates under recent settlements have outrun the prospective inflation rate for the coming year, it is arguable that the modest increase in the CPI which would be associated with increased taxes on oil products to personal consumers would leave the rate of increase in wages broadly unchanged.

The third option mentioned above would have broadly similar effects to increased taxes on oil products. However, the incidence of non-oil expenditure taxes is likely to be such that unless tax increases could be concentrated on items which are imported the results would include some reduction of output and employment in consumer goods producing sectors of the economy.

The extent to which the first option (or indeed the last-mentioned option) could be effectively pursued is limited by the existence of a land frontier with a different tax jurisdiction. Unless additional taxes were levied on consumer oil products in Northern Ireland, especially petrol, the pursuit of such an option in the Republic would generate some increase in cross-border purchases.

The options identified in the preceding paragraphs would involve the highly selective application of tax increases to specific areas and are advanced as a response to a specific set of circumstances and not as a strategy for correcting the fiscal imbalances in the medium term.

3. EXCHANGE RATE POLICY

(i) The Fiscal Policy Background

The assumptions underpinning the analysis of fiscal policy in the previous section were of an unchanged exchange rate for the Irish pound over the period to 1990, and a modest reduction in interest rates from their present level. Any reduction in the Irish Pound’s value over this period, all other things equal, will make redefining the imbalances in the public finances more difficult.

Some 40 per cent of the outstanding stock of National Debt has been contracted outside the State. A fall in the value of the Irish Pound relative to the currencies in which that portion of the debt is denominated, directly increases the value of the National Debt outstanding. Thus, a fall in the value of the Irish Pound, of say 10 per cent, will increase the National Debt by 4 per cent. For a given value of GNP, this would have had the impact effect of increasing the end-1985 National Debt-GNP ratio from 134 to almost 140 per cent. A related effect would be an increase in the cost of servicing the debt. Again, for a given value of GNP, the proportion of GNP pre-empted by National Debt interest payments would also be increased. All other things equal therefore the consequences of a falling exchange rate would be a tightening of the parameters within which fiscal policy has to operate together with an intensification of the severity of the measures required to restore balance to the public finances.

However, in the aftermath of a fall in the value of the currency all other things are unlikely to remain unchanged. A lower exchange rate not only changes the valuation of external liabilities and the cost of servicing them but also changes the Irish pound value of exports and imports of goods and services. For this reason a decline in the exchange rate may help to boost GNP. Whether, and for how long this happens, will depend on how the economy responds.
(ii) Output and Employment Effects

The impact effect of a devaluation is to increase the price of imports and to increase the prices obtained for exports in domestic currency terms. The higher import prices will lead to an immediate increase in the overall price level by an amount reflecting the share of imports in all goods and services consumed. Together with increased prices of exports, higher import prices will increase the profitability of firms in the tradable goods sector of the economy and/or permit increased market penetration on the part of such firms by means of lowering their prices relative to competitors. The duration of such increased profitability and the sustainability of whatever expansion in output and employment is thereby generated will depend upon the speed with which costs of production determined within the domestic economy, particularly labour costs, adjust to higher import prices.

The success of a devaluation in terms of the boost it imparts to output and employment depends in large part on a reduction in real wage and salary levels. A common rationale for a devaluation is that real wage and salary levels have become too high given the pre-existing value of the exchange rate. This raises a fundamental question: That is, whether the conditions necessary for a successful devaluation are any more likely to be achieved in the aftermath of the reduction in the currency’s external value than prior to the event. In other words is it realistic to expect a devaluation to achieve what the wage negotiation process has failed to deliver?

Simulation exercises carried out by the Central Bank concluded that a depreciation of the currency would provide only a temporary boost to output and employment. The simulations indicate that the extent of the devaluation would be almost entirely transmitted to import, export and output prices within 12 months and to consumer prices in the course of the second year. Wages are somewhat slower to adjust but even so it is estimated that within two years they would evolve in such a way as to compensate workers for about three-quarters of the cut in purchasing power sustained by them. The growth of export volumes would accelerate and that of import volumes decelerate but in both cases the effect would begin to peter out at the end of the first year, and become negligible within 3-4 years. The ultimate effect therefore, would be to leave the real economy unchanged but to leave the price level permanently higher than it would otherwise be, by the full extent of the devaluation.

A survey conducted earlier this year by the CII provided some indication of the sensitivity of output and employment in Irish industry to movements in the Irish Pound-Sterling exchange rate. On the basis of a questionnaire response it emerged, predictably, that the most sensitive sectors are those which compete primarily with UK firms, whether on the home or UK market, and which are engaged in the more traditional labour intensive activities such as textiles, clothing, footwear and some branches of food processing. In contrast the responses from the new industrial sectors indicated little or no sensitivity on this score.

The material in Chapter 2 showed that hourly earnings in manufacturing industry in domestic currency terms have increased significantly relative to the UK since our accession to EMS membership in 1979. However, when adjusted for movements in the Irish Pound-Sterling exchange rate, it emerged that the real exchange rate vis-à-vis the UK (the measure which is of most relevance as a barometer of labour cost competitiveness for the more traditional manufacturing sectors) depreciated between 1979 and 1985. More specifically the real exchange rate vis-à-vis the UK declined by almost 13 per cent in the 1979-1981 period because of the very large nominal depreciation which occurred over these years. Despite this, large reductions in output were recorded by many of the older branches of manufacturing, partly, it should be noted, because of the impact of the second oil crisis.

Moreover, the increase in profitability in the sectors concerned which might have been expected to accrue from exchange rate movements either did not materialise or, if it did, was not translated into the type of investment which might have made these industries more efficient and more competitive in the medium to long-term. The result was that when the favourable real exchange rate movements of 1979-1981 were followed by adverse movements in subsequent years, output and employment levels continued to contract, and at an accelerating rate.

This brief discussion helps to highlight an important point which is rarely made in relation to exchange rate policy, namely the impact of a depreciating or devaluing currency on the price of imported capital goods. The evidence from recent years would suggest that there are serious long-term structural problems which need to be corrected in the labour-intensive sectors of Irish industry, including chronically low levels of labour productivity. The resolution of these problems will involve inter alia, the adoption of more

---

*The evolution of output between 1979 and 1981 was as follows:

<table>
<thead>
<tr>
<th>Sector</th>
<th>1979</th>
<th>1980</th>
<th>1981</th>
</tr>
</thead>
<tbody>
<tr>
<td>Textiles</td>
<td>132</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Clothing</td>
<td>91</td>
<td>86</td>
<td>85</td>
</tr>
<tr>
<td>Footwear</td>
<td>69</td>
<td>69</td>
<td>69</td>
</tr>
<tr>
<td>Timber and Furniture</td>
<td>102</td>
<td>90</td>
<td>89</td>
</tr>
</tbody>
</table>

---
efficient production techniques through investment in superior machinery and equipment. Given that Ireland is not a capital goods producing country the required investment goods will have to be imported. A depreciating currency implies a higher cost for such imported machinery and equipment and constitutes a disincentive to such investment.

In this connection it is worth noting that the relative success of some of the traditional manufacturing sectors in Austria has been attributed to the hard currency regime pursued by the Austrian authorities. It is argued that a non-accommodating exchange rate policy has brought about structural change through two channels: (i) the innovation-promoting pressure which adverse movements in the real exchange rate bring about in the short-term and, (ii) the lower cost of imports which makes the importation of more efficient machinery and equipment more attractive.

(iii) Objectives of Exchange Rate Policy
From the point of view of cost competitiveness two broad alternative strategies for the exchange rate may be distinguished. The first of these may be termed a non-accommodating strategy whereby the nominal exchange rate is held constant irrespective of the evolution of domestic costs relative to those in our main trading partners. If domestic costs increase more than those faced by our trading partners the consequence will be an appreciation in the real exchange rate and a deterioration in competitiveness, at least in the short-term.

An accommodating exchange rate policy might be defended on the grounds that it obviates the reductions in output and employment which would result from the appreciation in the real exchange rate which would otherwise take place. This prompts two vital and interrelated questions. The first question concerns the timespan over which competitiveness and output and employment levels can be sustained by such an exchange rate policy. The second is whether the exchange rate is the appropriate instrument for securing or maintaining competitiveness.

The evidence from the simulation exercise conducted by the Central Bank and referred to above provides the answer to the first question. A reduction in the nominal exchange rate increases the domestic currency price of exports and imports on impact, and increases consumer prices soon thereafter. Moreover, labour costs also increase though with a somewhat longer time lag. The net result is that ultimately the real economy, that is, the magnitude of such variables as export and import volumes, output and employment levels, is left unchanged. The only variable permanently affected by a reduction in the nominal exchange rate is the domestic price level. The evidence from

the Central Bank simulations therefore, is that the competitiveness gains and the boost to output and employment levels initially generated by an accommodating exchange rate strategy are not sustained.

The crucial mechanism determining this conclusion is the response of labour costs to changes in the domestic price level. If labour costs did not adjust, or adjust only partially, to compensate wage and salary earners for the higher inflation induced by a reduction in the nominal exchange rate, then it is likely that such a reduction would produce a permanent boost to output and employment levels.

However the relationship between labour costs and prices, the determination of the purchasing power of wages and salaries, is a matter for the wage negotiation process. It cannot realistically be expected that it can be resolved by exchange rate policy. Accordingly the exchange rate should not be seen as a policy instrument of last resort or used as a substitute for the wage negotiation process or other cost-determining mechanisms if the latter fail to ensure the competitiveness of the traded sectors.

Rejection of an accommodating exchange rate strategy does not imply that policy in relation to the exchange rate has no role to play in protecting the competitiveness of the internationally trading sectors of the economy. If domestic costs remain unchanged relative to costs of production in our main trading partners, stability of the nominal effective exchange rate will protect competitiveness. If domestic economic agents, including wage and salary earners, exercise discipline in respect of costs of production determined within the Irish economy they should not be penalised by competitiveness losses resulting from a rise in the nominal effective exchange rate.

There are other mechanisms through which exchange rate policy can contribute to the maintenance of competitiveness. In the longer term the ability of the exposed sectors of the Irish economy to compete effectively on international markets will depend on the continuous reallocation of resources towards branches of activity where competitive advantage can be sustained and away from activities where low labour costs are the key to competitive success. An essential ingredient in this restructuring will be investment, not only in physical assets but also in areas such as marketing, research, and product and process development.

An accommodating exchange rate policy is unlikely to provide an environment conducive to such restructuring and to carrying out the requisite investment. Firstly, such a policy, by attempting to compensate for excessive domestic cost increases, may create the illusion that exchange rate adjustments are the key to competitive success, deflect attention from the real determinants of competitiveness and postpone the undertaking of the restructuring and investment required to address fundamental problems of inefficiency and low

177
labour productivity. Secondly, as pointed out above in the reference to the Austrian experience, an accommodating exchange rate policy would make the importation of the capital goods required for upgrading production processes more expensive for Irish industry. Thirdly, a weak and declining exchange rate is associated with interest rates higher than those obtaining in our main trading partners.

Pursuit of an accommodating exchange rate policy, particularly in an economy where the markets are of the view that the commitment to fiscal policy is weak, will generally necessitate an interest rate premium over those prevailing internationally. Such a premium reflects, inter alia, the markets' view on the likelihood of devaluation. Adverse effects on private investment and government debt servicing result. An explicit non-accommodating exchange rate policy on the other hand gives rise to expectations of a stable currency with attendant beneficial implications for domestic interest rates.

The case of Denmark is particularly interesting in this regard. Between the end of 1982 and early 1986 long-term interest rates in Denmark fell from 22 to 10 per cent. The interest rate differential narrowed significantly against Germany and fell to zero vis-à-vis the US. The fall in interest rates is generally attributed to improved market expectations arising from the decision to maintain a stable exchange rate within the framework of the EMS, an incomes policy aimed at improving competitiveness through wage guidelines, a tightening of fiscal policy, and the liberalisation of capital controls. It is particularly notable that notwithstanding the sharp fall in interest rates and the substantial narrowing of interest rate differentials vis-à-vis international capital markets, a substantial net capital inflow into Denmark has taken place replacing the large capital outflows which occurred in 1982.

The objective of exchange rate policy can be summarised as securing an external value of the currency which provides a stable environment within which the internationally trading sectors can operate. For operational purposes this can be translated into stability of the nominal effective exchange rate. The exchange rate should not be used as an instrument for achieving competitive adjustment — that is the role of the economic agents who determine domestic cost increases — but as a means of underpinning the discipline over costs which needs to be achieved within the domestic economy.

The pursuit of correct exchange rate policy can help to achieve control over costs of production principally through its powerful influence on the rate of inflation and on interest rates.

(iv) Institutional Arrangements
Since 1979 Ireland has been a member of the EMS. This involves a commitment to maintaining bilateral central rates against the other EMS currencies. The Irish pound in common with the currencies of its EMS partners therefore floats against sterling, the US dollar and all other currencies. The central rates in the EMS are not rigid, adjustments are possible with a view to bringing rates into more desirable alignments. Under the provisions governing the EMS, adjustments of central rates are “subject to mutual agreement by a common procedure which will comprise all countries participating in the exchange rate mechanism and the Commission”.

Against the basket of EMS currencies, adjustment of the nominal exchange rates is theoretically possible. There is however, a general expectation within the system that commitment to EMS membership will impose discipline on the conduct of domestic policy, i.e. that the authorities will pursue domestic policies which are compatible with a commitment to maintaining the exchange rate within specific margins of the central rate. While membership of the EMS does permit control over the nominal rates against EMS currencies, though subject to certain obligations, the fact that the EMS group of countries accounts for only 28% of our trade (Table 8.2) implies that control over the trade-weighted effective exchange rate is circumscribed. For example, if the objective of policy is to maintain relatively stable nominal exchange rates within the EMS then the nominal trade weighted exchange rate will fluctuate in line with fluctuations of sterling and the dollar against the EMS basket. Given that the sterling and dollar exchange rates are outside the control of the authorities the degree of influence over the nominal trade weighted exchange rate is attenuated.

<table>
<thead>
<tr>
<th>Year</th>
<th>% Shares</th>
<th>Exports UK</th>
<th>Exports EMS</th>
<th>Imports UK</th>
<th>Imports EMS</th>
<th>Average UK</th>
<th>Average EMS</th>
</tr>
</thead>
<tbody>
<tr>
<td>1971</td>
<td>9.7</td>
<td>66.0</td>
<td>11.7</td>
<td>49.5</td>
<td>11.2</td>
<td>57.8</td>
<td></td>
</tr>
<tr>
<td>1975</td>
<td>18.4</td>
<td>56.4</td>
<td>21.7</td>
<td>46.6</td>
<td>20.1</td>
<td>51.5</td>
<td></td>
</tr>
<tr>
<td>1978</td>
<td>30.2</td>
<td>47.1</td>
<td>20.8</td>
<td>49.5</td>
<td>25.5</td>
<td>48.4</td>
<td></td>
</tr>
<tr>
<td>1979</td>
<td>31.1</td>
<td>46.4</td>
<td>21.6</td>
<td>50.0</td>
<td>26.4</td>
<td>48.2</td>
<td></td>
</tr>
<tr>
<td>1980</td>
<td>31.7</td>
<td>42.7</td>
<td>20.1</td>
<td>50.8</td>
<td>25.9</td>
<td>46.8</td>
<td></td>
</tr>
<tr>
<td>1981</td>
<td>29.8</td>
<td>39.1</td>
<td>21.2</td>
<td>49.7</td>
<td>25.2</td>
<td>44.7</td>
<td></td>
</tr>
<tr>
<td>1982</td>
<td>31.6</td>
<td>39.0</td>
<td>22.2</td>
<td>48.2</td>
<td>26.9</td>
<td>43.6</td>
<td></td>
</tr>
<tr>
<td>1983</td>
<td>31.7</td>
<td>36.9</td>
<td>21.8</td>
<td>45.4</td>
<td>26.8</td>
<td>41.2</td>
<td></td>
</tr>
<tr>
<td>1984</td>
<td>33.7</td>
<td>34.4</td>
<td>21.7</td>
<td>42.9</td>
<td>27.7</td>
<td>38.7</td>
<td></td>
</tr>
<tr>
<td>1985</td>
<td>34.1</td>
<td>33.0</td>
<td>21.8</td>
<td>42.7</td>
<td>28.0</td>
<td>37.9</td>
<td></td>
</tr>
</tbody>
</table>

Source: Trade Statistics of Ireland, various issues

Any significant movement of the EMS group of currencies against non-EMS currencies, particularly sterling, gives rise to adjustment difficulties for Ireland. This is well illustrated by the experience since the end of 1985. By the end of July 1986 the Irish pound had strengthened against sterling by 13% over the average rate for 1985. Such sharp movements pose severe adjustment difficulties for those who export to the UK and for those who face UK
competitors on the domestic market. The problems posed by the short sharp appreciation is that the loss of competitiveness is immediate but that whatever benefits may accrue take much longer to come about. Moreover, compounding the problem, is the fact that the branches of manufacturing industry most exposed to fluctuations in the Sterling exchange rate tend to be amongst the most price-sensitive and labour-intensive.

For these reasons exchange rate policy cannot be indifferent to the configuration of exchange rates across various currency blocs. At the same time policy must be formulated with reference to the entire economy rather than responding to the particular situations of individual sectors. There is an onus on individual sectors to diversify the geographical orientation of their trade with a view to minimising their trade exposure to any particular currency. However, the policy action taken in the particular circumstances of a prolonged appreciation/appreciation of sterling vis-a-vis the EMS must have regard to the stability of the overall trade-weighted nominal effective exchange rate.

4. INCOMES POLICY

(i) Labour Costs and Competitiveness

In the long-term the potential rate of economic growth is determined by the rate of expansion in the productive capacity of the economy. In the short-term economic growth is determined by the degree of utilization of the productive capacity already in place. This degree of utilization is in turn dependent on the economy's international competitiveness.

Competitiveness in its broadest sense may be defined as that combination of elements which enables a firm to secure sales at the expense of market rivals. These elements can be divided into two broad categories, price and non-price factors. Non-price factors include such items as speed and reliability of delivery, after sales service, product quality and design, and marketing effectiveness. The source of competitive advantage will vary between businesses. In some businesses the cost and quality of raw materials may be the key determinant of competitive advantage. Agriculture-based industries fall into this category. In other businesses competitive advantage may be attained through the skill levels of the workforce or through technological innovation. In still other businesses levels of remuneration are the key factor in determining competitiveness.

Chapter 2 presented data on the cost structure of Irish industry and showed how the structure of costs varied between sectors. By far the largest element in costs is raw materials, which comprise 60 per cent of the value of gross output. But the largest element which is entirely susceptible to domestic control is wages and salaries, which account for over 40 per cent of manufacturing net output. From the perspective of the economy as a whole the importance of labour costs (wages, salaries, pensions and employers' PRSI contributions) can be gauged by the fact that in 1985 they amounted to almost 80 per cent of National Income.

In Chapter 7 it was pointed out that it is the internationally trading sectors of the economy which comprise the locomotive of economic growth. These sectors are subject to an inexorable discipline on costs of production because of the market environment in which they operate. In general, firms producing for the export market, or competing with imports on the domestic market, cannot pass on cost increases by raising prices above those charged by their competitors. Cost increases in excess of those experienced by competitors have to be absorbed by reductions in profit margins. Falling profit margins in turn lead to rationalizations or close-downs, and thus reductions in output and employment. Falling profits also render it more difficult to finance the investment required to effect the improvements in efficiency and productivity required to maintain competitiveness in the medium term.

Improving the cost competitiveness of the internationally trading sectors is not simply a question of limiting wage and salary increases to what is sustainable. It extends to controlling the costs of goods and services bought in from the sheltered sectors of the economy and also the costs of goods and services provided by the public sector. The sheltered sectors are not subject to the same discipline on costs as the exposed sectors, because cost increases there can be more readily passed on to consumers in higher prices or, in some cases, to taxpayers in higher taxes. This is especially the case when it is possible to exercise monopoly power. If a situation prevails whereby excessive cost increases are passed on by enterprises in the sheltered sectors to those engaged in international trade, the competitiveness of the latter is impaired. Policy in relation to the evolution of incomes in particular, and the improvement of competitiveness more generally, must acknowledge this fact.

(ii) Recent Trends in Incomes and Labour Costs

Before reviewing the recent trends in labour costs, it is useful to have as background the evolution of living standards over the period since 1980. Table 8.3 presents the details. Real gross personal income increased by 1.5 per cent over the five year period. However, when taxes on income and wealth are deducted, a real decline of 7 per cent emerges. A comparison of these two figures indicates the magnitude of the effect of taxation. The implications of this are discussed further below.

The various indicators of labour cost competitiveness and their evolution over the period 1980-85 have been extensively dealt with in Chapter 2. The main trends may be summarised as follows:

(a) in the period since 1980 average hourly earnings in manufacturing increased by a cumulative 20 per cent relative to our main trading partners in domestic currency terms;
Table 8.3
Personal Disposable Income 1980-85 (Annual % Change)

<table>
<thead>
<tr>
<th>Year</th>
<th>Gross Personal Income</th>
<th>Real Gross Personal Income</th>
<th>Disposable Personal Income</th>
<th>Real Disposable Personal Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>1981</td>
<td>+22.8</td>
<td>+2.0</td>
<td>+22.7</td>
<td>+1.9</td>
</tr>
<tr>
<td>1982</td>
<td>+13.9</td>
<td>-2.8</td>
<td>+11.8</td>
<td>-4.6</td>
</tr>
<tr>
<td>1983</td>
<td>+8.6</td>
<td>+0.7</td>
<td>+6.7</td>
<td>+3.5</td>
</tr>
<tr>
<td>1984</td>
<td>+9.1</td>
<td>+0.5</td>
<td>+7.1</td>
<td>-1.4</td>
</tr>
<tr>
<td>1985</td>
<td>+6.1</td>
<td>+0.6</td>
<td>+5.9</td>
<td>+0.5</td>
</tr>
<tr>
<td>1980-85</td>
<td>+75.7</td>
<td>-1.5</td>
<td>+65.9</td>
<td>-7.0</td>
</tr>
</tbody>
</table>


(b) exchange rate movements over the same period, however, accommodated to these increases such that relative earnings in a common currency remained stable (this was due entirely to movement in the Irish pound-dollar rate - a real deterioration of 1% per cent was experienced against the EMS);

(c) the average annual rate of increase in earnings between 1980 and 1985 was somewhat higher in the 'new' (12.9 per cent) than in the old sectors (11.6 per cent) with differential movements emerging mainly after 1983;

(d) unit labour costs in the new sectors declined at an annual average rate of 1.2% per cent between 1980 and 1985 with the older industries experiencing a rise of 0.4% per cent annually; and

(e) the tapering off of unit labour cost increases in the 'old' sectors between 1983 and 1985 reflects rapid increases in productivity brought about by labour shedding as a defensive response to competitive pressures.

The conjunction of falling living standards as measured by real personal disposable income, and deteriorating competitiveness comments. This combination of events cannot be explained by noting that the reduction in real personal disposable income highlighted in Table 8.3 is entirely attributable to increased taxes on personal income and wealth which, as Chapter 3 indicated, were used to prevent a further deterioration in the public finances.

Increased taxes have created a substantial and expanding wedge between labour costs to the employer and the net wages received by the employee. In manufacturing industry, between 1980 and 1985, gross labour costs in real terms increased by 13% per cent while the real disposable income of a single (married) male employee on average industrial earnings declined by 14% (10.1) per cent, creating a differential or wedge of 27.3 (23.1) percentage points over the period.

The wedge can be decomposed into a number of elements (see Table 8.4.) The addition of payroll taxes to the wage bill of the employer and the deduction of personal income taxes from the earnings of the employee are two elements. The third component arises from the fact that the employer and employee face different price movements when computing the real movements in their respective variables. From the employer's perspective the relevant price index is the CPI while from the employer's viewpoint the relevant price index is that which measures his selling prices. The difference between the two price indices is brought about partly by the imposition of indirect taxes. Over the period 1980-85 the increase in the 'wedge' of 27.3 points for single persons on average industrial earnings can be apportioned as follows: payroll taxes, 2.7 points; income taxes, 14.7 points and, indirect taxes, 9.9 points.

Table 8.4
Components of Real Wedge Increase (% Annual Change)

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Increase</th>
<th>Payroll Taxes</th>
<th>Income Taxes</th>
<th>Indirect Taxes</th>
</tr>
</thead>
<tbody>
<tr>
<td>1981</td>
<td>+ 4.9</td>
<td>+ 0.2</td>
<td>+ 1.1</td>
<td>+ 1.6</td>
</tr>
<tr>
<td>1982</td>
<td>+ 7.8</td>
<td>+ 1.5</td>
<td>+ 3.4</td>
<td>+ 2.8</td>
</tr>
<tr>
<td>1983</td>
<td>+ 8.4</td>
<td>-</td>
<td>+ 4.4</td>
<td>+ 2.9</td>
</tr>
<tr>
<td>1984</td>
<td>- 9.1</td>
<td>+ 0.1</td>
<td>+ 1.4</td>
<td>+ 0.6</td>
</tr>
<tr>
<td>1985</td>
<td>+ 6.1</td>
<td>+ 0.1</td>
<td>+ 1.3</td>
<td>+ 0.8</td>
</tr>
<tr>
<td>1980-85</td>
<td>+27.3</td>
<td>-1.2</td>
<td>+14.7</td>
<td>+ 9.9</td>
</tr>
</tbody>
</table>

(1) Be amount of the 'wedge' attributable to increases in indirect taxes can only be approximated. The constant tax CPI excludes price movements due to changes in the absolute tax content of items.

The decline that has taken place in real after-tax wages over the 1980-85 period has come about mainly through an increase in the tax burden. As a result income has been transferred to the public sector rather than to enterprises. There has not been a commensurate fall in labour costs nor a corresponding improvement in competitiveness. The existence of a large and increasing tax wedge, interposing itself between the respective measures of labour costs/income used by the two sides in the wage bargaining process has not been conducive to the achievement of moderation in the growth of labour costs.

* Ideally the index of manufacturing output prices should be used for this purpose but for the purpose of the table it was assumed that the constant tax CPI has been used since this permits the impact of indirect tax increases on the overall CPI to be identified. In the event the constant tax CPI and the index of manufacturing output prices increased at broadly comparable rates over the period.

**Table 8.3 continued on next page.**
(iii) Policy Issues

The background against which incomes are set to evolve in the medium term is likely to differ in one very important respect from recent periods. What is now in prospect is a period of low and decelerating inflation to 1987 followed by a period of low inflation thereafter. What implications this may have for the trend in real wages is uncertain since there is little by way of comparable previous experience on which to base a judgement on this score.

In times of high and rising inflation real wage moderation is likely to occur through a failure of nominal wage growth to match price increases especially when inflation is unanticipated. Real wage moderation may be more difficult to achieve in times of falling inflation due to downward inflexibility in nominal wage growth. Such inflexibility may be due in part to doubts on the part of wage earners that the reduction in inflation is other than transitory. In any event the evolution of wage increases under the 26th round to date would suggest that pay settlements are responding with a lag to developments in prices.

Whatever about low and declining inflation presenting a point of contrast between the prospective medium-term situation and the recent past, the other principal features of the medium-term outlook relevant to the evolution of incomes are unchanged in essence. In particular the constraint imposed on the growth of incomes by the need to maintain and improve competitiveness remains. If employment and output are to grow more rapidly than the projections of Chapter 6 suggest, a considerable strengthening of international competitiveness in all its facets will be required. This requirement assumes even greater urgency given that fiscal policy must of necessity be restrictive.

Projections of wage developments in our main trading partners provide the guidelines for the evolution of incomes in the exposed sectors of the Irish economy. For the OECD as a whole hourly earnings in manufacturing are projected to rise on average in 1986 and 1987 by 43/4 and 13/4 per cent respectively, while unit labour costs are projected to increase by 21/2 per cent in 1986 and by 13/4 per cent in 1987 for the seven major industrial countries. There can be little doubt that if wage increases in Ireland tend to outstrip these, further employment losses will be sustained. There are a number of ways in which government policy can create an environment conducive to the achievement of wage moderation.

Firstly, by ensuring a rapid feed through into the domestic price level of the recent reduction in oil prices and the prices of other imported goods. Failure to do this at least as quickly as is occurring in our main trading partners will inevitably result in a competitive disadvantage. Competition policy, discussed in the final section of this chapter, has a key role to play in this regard.

Secondly, directing macro-economic policy to achieving a sustained reduction in the inflation rate will help to substantially reduce inflationary expectations. It is only by sustaining low inflation for a number of years that confidence in a low inflation future can be strengthened. In an economy such as Ireland's exchange rate policy has a key role to play in this regard.

Thirdly, policy in relation to taxation can ensure that the tax wedge discussed earlier, does not exacerbate the wage negotiation process. Indexation of tax bands and allowances to the CPI for example, would help to make the system of direct taxation neutral with regard to non-inflationary wage settlements. A policy of reducing marginal rates of income tax by expanding the personal income tax base, as suggested in Chapter 10, would help to remove other distortions which the present tax system introduces into the wage negotiation process.

Fourthly, the evolution of public sector pay has implications for wage and salary increases in the private sector, directly through the concept of comparability and indirectly through the pressure which high rates of pay increase in the public sector exert on the public finances and which is transmitted to the private sector through increased taxes and/or increased costs of publicly provided goods and services. In this regard it may be noted that the annual average of real per capita public sector pay was -0.7 per cent between 1980 and 1985 though this figure conceals significant differences in the year-to-year changes.

The mechanisms available to Government to directly influence private sector settlements are limited. Since 1982 a system of decentralised wage negotiations has replaced a system of centralised national wage agreements. Under the decentralised system achieving the requisite level of wage moderation is largely dependent on individual firms linking wage settlements with ability to pay. Aside from exhortation and a public education function (which should not be underestimated) the main policy instruments available to Government to influence private sector wage settlements are those which shape the background against which wage negotiations are carried out. The outcome of the various cost-determining processes should be that the average rate of cost increase in Ireland not exceed the weighted average of cost increases in our main trading partners. Government policy should be directed to providing the environment most conducive to achieving this outcome.

5. COMPETITION POLICY

Competition policy has featured in the preceding discussion on two occasions. Firstly, it was indicated that it has a role to play in ensuring that the benefits of international oil price reductions are passed through fully and speedily. This consideration also applies in respect of a feed-through resulting from currency movements. Secondly, in the context of discussing the cost and price
behaviour of the sheltered sector it was indicated that competition policy was the key to ensuring that excessive cost increases were not passed on to the traded sectors.

Competition policy has been altered quite significantly in the past year. There has been a radical realignment of the institutions dealing with competition policy. This realignment, however, is underpinned by a more fundamental change in the instruments of competition policy, involving a major emphasis on the promotion and enforcement of competition and allowing detailed price control arrangements to lapse. The Council has commented previously on these issues. In NESC No. 75 the Council expressed concern that the mandate of the Restrictive Practices Commission (RPC) (which is the main policy instrument for the promotion of competition in the services sector) exempted large parts of the services sector. In NESC No. 79 the Council questioned whether the public interest might not be better served if the RPC and the National Prices Commission were merged into an Office of Competition Policy. The Council, therefore, welcomes the changed arrangements.

However, a number of cautionary notes should be sounded about the new arrangements. (i) Promotion and enforcement of competition is not an instantaneous process. Changing the nature of particular markets or sectors through the removal of restrictive practices (entry barriers, price agreements, market sharing arrangements etc) takes time and there will usually be a lag before prices are affected. (ii) While detailed price control has lapsed it should be remembered that prices and price movements provide the most potent evidence of the absence of competition. Regular monitoring of prices, particularly in areas where absence of competition might be expected, should therefore form part of the new arrangements. Regular monitoring should be emphasised since ad hoc surveys do not provide a benchmark against which to reach conclusions. (iii) There are two broad types of approaches to competition policy. (a) A structural approach, the objective of which is the promotion of more competitive market structures. The underlying philosophy of this approach is that a more competitive structure will place constraints on the conduct of the market participants and lead to a desirable price performance. (b) Another approach to competition policy is one in which constraints are placed on the market outcome i.e. direct action on prices. While the former approach is generally preferable direct action on prices should not be ruled out pending more fundamental changes in market structure, particularly given that changes in market structure take time. In addition, in a limited number of instances direct action on prices may be desirable.

The commercial state-sponsored bodies constitute a special case in the context of competition policy. This is because they are either monopolies or have significant monopoly power. For these and other reasons they are not constrained by market forces to the same extent as their private sector counterparts in the sheltered sectors, e.g. the entry barriers may have legal force. There is also an allied consideration which renders them different: they are nominally commercial entities but sometimes face some objectives of a more social nature. There is a danger that the absence of market forces may give rise to sub-optimal performance (excessive costs, inefficient practices) while the specification of vague and incoherent objectives by Government may facilitate the concealment of this sub-optimal performance.

Many of the commercial state-sponsored bodies were subject to price control under the old arrangements. The exercise of price control was essentially a proxy for market forces. Now that price control has been superceded by a broader competition policy in which the objective is to create competitive markets there is a danger that commercial state-sponsored bodies may not come under the jurisdiction of this policy, despite the broadening of the sectors to which competition policy will apply. This is due to the fact that many of these monopolies are statutorily based and the exclusion of competition is guaranteed by statute. In this context the commitment in Building on Reality to the preparation and publication of performance indicators for these bodies and to the issuance of clear and consistent objectives against which performance can be assessed assumes even greater importance. Finally, commercial state-sponsored bodies, however, must be viewed in a broader context than competition policy. The contribution which these bodies can make to economic performance and the overall framework within which this contribution can be maximised is addressed in the industrial policy discussion in Chapter 11.
SOCIAL POLICY AND SOCIAL EXPENDITURE

1. INTRODUCTION
This chapter is concerned with the social policy objectives of government. Those objectives, as stated by NESC, include reductions of inequality in income and wealth, elimination of inequalities of opportunity, provision of access for all to certain specific services, provision of services to particular disadvantaged groups and the development of citizenship based on mutual obligations in the community.* In practice the pursuit of these objectives entail the provision and development of extensive services in social security, health, housing, education and other areas, and these services require large scale public expenditures. The immediate context of the discussion of social policy in the 1986-1990 period combines, therefore, general social policy considerations and the specific fiscal environment in which policies must evolve, as documented in Chapter 6.

In this chapter we discuss three related aspects of social policy. Section 2 confronts the general issue of the economic consequences of the welfare state and discusses the possible diseconomies which can arise from social programmes. Section 3 locates social policy in the immediate economic context and outlines the considerations which arise in the social policy domain given the objectives of social policy and the very constrained situation in the public finances. In Section Four policy implications are drawn in respect of the four principal areas of social policy — social welfare, health, education and housing. Finally, it should be noted that specific aspects of social policy affecting women are dealt with in Appendix 3.

2. SOCIAL PROGRAMMES AND THE ECONOMY
Welfare State expenditures are traditionally conceived as having an economic rationale, in terms of allocation, distribution and stabilisation functions in the economy. Thus the 'public goods' characteristics of certain goods and services give rise to non market provisions by the State; the distribution of incomes and resources generated by the market makes redistribution an

essential activity of the State; the expenditure and taxation activities of the State may contribute to stabilisation through affecting aggregate demand in the economy. Specific 'social' programmes of government can also be considered as developing and sustaining human capital (education and health) and physical capital (housing), and providing essential infrastructure. In many developed economies governments have accepted the Welfare State-mixed economy and accordingly have adopted extensive social policy responsibilities. In Ireland, for instance, social expenditure now accounts for 36% of total GNP. However, in recent years there has been a questioning of the nature and extent of government intervention in the economy and this questioning has arisen in part from the conjunction, in many countries, including Ireland, of poor economic performance and expanded social policy commitments.

A body of both popular and academic opinion alleges that the nature and scale of government intervention, and in particular government social programmes, have contributed to the relatively poor performance of the industrialised economies from the mid-seventies. The popularisation of this perspective has led to a questioning of the mixed economy — Welfare State. It has been argued that State interventions have become ineffective in stabilising and regulating macro economic performance, that the avowed redistributive goals of public policy have not been attained, and that disincentives and distortions arise from specific sub-programmes in the public sector. The question arises, therefore, as to whether and to what extent, these general considerations should govern policy in the period ahead.

In considering the relationship between the public sector and economic performance it should be noted that it is difficult to establish simple, aggregate relationships between measures of public sector size and macro economic performance. The OECD* review of the evidence on this issue explicitly warns against generalisation. Recent commentators** have indicated firstly that there is no correlation between private sector employment growth, and public sector size and secondly, that there is great diversity of economic performance among countries with large and small public sectors. The critical scrutiny of public expenditure is therefore likely to be more fruitful if focused on the effectiveness of specific programmes and interventions, and on the precise mechanisms by which public sector programmes affect the economy.

(i) The Scale of the Public Sector

Before proceeding to discuss social programmes in these terms Ireland's comparative position in regard to the scale of the public sector should be observed. As Table 9.1 indicates public expenditure in Ireland relative to GNP is not exceptionally high, 47.6%, compared with 46.7%, 49.6%, and

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*OECD, Role of the Public Sector, 1985

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190
in OECD countries in either 1972 or 1981. Neither is there evidence, according to the OECD, of a relationship between changes in the replacement ratio and changes in the level of unemployment between 1972 and 1981.

The OECD concluded its review of the evidence by suggesting that "induced unemployment arising from more generous unemployment benefits has not been a major factor in explaining the medium term trend rise in unemployment and certainly cannot explain the dramatic increases in unemployment since 1979."

In regard to Ireland there may be a priori grounds for suspecting some element of induced unemployment. Long-term unemployment has risen significantly, while the real value of unemployment benefits and assistance payments increased at an annual average rate of 2.7% and 3.3% respectively from 1976 to 1982. During the same period average and marginal tax rates on employee incomes increased significantly. Actual, as distinct from hypothetical or illustrative replacement ratios may be quite high, a sample inquiry in the Dublin area reported a weighted average replacement ratio of 71%. Recent calculations suggest that during the 1975-1985 period illustrative replacement ratios rose until 1982 and since then have stabilised or declined.

Studies of the relationship between unemployment compensation and unemployment in Ireland suggest that the main impact of unemployment compensation payments is through the extension, in 1968, of the maximum period for which unemployment benefit could be claimed. Additionally this evidence suggests that improved real payments or increased replacement ratios tended to increase unemployment duration in the first six months of unemployment, but the evidence for an effect at longer durations is "very weak." The detailed review of the international and Irish material on this topic undertaken for the Commission on Social Welfare concluded as follows:

"In summary, the Irish studies show some evidence that an increase in benefit leads to an increase in duration of unemployment. There is some evidence that an increase in benefits in Ireland relative to those elsewhere leads to increased net immigration to Ireland. There is no evidence that any substantial part of the increase in unemployment which has occurred over time in Ireland over the past decade has been due to incentive effects."[11]

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The OECD comparative analysis provides no support for the existence of a simple aggregate relationship between unemployment levels and replacement ratios.

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"The above points are the more important aspects of this argument. In addition it might be suggested that (i) unemployment payments raise the incentive to work in industries susceptible to seasonal fluctuations - a study of whether or not the aggregate unemployment rate is raised by unemployment compensation is an automatic statistic, which may reduce unemployment in the short term through the maintenance of aggregate demand.

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[10] OECD, The Role of the Public Sector, pages 155-156
[11] [These figures refer to single persons, the corresponding figures for a man, woman and two children are 1.8% and 1.9%]
An important consideration concerning social security payments and possible work disincentives in Ireland is the sensitivity of actual replacement ratios to the family and dependency status of welfare recipients. Ireland, unlike many European social security systems, incorporates additional payments for adult and child dependants of the recipient. For this reason single persons receiving a personal rate of payment have low replacement ratios (at any given earnings level). Conversely, married recipients with dependant spouses and children have high replacement ratios. As Table 9.2 shows, a significant proportion of unemployed benefit recipients are single (60%) and a further 9% are married without children: only 8.3% have four or more children (1984 data). Any arguments about replacement ratios based on "typical" cases may be misleading: Table 9.2 shows that the replacement ratios for most workers, when average earnings are used as a benchmark, are quite modest. For instance, unemployment assistance for single people confers a replacement ratio of only 27%, and only 46% in the case of unemployment benefit. Two important qualifications attach to the figures in Table 9.2. In the first place, the calculations do not include tax rebates and therefore some replacement ratios are understated. Secondly, some unemployment assistance recipients are young, single persons residing in the parental home and therefore subject to the household means test which can reduce or eliminate their assistance entitlement. In such cases the replacement ratios in Table 9.2 oversstate their replacement ratio.

The structure of social security payments may be more important than the level of payments as the payments are differentiated by family size. This results in higher replacement ratios for workers with large families, and the small proportion of unemployed workers with large families in low paid employment, or in search of low paid employment, are likely to be more susceptible to disincentives.

(iii) Sickness Payments

Similar issues arise in relation to sickness payments, which comprise about 13% of total social security spending (€211m on disability benefit in 1985). The purpose of sickness benefits is to protect workers from income loss and hardship during a period of absence from work due to illness. The OECD has pointed out that there are wide divergencies in the rate of sickness absence across countries, and that there is some evidence of a link between the incidence of sickness absence and the replacement ratio, for sickness payments. Ireland and Sweden, the OECD noted, have high rates of sickness absence per worker and relatively high expenditures on sickness benefits.

Analysis by Hughes** of the disability benefit scheme shows that there was a rapid growth during the nineteen seventies of spells of sickness absence
(when growth in the insured labour force is discounted), and that these spells grew more rapidly than in Northern Ireland or the U.K. The research indicated a significant relationship between changes in the replacement ratio and the level of certified work incapacity. The comments above regarding the sensitivity of replacement ratios to marital and family circumstances apply also in the case of disability benefits, as does the comment about the distribution of recipients by family size. Therefore some common questions arise in the case of disability benefit and unemployment benefit.

- The family size differentiation in the payments creates high replacement ratios for workers with large families.
- The exclusion of these benefits from income taxation increases the effective replacement ratios.

Additionally, the relative rates of disability claims between sectors of the labour force, the link between unemployment and disability claims, the role of medical screening, and the interaction between the tax and benefit systems are issues which warrant further attention. The economic losses arising from sickness, absenteeism, and disability claims indicate the seriousness of these issues. Hughes' calculations for 1978, for instance, indicate that the cost of certified incapacity, measured in terms of the value of output foregone, was 5.5% of GDP.

(iv) Pensions

Retirement and old age pensions, in Ireland as in many advanced economies, comprise a significant share of Government’s social commitment. These programmes have been the largest element of social security spending for some time: in 1985 they accounted for 25% of the social welfare budget, almost £900 millions when ancillary benefits in kind are included. A recent concern among economists about retirement pensions is their potential depressing effect on private savings and capital formation. It has been argued that pay-as-you-go "unfunded" state pensions may lower savings: the redistributive aspects of these pensions — the propensity to consume of beneficiaries being generally higher than that of contributors — may lower the aggregate savings ratio: the increased lifetime income arising from State pensions provision may lead to lower savings and higher consumption. Empirical research and theoretical debate on these issues has to date been inconclusive; the OECD** concluded that "the effects of social security provision on savings remains ambiguous on the basis of theoretical reasoning and empirical investigation", and the ILO in its review of social security concurred in this assessment.1

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1Hughes, op. cit., pages 11-11.

196
No empirical research has been undertaken in Ireland on the impact on savings of the development and level of public pension benefits. Public pensions grew in scope, in real value, and in the number of beneficiaries during the last decade and a half, as Table 9.3 shows. However, the basic data in Table 9.3 offer little support for any direct correlation between public pension growth and overall savings. This question merits full investigation in view of the scope of public pension provision in Ireland.

(v) Social Programmes and Economic Consequences

The paragraphs above have considered the possible deleterious effects on economic behaviour of the social security system. This discussion of social programmes was confined to the social security area as it is the largest sub programme within the social services in Ireland at present and, moreover, the area in which on a priori grounds, some disincentives or inefficiencies might be anticipated. Although the analysis has clearly indicated the absence of any general link between economic performance and the social programmes, it has also indicated that the levels and structure of specific social provisions can create the conditions, at a micro-economic level, in which disincentives might arise. For this reason, the efficiency implications of social policy are incorporated in the discussion of social policy 1986-1990 in section 4 below.

3. THE CONTEXT OF SOCIAL POLICY 1986-1990

(i) The Fiscal Imperative:

The relevant sections of Chapter 3 have described the evolution of social expenditures in 1980-1985; these expenditures (gross) grew in volume terms at 3.9% per annum and comprise 72% of supply services expenditure. Transfer payments grew more rapidly; social welfare expenditure grew in total by 158% from 1980-85 and accounted for 55% of the total increase in social expenditure. Education and health expenditures grew less rapidly, and were subject to some volume reductions in the later part of the period. It was indicated that total social welfare expenditure growth was about equally attributable to increased real rates of payments and increased numbers of recipients. In Chapter 4 the prospective public finance situation was outlined. Given the necessity to stabilise the debt/GNP ratio the analysis indicates that a shift in the non-interest balance of about 4% of GNP would be required. The significance of social expenditures in this context is highlighted by the fact that 36% of GNP is apportioned to them; the sheer scale of the social programmes is such that modest developments in social policies can have significant budgetary implications.

(ii) Social Policy Objectives

The fiscal imperative represents one side of the social policy picture for 1986-1990. The other side of the picture consists of a number of factors. In the first place, there is the unavoidable growth in demand for some services which arises from demographic and labour market developments - for instance increased beneficiaries of pension programmes or unemployment compensation schemes. Additionally, levels of provision in some services may be very low and therefore difficult to limit further. Furthermore, the acceptance by Government* and by the NESC** of the continuing need for social policies which provide minimum standards, which redistribute resources, and which protect the disadvantaged, suggests that social policy in 1986-1990 must be considered within the framework of social policy objectives. The task of social policy in the 1986-1990 period is, therefore, to manage coherently the tension which arises from these two somewhat opposing sets of considerations: on the one hand the necessary fiscal restraint, and on the other the social context arising from evolving demographic and social patterns, the need to conserve minimum levels of provision and to pursue general social policy objectives. Clearly a general set of principles or criteria are required to discuss the social policy and social expenditure implications of this analysis.

It is clear at this point that any discussion of social policies for 1986-1990 must be conducted within a framework. This framework must recognise the expenditure implications of social programmes, the broad social policy objectives of Government, and also the possible inefficiencies and diseconomies which can arise from social programmes.

(iii) Framework for Analysis of Social Programmes

Firstly, social policy developments in the period ahead are significantly constrained by the necessity to correct the public finances. The magnitude of total social spending is such that some contribution to public finance adjustments is required in this area. In considering the requirement that net current public expenditure must be restrained the policy focus should include the revenue aspect of net expenditure as well as the direct expenditure aspect. In the social services domain this issue is of particular importance because of the existence of two general sources of revenue - earmarked levies/contributions such as PRSI and the health levy, and charges for services such as school fees, rents for local authority dwellings and hospital charges. There may be efficiency as well as social grounds for considering changes in the revenue aspect of net expenditure.

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*In Building a Nation it was stated that "A balance is required between what is necessary to meet acceptable economic conditions and what relates specifically to the creation of a more just and equal society." (page 4/1)

Secondly, the efficiency implications of the level and structure of social programmes, and of possible changes in these programmes, must be examined. Some attention was given to the possible inefficiencies which might result from the social security system in Section 2 of this Chapter. The incentive implications of unemployment compensation and sickness payments, for instance, are key issues. However, potential diseconomies may also arise in the other social areas — health, housing and education. It is not intrinsically the case that efficiency criteria clash with ‘social’ criteria such as redistribution or minimum standards. The purpose of the discussion in Section 3 of this Chapter is to assess social expenditure programmes in the light of the criteria being presented here, and to indicate policy developments which might be consistent with a balance of these criteria.

Thirdly, redistribution is a widely acknowledged aim of public policy. Although the social services are generally considered to be the instrument of redistribution, the sub-programmes of social expenditure may vary in their redistributive effectiveness. To the extent that redistribution is accorded some policy precedence it may have implications for the relative claims on public expenditure among the social services. Redistribution of course is a very diffuse objective and consideration may also be needed of different dimensions of redistribution — vertical as between income groups and horizontal as between household types for example. Moreover, the goal of ‘equality’ with which ‘redistribution’ is associated may have different and possibly conflicting meanings (equality of opportunity, equality of conditions, equality of outcomes etc.)

Fourthly, although these are difficult to quantify, or to clearly identify, the concept of minimum standards and provisions can inform discussion of the levels and adequacy of social services.

Finally, the seriousness — at present and in the near future - of the unemployment situation suggests that the employment content of social services be noted. In this regard social security may be contrasted with the other social services: unlike social security, health and education services directly employ very large numbers (58,000 in health services, for instance), and housing expenditures both directly and indirectly have appreciable employment consequences.

These considerations, although they do not amount to a set of objective, operational rules regarding possible policy choices, offer a general framework within which policy strategies can be discussed. Policy judgements depend on the relative importance attributed to different considerations. For example, although social welfare programmes are highly redistributive when compared with other programmes, the magnitude of social welfare expenditures cannot be disregarded in the fiscal context which will pertain in 1986-1990. Some retrenchment in direct housing expenditure and indirect subsidisation of owner occupation might be justified by reference to the minimum standards and redistribution criteria, however these expenditures are relatively modest when compared with social welfare and health commitments. Distinctions can also be made, in considering the policy criteria, between sub-programmes of social expenditure, for instance between the various levels within education, tenure groups within housing, institutional as opposed to community services within health and so on.

4. SOCIAL EXPENDITURE AND SOCIAL POLICY 1986-1990
This section assesses social programmes and policies given the criteria outlined above.

(i) Social Welfare
Social welfare services are the largest single item within the social programmes and have been growing rapidly from 1980 to 1985 due to increasing real rates of payment and growing numbers of recipients. Table 9.4 summarises the future outlook in respect of social welfare payments, given the likely growth of recipient numbers and the changing rates of payments implied in the inflation rate.

The most important point to be noted in relation to Table 9.4 concerns the projected levels of unemployment payments. These figures derive from the projections in chapter 6 of the levels of unemployment which are implicit in the projected labour force of 1317 thousand, combined with two scenarios regarding the levels of employment in 1990. The qualifications regarding the labour force projections therefore have ramifications for the data in Table 9.4. Moreover as is pointed out in Chapter 6, the pessimistic scenario entails, in an arithmetic sense, an unemployment rate 50,000 higher than currently prevails, or a rate of 21%. As is also indicated in Chapter 6, the evolution of the labour force, i.e. participation rates and net migration, is itself dependent on the level of employment and therefore the realisation of the pessimistic employment projection might result in the increased unemployment being 'choked off' by rising emigration or changing participation rates.

In Table 9.14 the expenditure outcome of the two unemployment scenarios is given, along with more straightforward data on other social welfare schemes, as follows:

- pensions expenditure on the elderly and widows, will reflect the very small increase in the relevant groups over the period to 1990;
- disability and invalidity claims arise from labour force participation and this volume increase allows for the projected labour force;
children's allowances numbers are almost wholly demographically determined and the figures incorporate the projected decline in the child population;

— deserted wives payments have been growing very rapidly (approximately 10% per annum in 1980-85 period) and this rate of increase is assumed to continue.

All of the projected expenditure figures assume an inflation rate of 3% on average, and that payments will be held constant in real terms, i.e. that on average increases of 3% will apply annually during the period.

It can be seen that the projected demographic changes and the maintenance of real social welfare payment levels would together result in significant expenditure increases. If the optimistic assumption regarding unemployment is considered it appears that total expenditure will grow by 14.3% to 1990, or at annual average rate of 3.4%; in contrast, the pessimistic assumption entails total and annual average increases respectively of 24.9% and 5.7%. These figures highlight a number of issues: firstly, the evolution of unemployment will have a very significant impact on the growth of social welfare spending; secondly, some element of increased expenditure is non-discretionary in that it arises from population and labour force trends; thirdly, the maintenance of payments in real terms necessitates large expenditure growth and the importance of policies regarding increases in social welfare payments is brought into sharp relief.

Social Welfare — Revenues

As indicated by the discussion in Section 3 (iii) the revenue aspect of social welfare expenditures must be considered. Those expenditures are funded by earmarked contributions (PRSI) from employers, employees and the Exchequer — details of 1985 expenditure and revenue are given in Table 9.5. The Exchequer contribution to total expenditure was 60% — the balance from employers and employees. Contributions from the latter, however, comprised 74.6% of 'insurance' benefits expenditure. Two separate, but related, aspects of social insurance arise for consideration. In the first place the structure of social insurance warrants discussion.

The Council believes that, as presently structured, the system of social insurance contributions is inequitable and inefficient and that reform of the system is justified by reference to the reports of the Commission on Taxation and the Commission on Social Welfare. In the former case it was argued that 'the system of social insurance should be evaluated, as a tax, according

*First Report of the Commission on Taxation, Direct Taxation, Stationery Office, July 1967, Chapter 31
to the criteria of equity, efficiency and simplicity; that when so evaluated it is inequitable due to the very limited base, inefficient because of its deleterious employment consequences, and lacking in simplicity because of the obligations it imposes on employers, the varying classes and rates of contribution and the complication of the marginal rate structure of taxation.

The Commission on Taxation accepted the continuation of an earmarked social security contribution (by way of an exception to their general opposition to earmarked taxes) but proposed a Social Security levy at a single rate on all income including realised capital gains, taxable gifts and inheritances.

The Commission on Social Welfare* argued that an earmarked social security contribution system should be continued, that the regressive nature of the present arrangement, i.e. the income ceiling on contributions, should be abolished, and that the contribution base be widened to include the self-employed and the public service. It was the view of the Commission that PRSI could be validly perceived as a form of insurance, that it is appropriate to have a redistributive element, and that the evidence regarding its employment effects did not justify the abandonment of the payroll basis of social security contributions.

| Table 9.5 |
| Details of Social Insurance Revenue and Expenditure, 1985 |

<table>
<thead>
<tr>
<th>Description</th>
<th>£m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expenditure - Insurance Payments</td>
<td>1,704.9</td>
</tr>
<tr>
<td>Expenditure - Assistance Payments</td>
<td>982.9</td>
</tr>
<tr>
<td>Total Expenditure</td>
<td>2,187.8</td>
</tr>
<tr>
<td>Total Revenue</td>
<td>2,740.0</td>
</tr>
<tr>
<td>of which, employers</td>
<td></td>
</tr>
<tr>
<td>employers</td>
<td>683.5</td>
</tr>
<tr>
<td>state</td>
<td>283.8</td>
</tr>
<tr>
<td>other</td>
<td>1,370.7</td>
</tr>
<tr>
<td>Revenue as % of expenditure</td>
<td></td>
</tr>
<tr>
<td>Total Reveneural expenditure</td>
<td>100.2</td>
</tr>
<tr>
<td>State Contribution/Total expenditure</td>
<td>60.2</td>
</tr>
<tr>
<td>Employers plus employee contributions/total expenditure</td>
<td>37.5</td>
</tr>
<tr>
<td>employee contributions/insurance expenditure</td>
<td>12.5</td>
</tr>
<tr>
<td>employers' contributions/insurance expenditure</td>
<td>51.1</td>
</tr>
<tr>
<td>Total Reveneural expenditure</td>
<td>21.5</td>
</tr>
</tbody>
</table>

Source: Statistics of Information on Social Welfare Services, 1985

(ii) The expenditure total in this row includes administration etc., not shown separately in the table

The Council accepts the general conclusions of both commissions that an earmarked contribution system should continue and that a broader basis than at present is required. The Council therefore recommends that the system of earmarked contributions in respect of social welfare entitlements be made comprehensive.

It is recognised that whichever approach to the reform of social insurance is adopted consequential choices and issues arise. In the social security levy proposal the question will arise as to whether there ought to be an insurance (benefit) - assistance (allowance) scheme of payments as at present, or whether entitlement to the payments should be on some other basis. It should also be noted that there are revenue implications: the social security levy which should be "about 8%" according to the Commission on Taxation would yield significantly less* (in 1983/84 terms) than the current social insurance system: the Commission on Social Welfare proposals would give an increased yield of £226m (in 1985 terms). The Council notes that the net revenue figures arising from the Commission on Social Welfare's proposals do not quantify the effect of the following factors: (i) the increased cost in insurance benefits expenditure which will derive from wider entitlement to social insurance (ii) the diminution in social assistance expenditure which will result from the inclusion of long term social welfare benefits as part of total annual income for tax purposes. The Commission acknowledged the first two of these points. It is clear therefore that the actual revenue effects of the Commission's proposals will depend significantly on the precise adjustments to the structure of social insurance entitlements, and on their timing.

The second general issue in respect to social insurance is the rate of social insurance contribution. Since 1982 the general rate (Class A) for employees has remained at 5.5%. It might be argued that this is anomalous in view of the rapidly rising expenditure. In considering the rate of employee contribution the analysis by Hughes of old age pensions, which is the largest item of social welfare expenditure, indicates that rates of return on pension contributions are high:

"The corresponding figures for the pension contributions attributable to employees are 6 per cent and 13 per cent, respectively. Given the low real rates of return on stocks and bonds in Ireland in the last two decades the average contributor to the State pension schemes would find it extremely difficult to get a rate of return approaching the yield on State pension contributions and it is concluded that if the structure of the scheme remains unchanged it will give very good value for money to insured workers retiring in 2006. The size of the internal rate of return

for the average insured worker retiring in 2006 does, however, raise questions about the cost of maintaining the current relationships between social insurance pension contributions, benefits and average industrial earnings in the future.**

Additionally it should be pointed out that in the 1980-85 period that 'gross' and 'net' social welfare expenditure have converged: net expenditure as a percentage of gross has gradually and continually increased from 57.6% to 62.0%. Revenue has therefore been making a diminishing contribution to total expenditures.

The Council therefore considers that there is scope for increasing the revenues to the social insurance fund, but such increase should not be elicited solely on the basis of increased rates of contribution. The rate of contribution must be considered in conjunction with the required broadening of the contribution base: the wider the contribution base, the lower is the rate of contribution required to attain a given revenue, and conversely.

**Social Welfare - Benefit Levels**

The complementary consideration to revenues is expenditure, which in the case of social welfare is determined by numbers of recipients and rates of payments. Discussion of this aspect of net expenditure effectively amounts to an analysis of rates of social welfare payments, as the number of beneficiaries is almost wholly pre-determined by demography and similar trends.

In its analysis of the levels of social welfare payments the Commission on Social Welfare pointed out that:

- many social welfare payments are seriously inadequate and only one or two categories of recipients, i.e. those for long term recipients with age additions and other supplements, have payment levels which can be regarded as minimally adequate;
- there is considerable, but unjustifiable, diversity in the levels of social welfare payments between different recipient categories;
- the real value of social welfare payments has risen continuously over a long period of time;
- there has been a convergence between the disposable incomes of social welfare recipients and of employees.

The Commission made the following key recommendations** regarding the level of social welfare payments:

- all social welfare payments should be at a level which is minimally adequate by current standards;
- payments should be annually and uniformly increased once minimal adequacy had been attained;
- the additional payments which proliferate within the payments system should be phased out in the context of the evolution of a consistent minimally adequate social welfare payment for all recipients;
- the reformed system of payments would of necessity be phased in, and cognisance would need to be taken of net relative incomes of employees and social welfare recipients in improving the system of payments;
- all social welfare payments should be assessed as part of total annual income for income tax purposes, and that welfare payments should be co-ordinated with the system of taxation.

The Commission noted the gross additional expenditure at £560m - which would be substantially offset by the extensions to social insurance which they also recommended (£226m), and further offset by any reductions in tax allowances - the latter also being part of their recommended financing strategy.

Priority proposals were also spelt out in the Commission's Report as follows:

- an immediate improvement in the position of recipients with the lower level payments;
- a development of the system of family income support entailing modification of Family Income Supplement, an age addition to the Children's Allowance Scheme and rationalisation of child dependent allowances;
- extension of fuel and free electricity to all long term social welfare families;
- payment of a quarterly lump sum to long term social welfare families;
- improved delivery and administration of the services;

The Commission argued that these priorities were affordable in the context of the first steps which might be taken in the implementation of its financing proposals (modest limitations on tax allowances, steps to widen the base of social insurance). However, the Council noted that although the Commission generally indicated the financing sources for its priority proposals, it did not quantify the actual sums obtainable from specific aspects of the proposals.

In the light of the above it might be argued that there should be average real reductions in all social welfare payments. Support for real reductions can be derived from the sheer scale of the social welfare budget and the overall budgetary impact of marginal increases in this programme of expenditure: further there has been significant real improvement in the 1980-85 period.

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and prior to this, the payment levels, and payment levels have converged with disposable earnings. However, if recognition is accorded the social criteria of minimum standards and redistribution, then significant arguments apply against recommending real overall reductions in payments. As pointed out by the Government, the incomes of many social welfare recipients are seriously deficient and a minimum policy in this regard would be to sustain the real value of the lowest payments. From a redistribution standpoint real reductions in social welfare could seriously impair the redistributional efficiency of public expenditures. As the OECD* has pointed out, in OECD countries social security cash payments are far more redistributive than non cash social services or taxation, and analysis of the Irish data suggests that this conclusion also applies to Ireland. To the extent, therefore, that redistribution between income groups is accepted as a criterion of policy evaluation, then social welfare payments should be regarded as generally successful.

Alternatively it might be argued that the real value of social welfare payments should be maintained on a year to year basis. The proclaimed importance of redistribution and the stated desire to significantly improve the incomes of the poorest groups in the population might provide a rationale for this view. This view must be tempered by financial and economic considerations. In the first place the scale of expenditure involved in social welfare suggest that social welfare expenditure cannot evolve independently of the general fiscal situation. Further, efficiency considerations dictate that although in the past disincentives have not been a general problem, future payment levels cannot be determined without reference to changes in disposable earnings.

The view of the Council in regards to the Commission on Social Welfare's analysis, and in regards to the related issues of the evolution of social welfare payments in the period ahead is as follows.

The Council generally endorses the analysis of the Commission and accept that the overall goal of public policy should be to provide an adequate, uniform and simple set of social welfare payments, and that in the short term there is a need to increase the lowest payments and to give priority to families. Therefore, in the Council's opinion, in the period ahead:

- nominal social welfare payments should be increased annually;
- increases should be differentiated so that over a period of time some convergence in the rates of social welfare applicable to different categories is attained;
- increases in social welfare payments should not result in an unacceptable narrowing of the gap between net employee incomes and social welfare payments;
- social welfare payments should be counted as part of total annual income for tax purposes.

Finally, there may be scope to reduce the reliance of social welfare recipients on the social welfare system. This might be achieved by offering, where appropriate, greater choice to claimants to 'mix' their sources of income as between earnings (for instance) and a social welfare payment. A more flexible structure of social security, which can incorporate part time earnings and earnings from subsidiary employment, might allow recipients to obtain, in total, a higher income than that obtainable exclusively from social welfare; simultaneously total expenditure per recipient could be reduced. The Council endorses the views of the Commission on Social Welfare which advocated this approach in principle, especially for the unemployed, although it is also noted that administrative difficulties might arise with this proposal.

Social Welfare Policies: an Overview

The Council's recommendations in the area of social welfare represent a proper balance of the criteria which should govern social policy discussions in the period to 1990. Council recognise the magnitude of the social welfare budget and thus cannot recommend overall indexation of payment levels. Equally however, the importance of minimum standards and redistribution suggest that the very lowest social welfare payments should accrue relative increases. The potential significance of disincentives in a segment of the labour market requires that payments not evolve independently of employees' disposable earnings. The importance of both efficiency and redistribution criteria dictate that a comprehensive approach towards the earmarked social security contribution and a greater contribution from revenues to social welfare expenditures should be initiated.

(ii) Social Policy — Health

Health services expenditure is the second largest item in the social services programme. The analysis in Chapter 3 indicated that in expenditure terms the 1980-1985 period could be sub-divided in terms of an early, expansionary phase until 1982, and a later phase of contraction until 1985. In 1985 the real level of spending was below the 1982 level. Broadly similar considerations to social welfare apply in the health services when public expenditure restraint is considered alongside general policy objectives.
Irish Health care expenditure is somewhat above the international average (Table 9.6) at 8.2% of GNP in 1982. Additionally, the Irish share of GDP devoted to health is higher than the average relationship between GNP per capita and health expenditure (as % of GNP) would suggest. Figure 1 shows, for instance, that Ireland is an "outlier" in the scatter diagram relating GNP (per capita) to health expenditure: the share of GNP apportioned to health is very much higher than the share in countries with significantly higher GNP per capita. This may be indicative of some scope for expenditure restraint in the period ahead.

Health Services — Revenues
An initial strategic consideration arises as to the role of revenue and expenditure in determining net current expenditure. Table 9.7 below summarises the revenue situation for 1986. It can be seen that a very large proportion of the income of the health services (85.7%), is derived directly from Exchequer funds, 6.2% from the Health levy, and the small balance remaining from charges and other income. It might be argued therefore that there is scope for increasing the non-exchequer contribution to total health service revenue. The significance of pricing and incentives in the Health care system, which will be discussed further, suggests that increases in non-exchequer revenue to fund health expenditures might contribute to more efficient utilisation of resources.

The 'Health Levy' in comparison with its social welfare counterpart (PRSI) makes only a slight contribution to the funding of health services. During the 1980-85 period the rate of health levy contribution was 1%. Some similar questions arise in the case of the health levy. An increased rate of levy might be proposed but the Council is aware that there are anomalous features in the Health levy: its base is restricted because of the income ceiling and the exclusion of all income of medical card holders, and the complex pattern of health service entitlement is not related to the levy's contribution structure. Further, the Commission on Taxation argued against such assigned revenues and the Commission on Social Welfare criticised the levy as it rendered the PRSI system more complex. Although a clear economic case can be stated for increasing the non-exchequer revenues for health services, it would be difficult to argue for a higher rate of health levy given its present structure.

Health Service Efficiency Issues
The second set of issues related to health expenditure concerns the efficiency implications of the structure and financing of health services. For three reasons public expenditures on health in contemporary Welfare States may have
become somewhat uneconomic. Firstly, the continued growth in public health expenditures may not be related to or directly contributing to improvements in health.

Underlying this concern is the recognition that (a) the output of health services is no longer readily identifiable* — except in the most general terms — or easily quantifiable; and (b) the a priori links between health expenditures — health resources — health outputs may not be as strong as supposed.

Secondly, the financing arrangements of health care are 'insurance' arrangements in the widest sense, entailing guaranteed access to a range of health resources on the basis of either earmarked contributions — public or private — or general provision and financing of health care. Intrinsically this creates a tendency to over-utilisation of resources: in any version of the "insurance" arrangement some or all services are free at the point of use, and no decision maker, either patient or provider, bears an added cost when a resource is used. In effect many modern health care systems have inbuilt tendencies to over-utilisation of resources — and this tendency is theoretically applicable in public insurance schemes, private insurance schemes or centrally tax financed systems. There are supply and demand aspects to utilization. On the supply side institutional structures, especially remuneration techniques, significantly affect resource usage decisions of medical care providers; on the demand side pricing could affect the demand and hence utilisation. Additionally demand and supply are not independent in health care systems: an addition to health resources can, of itself, generate utilisation of these resources; the suppliers of health (notably physicians) rather than the consumers, to a considerable extent make the resource using decisions. This inter-dependence of supply and demand is mediated through remuneration and incentive structures.

Thirdly, the historical origins and organisational arrangement of many health care systems may contribute to the present uneconomic aspects of these systems; contemporary health regimes originated in large scale institutional/hospital provision which is relatively expensive: the orientation and training of medical manpower is to a considerable extent geared to hospital based care and to the use of expensive, highly technological procedures; until recently the relative importance of more economic non institutional care and preventive programmes was not fully appreciated.**

Recent analysis suggests that the general problems noted above arise to a significant degree in the Irish system of health care.† The health care system

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*For instance traditional measures of aggregate health status such as changes in life expectancy or infant mortality are now regarded as extremely crude.

†The health care system

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*This item refers to charges for semi private and private accommodation in public hospitals.
is structured into a set of perverse incentives which generate uneconomic use of health resources at a number of levels. At the level of general practice (G.P.) there is evidence of physician-induced demand and utilisation of services: for instance, 34.9% of most recent GP consultations result in a return visit being arranged with the same GP — for persons in Category I health service entitlement whose visit is funded by the State — this contrasts with only 16.5% return visits by persons in the other categories who pay for each visit. Statistical analysis of GP utilisation indicates some level of uneconomic utilisation.

Pharmaceutical medicines are provided free to Category I patients through the free GP services, and they are subsidised for other patients. The evidence suggests that there is a very high utilisation of pharmaceuticals by Category I patients (even when other relevant variables are controlled such as age, sex, social group and GP utilisation) for whom pharmaceuticals are free. European systems of G.P. services based on a fee per item of service have higher prescribing rates. The cost in 1985 of the choice of doctor scheme for Category I patients, including the cost of drugs, is £108.4m an increase of 9% over 1984.

Other levels in the present health care arrangements merit comment. GPs bear none of the costs of referring patients to more expensive areas of the health care system — such as hospitals, or specialists on an outpatient or inpatient basis. Specialists’ incentives structure vary as between public and private patients. In the latter case since they too are paid on a fee-per-item-of-service basis their remuneration system will not encourage economical utilisation. Most private patients are insured through Voluntary Health Insurance: in the case of hospitalisation patients, or their medical advisors, have no financial motives for minimising hospital admissions or durations, and in the case of outpatient specialist consultations the “deductible” which is applied is very modest. Specialist utilisation may also be induced through the eligibility structure: Category II patients (50% of the population) are entitled, free, to use specialists but must pay for the cheaper GP service. Equally with hospitalisation. Only one third of the population (Category I) are entitled free to the least expensive service - GPs, but the whole population are entitled free to use public hospital beds — the most expensive service.

Finally, the nature of the incentive structure encourages participation in Voluntary Health Insurance and hence use of costly private care; tax relief on VIII premia may be an inducement to the use of private hospital care — the most expensive area of health services.

A detailed analysis of the economic aspects of Irish health care by Tussing, concluded:

“A review of the incentives structure facing providers and patients reveals, then, very few instances in which participants have a significant motive to economise on medical care resources, public or private, and more than a few instances in which there are inducements to use resources”.

Health Services — Overall Policy

In the light of these points it would seem reasonable to consider the following general recommendations regarding public expenditure on health in the period 1986-1990. Firstly, the pattern of demand as distinct from its quantity, should be redirected towards the more cost-effective sectors of the health care system. This, in turn, implies that changes in the incentives and remuneration system, consistent with the analysis above, should be implemented. Secondly, the supply of the most expensive resources, namely hospital beds, should be controlled. This can be achieved without affecting minimal standards; acute hospital bed provision is already relatively high by international standards** and relative to apparent needs as Table 9.8 shows. Ireland’s hospital bed provision is higher than that of the UK or of Denmark — another small, somewhat rural society. Moreover the smaller share of the elderly in the total population of Ireland (who are relatively intensive users of the health services), sharpens the disparities in levels of provision.

Further, general hospital development has continued in the previous five years with the completion of many new hospital facilities in some regions.

### Table 9.8

<table>
<thead>
<tr>
<th>Age Group</th>
<th>Ireland</th>
<th>U.K.</th>
<th>Denmark</th>
</tr>
</thead>
<tbody>
<tr>
<td>0-14</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>15-64</td>
<td>150</td>
<td>150</td>
<td>150</td>
</tr>
<tr>
<td>65+</td>
<td>150</td>
<td>150</td>
<td>150</td>
</tr>
<tr>
<td>All ages</td>
<td>400</td>
<td>400</td>
<td>400</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Hospital Beds per 1,000 Population</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ireland: 9.5</td>
</tr>
<tr>
<td>U.K.: 8.2</td>
</tr>
<tr>
<td>Denmark: 8</td>
</tr>
</tbody>
</table>


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*A Tussing, op cit, page 100
**1985: SC. Report No. 71, Health Services. The Implications of Demographic Change, 1951

Evidences for hospital beds per 1,000 is in contrast to the general argument about the level of premia. These services comprise 9% of current expenditure on health and 11% of capital expenditure. The index of hospital beds per 1,000 is 215,650, as compared to 1985: from 1986 to 1987: with a ratio of 100.7 to 100.1. In the past ten years the general situation remains unchanged in this area, the UK evidence indicates that community, non hospitalised premia may be far less expensive for some sub groups within the conventional population. But the wider strategy of the extended care continues to be a concern.
Psychiatric services which are largely institutional at present, account for 12% of the total cost. In the development of psychiatric services in planning for the future, the alternative to this policy is to retain the existing psychiatric services while simultaneously developing a system of psychiatric services that more closely matches the need for the rapid development of more appropriate non-institutional services.

A further specific issue arising from the general analysis is the question of financing psychiatric care. This is often a significant part of the costs of health care. In the Irish health care system, psychiatric care is largely provided by Government hospitals. The general approach to finance psychiatric care is to allow for an additional burden for the cost of psychiatric care, and to ensure that the costs of this care can be defined. The efficiency of the financing of psychiatric care is considered in light of the need to ensure that the psychiatric system is not driven by the need for psychiatric care to the extent that it becomes a completely integrated part of the system. The financing of psychiatric services needs to take into account the need for further developments in psychiatric services in the light of the recent developments in psychiatric care.

Finally, in relation to health services, the Government has been considering the possibility of extending the number of outpatient services, and the cost-effectiveness of such an approach should be noted.

The recent growth in Chapter 3 revealed that the aggregate real gross expenditure in the public service sector has not been rising, and that, in parallel, real expenditure in the non-profit sector has not been falling, but the rate of growth in Chapter 3 has been rising, however.
During the period to 1990 and beyond the demographic pressures which determine 'demand' for education will diminish somewhat. However, in the period to 1990, projections indicate that enrolment at third level will grow significantly, while second level and primary levels will grow more slowly. However, the crucial historical pressure on educational expenditures which has compounded the demographic pressures, has been increasing cost per pupil. Unit costs rose, in constant prices, by 40.6% over the 1971-80 period and this reflects a 'relative price effect'. In education, as in health, pay costs are a very significant factor, at primary level and at second level pay is 68% of total expenditure (current and capital). The evolution of pay is, therefore, a critical factor in the management of total public expenditure on education.

The extent to which greater real reductions in education expenditure can be contemplated can be considered in the light of the criteria applied throughout the social expenditure discussion. The Council accepts in principle that education contributes positively to economic performance through its investment in human capital. If this principle is accepted, however, its realisation depends on the specific allocations of education expenditure between sub-sectors, and this in turn requires that capital and current spending be increasingly devoted to the sectors of education which more directly bear on the growth and development of the economy.

'Investment' in education is not entirely independent of the redistributive considerations. Expenditure on education generates substantial 'private' rewards as well as 'public' benefits and the balance between these shifts towards private benefits in ascending the cycles of education. For this reason it can be argued that financing of Third Level education, as presently structured, does not accord with efficiency or redistributive requirements. The redistributive principle is violated not only by the appropriation of private benefits (in the form of higher life times incomes) from public expenditures, but by the demonstrable failure of the financing system to equalise educational opportunities.

It is still the case that substantial social inequalities exist in the educational system. As Table 9.9 shows, (male) school leavers from low social economic groups are more likely to leave the Educational system without qualifications or with lower qualifications levels. Even if pupils from lower social class groups attain Leaving Certificate standard their participation rates at Third Level are lower than that of their middle class counterparts, as Table 9.10 indicates. The Third Level participation rate for upper class males (68.1%) is more than double that for working class males (31.7%).

Table 9.10 also reveals the continued disparity between the sexes in Third Level participation. In three of the four social class groups identified girls were markedly less likely to pursue further education than boys. This disparity is a reversal of the pattern in second level education because as the ESRI study on Schooling and Sex Roles* pointed out, girls are more likely to reach Leaving Certificate than boys. It is clear that public policy has a role in the elimination of sex inequalities in education. In particular, the Council notes the key policy issues identified for consideration in the ESRI study:

- syllabus review with a view to eliminating role stereotyping;
- changes in subject provision and subject allocation practices;
- initiation of programmes at junior and senior cycle to improve the take up of science and mathematics subjects among girls;
- changes and developments in school curriculum and management policy.

There is evidence from recent research that although the implementation of egalitarian policies since the late nineteen seventies has been associated with some improvement and equalisation of education opportunities, that very fundamental social inequalities in education still remain and that these inequalities in turn generate impermeable barriers to social and occupational mobility, and that the Irish social class system is highly stratified* by sex.

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Table 9.10

<table>
<thead>
<tr>
<th>Social Background of Pupils</th>
<th>Per cent of those with the Leaving Cert from Each Class Background Who Went on to Third Level Education in 1981</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>M</td>
</tr>
<tr>
<td>1. Upper middle class</td>
<td>66</td>
</tr>
<tr>
<td></td>
<td>(69)</td>
</tr>
<tr>
<td>2. Lower middle class</td>
<td>44</td>
</tr>
<tr>
<td>and farmers</td>
<td>(44)</td>
</tr>
<tr>
<td>3. Upper working class</td>
<td>56</td>
</tr>
<tr>
<td></td>
<td>(56)</td>
</tr>
<tr>
<td>4. Lower working class</td>
<td>18</td>
</tr>
<tr>
<td></td>
<td>(18)</td>
</tr>
</tbody>
</table>


international standards. The Council therefore regards it as essential that educational policies should accord greater precedence to the attainment of equal educational opportunity. Pursuit of social objectives in education is related to the financing mechanisms within the educational system. At second level education the Council note that the Government has ended the capitation grants to schools outside of the 'free' scheme. This, in effect, means an increase in the contribution to second level education costs from the disposable income of parents, and this development is broadly compatible with a more equitable approach to the financing of second level education. The Council therefore approves of this initiative, but are concerned that a more integrated approach to social inequalities in education be developed which will comprehend the first level and second level education system.

At Third Level, as has already been shown, social differentiation in participation is still very marked. This differentiation reflects to a considerable degree the more basic social inequalities which effect education at all levels, but may also reflect inefficiencies and inequities in the financial aids available to induce Third Level participation. The data given in figure 9.2. shows the trend in the real value of higher education grants and it is clear that no consistent policy of sustaining the grants has been pursued until recently.

The Council agree with the Government's decision (published in the National Plan)\(^*\) to increase the grant levels by 10% in September 1985 and to index them thereafter to the rate of inflation. Additionally, the Council notes that the Plan's commitment to consider partial payment of fees and a more gradual 'tapering' of eligibility limits for grants, as recommended by the National Planning Board, has not been implemented.

The Council recognises that although financial instruments such as grants may not overcome the complete social and economic barriers to participation in Third Level education, that these instruments should be structured with a view maximising their efficiency and equity. Analysis of the financing instruments in\(^*\) Ireland have identified a range of alternatives to the present system and the Council therefore consider that a review of the financing of third level education should be undertaken.

The financing of third level education pertains also to the issue of revenues and pricing mechanisms and of the potential contribution of fees/charges to the control of net expenditure.

In the previous five year period some shift appears to have taken place in the relative balance of State commitments and private contributions — although the published information available on this topic is very limited.\(^1\) As the illustrative data in Table 9.11 shows, fees appear to have risen significantly more rapidly than the general price level. These fee increases may of course be consistently related to actual costs in this sector of education.

<table>
<thead>
<tr>
<th>Year</th>
<th>Nominal Prices</th>
<th>CPI</th>
<th>Constant (1968) Prices</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980/81</td>
<td>146</td>
<td>100.0</td>
<td>146.0</td>
</tr>
<tr>
<td>1981/82</td>
<td>321</td>
<td>121.9</td>
<td>266.4</td>
</tr>
<tr>
<td>1982/83</td>
<td>326</td>
<td>131.1</td>
<td>265.4</td>
</tr>
<tr>
<td>1983/84</td>
<td>358</td>
<td>145.7</td>
<td>291.4</td>
</tr>
<tr>
<td>1984/85</td>
<td>392</td>
<td>154.3</td>
<td>323.8</td>
</tr>
<tr>
<td>1985/86</td>
<td>473</td>
<td>164.5</td>
<td>385.4</td>
</tr>
</tbody>
</table>

\(^1\) Air, Commerce, 1968 at 1978
Source: University College Dublin

\(^*\) Building on Reality, Secondary Office, Dublin 1984, page 91
\(^\text{***}\) Comprehensive Public Expenditure volumes for 1984 and 1985 indicate that net expenditure on diverging from gross expenditure as a result of proportionately increasing revenues from fees, other than grants, etc.
(iv) Housing Policy

Housing expenditure is largely of a capital nature; as the data in Chapter 3 indicated, housing capital expenditure is 66% of all housing expenditure and 72% of all social capital expenditure. Two contrasting patterns are revealed in the 1980-85 housing expenditure data: the continuous rise in housing current expenditure—a rise of 84% during the period—which contrasts with the trends in health and education, and a fall during the 1982 to 1985 period in capital expenditure.

A comprehensive review of housing policy has been commissioned by Council and the Council cannot anticipate its specific policy conclusions. However, in the context of the medium term outlook for the economy and of the general principles which have informed earlier sections of this Chapter a number of points might be noted.

Firstly, the future of expenditure on housing must remain somewhat uncertain. A slower growth in household formation and an appreciable decline in the marriage rate imply falling demand in the local authority sector. Moreover, there are indications of an inadequacy of supply relative to needs, as the data in Table 9.12 on the housing waiting lists suggest. However, as indicated in Chapter 4, the largest item of current expenditure is the subsidy to local authorities on foot of loan charges, and this expenditure is determined, in part, by interest rates rather than the level of housebuilding activity. To the extent to which diminished need and lower pressure on interest rates persist during the 1986-1990 period, then expenditure on housing may moderate.

<table>
<thead>
<tr>
<th>Year</th>
<th>Average Weekly Earnings</th>
<th>Average Weekly Rent</th>
<th>CPI</th>
<th>Real Average Weekly Rent</th>
<th>Real Value Unemployment Benefit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>1981</td>
<td>116.7</td>
<td>116.7</td>
<td>120.4</td>
<td>90.9</td>
<td>90.9</td>
</tr>
<tr>
<td>1982</td>
<td>117.7</td>
<td>117.7</td>
<td>120.8</td>
<td>91.9</td>
<td>91.9</td>
</tr>
<tr>
<td>1983</td>
<td>117.1</td>
<td>117.1</td>
<td>120.8</td>
<td>92.3</td>
<td>92.3</td>
</tr>
<tr>
<td>1984</td>
<td>165.1</td>
<td>165.1</td>
<td>120.3</td>
<td>94.9</td>
<td>94.9</td>
</tr>
<tr>
<td>1985</td>
<td>179.6</td>
<td>N/A</td>
<td>120.3</td>
<td>N/A</td>
<td>N/A</td>
</tr>
</tbody>
</table>

Source: Quarterly Bulletin of Housing Statistics, Department of the Environment

Thirdly, some abatement in public housing expenditure might justifiably arise in the current context of generally adequate housing provision. There has been a general improvement in the size, quality, and availability of housing, and improvement on such indicators as overcrowding, provision of basic amenities, and size of housing waiting lists. The requirement for minimal standards in housing are unlikely to be breached in the short term by reductions in public expenditure on housing.

Fourthly, in relation to taxation and housing a significant element of public intervention in housing is the indirect subsidy to owner occupation by means of mortgage interest tax relief. This indirect expenditure is not counted as direct public expenditure. At a time of serious fiscal restraint and in a context where tax reliefs, and the tax expenditures to which they give rise, create a serious degree of regressiveness in housing subsidies, it may be difficult to justify the extent of this indirect subsidy. The absence of rates on domestic property and the non-taxation of capital gains on the sale of principal residences compound the extent of subsidies to owner occupation. In previous reports the Council has drawn attention to these issues and argued that the regressive aspects of housing subsidies be curtailed. Further, this plethora of subsidies has efficiency implications for both housing markets and the taxation system. Without pre-empting the results of its forthcoming report on housing policy the Council suggests that economic efficiency, fiscal restraint and redistribution converge on the recommendation that subsidies to owner occupation, direct and indirect, be significantly abated.

* Note: Report, No. 75, Economic and Social Policy 1985, Annex and Recommendations


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222

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Table 9.12: Waiting Lists for Local Authority Housing

<table>
<thead>
<tr>
<th>Year</th>
<th>Total</th>
<th>County Boroughs</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>20,931</td>
<td>9,074</td>
</tr>
<tr>
<td>1985</td>
<td>22,411</td>
<td>6,720</td>
</tr>
</tbody>
</table>

Source: Quarterly Bulletin of Housing Statistics, Department of the Environment

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223
The Council is of the view that the housing system as a whole has functioned effectively in that adequate and secure accommodation is available to the generality of the population, and that the focus of public housing expenditures should shift somewhat towards socially vulnerable groups and groups on the margins of the housing system. The largest identifiable sub set within this category are the Travellers, a significant proportion of whom reside in accommodation which does not accord with acceptable minimum standards: — 47% of traveller families live on the roadside, a further 7% on serviced sites, 8% in chalets and 30% in standard houses. These accommodation arrangements give rise to serious difficulties in access to the most basic amenities, as Table 9.14 shows.

The authors of the recent study on the living conditions of travellers concluded: "The central conclusion of this study is an inescapable one: the circumstances of the Irish Travelling people are intolerable. No humane and decent society once made aware of such circumstances could permit them to exist."

The Council considers that it is essential that the housing needs of especially deprived and marginal groups, such as the Travellers and the homeless, should receive priority in terms of public expenditure on housing. Attainment of minimum standards and the pursuit of modest redistribution would appear to justify some reallocation of resources towards those on the periphery of the housing system.

Finally in relation to housing policy and housing expenditure the significance of capital expenditure should be recalled, and the employment ramifications of the housing sector should be noted. To the extent to which a decrease in public expenditure on housing results in lower employment, then employment considerations might be seen as offsetting other considerations.

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*Rummans, Travelling Welfare, op. cit., page 21*
REFORMING THE TAX SYSTEM

I. INTRODUCTION

Chapter 8 outlined the framework within which fiscal policy will have to operate over the period to 1990. It was made quite clear in that chapter, if the minimal requirement of stabilising the National Debt-GNP ratio is to be attained, that the stance of fiscal policy will necessarily have to be restrictive in the medium term. This means that there will be no scope for aggregate fiscal policy instruments such as the EBR to be used as a means of expanding economic activity over the next five years.

The parameters governing the broad stance of fiscal policy have implications for taxation policy. If tax revenues are reduced as a proportion of GNP relative to their implied evolution in the medium-term projections developed earlier in this report, then expenditure reductions in excess of those indicated in Chapter 8 will be required to secure the stabilisation of the debt-GNP ratio.

Sweeping tax reductions are sometimes advocated on the grounds that the economy would respond in such a way as to generate increased revenues at lower tax rates than those which currently obtain. While the conditions which would be required to produce such a response exist in theory, the validity of this proposition must be doubted in practice.

There may be some validity in applying a similar proposition to tax reductions on individual goods and services. Such reductions however would have to be selective and highly specific. Accordingly their scope is likely to be limited relative to the size of the overall tax burden.

Given the gravity of the problems which beset the public finances, prudence would suggest that even such specific tax cuts which would require relatively large consequential increases in the level of economic activity to safeguard revenues, be avoided, and that changes in the taxation system be costed on the assumption that levels of economic activity remain unchanged. If this practice is followed whatever increase in revenues occurs will come as a bonus.
While a reduction in the overall burden of taxation would not appear to be an option in the medium term a major restructuring of that burden is both feasible and desirable. The present taxation system is widely viewed as inequitable. Its structure is widely perceived as contributing to economic inefficiency through the misallocation of resources. Its provisions are imperfectly understood by taxpayers and impose a large burden on those charged with the responsibility of administering the tax code and collecting revenue. The analysis in Chapter 4 provides ample evidence in support of these views.

To the extent that the structure of the present taxation system leads to a waste of national resources, tax reform, by which is meant a restructuring of the burden of taxation, offers the opportunity of stimulating economic activity in the medium term at a time when neither reductions in the overall burden of tax, or expansionary fiscal policy can. Accordingly tax reform may now be the most powerful instrument available to Government to promote faster growth in output and employment in the short to medium term. Building up the productive capacity of the economy through better-designed sectoral policies as advocated in Chapter 11 is likely to yield significant results only in the longer term.

In March 1980 the then Government announced its decision to appoint a Commission on Taxation. That Commission was established with terms of reference which included the following:

"To enquire generally into the present system of taxation and to recommend such changes as appear desirable and practicable so as to achieve an equitable incidence of taxation, due attention being paid to the need to encourage development of the national economy and to maintain an adequate revenue yield".

Between April 1980 when it held its first meeting, and October 1985 when it was disbanded, the Commission published five reports which taken together comprise the most comprehensive and thoroughgoing analysis of the taxation system undertaken in the history of the State. The approach and recommendations of the Commission therefore, provide an invaluable basis for considering how the tax system might be overhauled in order to secure a system which more fully satisfies the criteria of equity, efficiency and simplicity.

The content of this chapter is organized as follows. Section 2 sets out the basic principles which underpin the approach of the Commission to reforming the tax system and briefly describes the principal features of the eventual system proposed as well as the phasing envisaged by the Commission. Section 3 examines the first phase of reform proposed by the Commission in greater detail. Section 4 comprises a brief review of changes made in the tax system since 1982, when the Commission's first report was published, with a view to establishing whether there has been a coherent taxation policy in place and whether the changes which have been made have moved the tax system closer to that proposed by the Commission. Section 5 sets out the Council's views on the principles enunciated by the Commission and the Council's recommendations on taxation policy in the medium term.

2. THE COMMISSION ON TAXATION: PRINCIPLES, RECOMMENDATIONS, AND PHASING

(i) Principles

Tax systems are usually evaluated against the criteria of equity, efficiency and simplicity. Accordingly, when it comes to considering proposals for tax reform these three attributes provide the dimensions along which the merits of the recommendations can be assessed.

The first step in the formulation of proposals for tax reform is to postulate a set of principles which capture the notions of equity and efficiency at a conceptual level. A second step is to design structural parameters, operational guidelines, and administrative procedures, which are capable of translating the principles into a tax system which is at the same time equitable and efficient, and which is also easy to administer and to understand.

The myriad detailed recommendations of the Commission on Taxation can be reduced to a basic set of principles. Such principles can be inferred fairly readily and are limited in number. The discussion below concentrates on the eight most important of them.

At the outset it is worth attempting to distinguish between two sets of principles even at the risk of arbitrary differentiation. Firstly, there are principles which command universal acceptance and agreement in theory because they are based on generally accepted notions of equity or commonsense. The adoption of such principles in theory whatever about the operational guidelines which might be chosen to activate them, is accordingly unlikely to be contentious.

On the other hand there are principles which reflect a particular view of society or, more specifically, of how the economic system should operate. Such principles are amongst those on which political parties divide and fight elections. They are not nearly as likely to be based on generally accepted ideas or to command widespread agreement.

It is useful to bear this distinction in mind when considering the principles espoused by the Commission on Taxation in formulating their approach to tax reform.
Principle 1: The direct tax base should be defined on a basis which measures the amount which a person could spend in a particular period while maintaining intact the real value of his capital in terms of general purchasing power.

The Commission consider that the present definition of income for tax purposes has evolved in a piecemeal fashion, that it is unclear and inconsistent, and that it generates serious problems in administering and interpreting the tax code. A clear and unequivocal definition of what constitutes income for tax purposes is regarded as the basic building block of a reformed tax system.

The definition proposed by the Commission covers all accretions of purchasing power including earned income, social welfare benefits, fringe benefits, lump-sum receipts and other windfalls. It does not matter through what medium the income accrues, whether through working, operating a business, returns from property, whether gained from selling property or received as a gift. Nor does it matter whether the income is expected or unexpected, received in cash or in kind, received for services rendered gratuitously, or whether it is regular or irregular.

The stipulation that the definition of income for tax purposes should have regard to maintaining the real value of capital has implications for the treatment of inflation in the tax code. (see Principle 4)

Principle 2: Income from different sources should be taxed in the same way.

The equity dimension of this principle is transparent, implying as it does that all accretions of purchasing power in whatever form or from whatever source should be taxed at the same rate and should be subject to the same provisions in respect of the time period in which payment is due.

To the extent that differential tax treatment of income from different sources results in the misallocation of resources this principle also has a strong efficiency dimension. Furthermore the adoption of this principle together with the institution of a single rate of tax as proposed by the Commission would result in a much simpler taxation system and one in which many of the incentives to tax avoidance inherent in the existing system would be removed.

Principle 3: A husband and wife living together should be regarded as the basic unit for tax purposes. In principle, the same unit should be used for all taxes.

The Commission maintain the most important considerations in the choice of the appropriate tax unit to be the following:

(i) families in the same circumstances and with the same joint resources should be taxed equally;
(ii) the decision to marry or not should be unaffected by tax factors;
(iii) the system should not discriminate on grounds of sex and,
(iv) the arrangements involved should be easy to administer and understand.

Having examined these considerations the Commission come down in favour of the adoption of the family rather than the individual as the basic unit of taxation but recommend that married persons should continue to have the right to be charged to tax as single persons.

Principle 4: The tax system should be neutral with respect to inflation.

The Commission identifies three headings under which the impact of inflation on the tax system can be assessed: payment of tax; fiscal drag and, the tax base.

(i) Payment of Tax. Any delay between the event which gives rise to tax liability and the actual tax payment, generates reductions in the real burden of tax when prices are rising. If such delays can not be equally availed of by all taxpayers inequities will result. The provisions of the existing tax system which produce such consequences should, in the Commission's view, be removed.

(ii) Fiscal Drag. The Commission point out that when a tax is levied at progressive rates or involves exemptions and deductions which remain unchanged in money terms, substantial increases in prices and incomes have the effect of increasing receipts from particular taxes faster than the rate of inflation. The Commission indicate that a further effect of inflation is to increase the proportion of tax revenue attributable to income tax and also show how, under inflationary conditions, when personal tax rates and allowances remain unchanged, the rate of increase in tax payable varies between income groups and between taxpayers with different numbers of dependents. The restructuring and redistribution of the tax burden which takes place as a result of fiscal drag is unplanned and has inequitable effects which are arbitrary. In line with the principle that the tax system should be neutral with respect to inflation the Commission make a number of recommendations on indexation.

(iii) The Tax Base. Inflation impacts on the tax base in respect of business income, capital gains and investment income. If the associated problems are not resolved misallocation of resources will ensue.

Principle 5: In so far as individuals when left to their own devices will spend their income wisely and business will choose the most
efficient means of production, the minimisation of waste requires that a tax system should not influence individual or business choices.

The Commission devotes an entire report, *Direct Taxation: The Role of Incentives*, to a detailed consideration of the role of the tax system in providing incentives which impact on business choices. In the Commission's view such incentives have a limited role to play in promoting economic growth in Ireland for a number of reasons. Firstly, the Commission judge that the level and pattern of economic growth is affected much more by the general economic policies of the Government than by set specific measures labelled 'incentives'. Secondly, it is the Commission's view that incentives are justified on limited grounds only: (i) where the market clearly fails to bring about the desired allocation of resources; (ii) where incentives may be required to match those offered in other countries competing to attract desirable internationally mobile capital investment; (iii) where incentives may be required to offset shortcomings in other policy areas. Thirdly, the Commission point out that the provision of incentives to one sector requires that other sectors must bear a higher burden of taxation and/or the reduction in public services.

The Commission's recommendations on tax-based incentives in their Second Report are influenced by their perception of what the economic effects of implementing the proposals in their First Report would be. As the Commission see it these effects would result in the creation of a more favourable economic environment in the following ways:

(i) a switch in the balance between borrowing and saving in favour of the latter;
(ii) a reduction in the balance of payments deficit on current account;
(iii) an increase in the level of output arising from greater competition;
(iv) a higher level of employment;
(v) an increase in the efficiency of investment.

It is the Commission's view that in such circumstances the need for state-funded incentives, either tax-based or direct, would be reduced.

**Principle 6: As a general principle it would appear preferable to make direct payments to those in need than to provide assistance through the tax system.**

Broadly speaking there are two types of need germane to the discussion of tax issues. One type of need derives from low absolute levels of income and is established with reference only to a person's financial circumstances. The other type of need is established on the basis of non-financial circumstances and derives from the perception that people with the same income but with different numbers of dependents, or who are disadvantaged on such grounds as physical incapacity or age, require special assistance. The first type of need corresponds to the vertical dimension of equity while the second reflects the horizontal dimension. The principle underlined above can be taken as applying to both.

As far as the vertical dimension of equity is concerned the Commission's view of the role of the tax system has its basis in the distinction between nominal and effective progressivity and the implications of such a distinction. The Commission makes the point that a nominally progressive system may result in the more unequal distribution of disposable income than one which is nominally less progressive because opportunities for evasion and avoidance are not equally distributed.

**Principle 7: Taxes should not be earmarked for specific purposes.**

The Commission examine the arguments for and against the practice of assigning revenues whether in the form of earmarked taxes or special levies. They note the argument that earmarking may be desirable to the extent that it conveys to the public the notion of value in terms of taxes paid for Government services and may thus diminish public resistance to taxation. The Commission observe that the opposite effect may also obtain: namely, the reinforcing in the public mind of the impression that, for the greater bulk of taxation, value for money is not obtained.

Two other arguments are advanced against the general idea of revenue assignment: (i) the additional administrative and compliance costs which result from a proliferation of taxes and levies and, (ii) the danger that the practice may lead to a waste of resources in the public sector. On the second point the Commission consider that it is desirable for revenue to be allocated between the competing public expenditure heads on the basis of criteria of need and desirability rather than on the basis of how much revenue is raised under particular tax heads.

**Principle 8: Compulsory social insurance contributions are more appropriately regarded as a tax and should be evaluated by the criteria of equity, efficiency and simplicity applied to taxation.**

It is important to establish the extent to which social insurance contributions conform to the characteristics of a tax rather than of insurance premiums. To the extent that they exhibit the attributes of insurance premiums it would be inappropriate to apply the criteria of equity, efficiency and simplicity used to evaluate taxation.

The Commission make the point that where a close relationship does not exist between social insurance contributions and benefits, such contributions
become akin to a tax in that they are compulsory payments which do not confer proportionate benefits. Contributions are entirely pay-related but additional payments do not generally produce additional benefits. Moreover, many of the benefits are graduated in respect of dependency while contributions are not. A further point made by the Commission is that the amounts of insurance benefits relative to the corresponding assistance benefits are not sufficiently high to be consistent with the concept of a genuine insurance scheme.

Having established, to their satisfaction, that it is appropriate to regard social insurance contributions as a form of taxation, the Commission proceed to evaluate them accordingly.

(ii) Recommendations

The following is a summary of the salient features of the system of taxation which would eventually be in place if all the recommendations made by the Commission on Taxation in their first four reports were implemented.

Income Tax A single rate of tax would apply to all income with income defined as indicated in the discussion of Principle 1 above. The proposed income tax would apply equally to all sources of income in line with the second principle. The self-employed and farmers would be treated in the same way as employees, particularly with regard to the treatment of expenses, and the year of assessment. Investment income would be treated like income from any other source, with income from interest-earning assets taxed on the excess of the interest rate over the inflation rate. On the grounds that they confer on their recipients the same command over economic resources as a stream of income, all forms of capital accretion would be taxed in the same way as income. For similar reasons fringe benefits would be taxed on the basis of the market value of the goods and services received.

Under the proposed system the discretionary reliefs and most of the secondary allowances currently available would be abolished and the remaining allowances replaced by tax credits. The proposed abolition of discretionary reliefs may be seen in the context of the Commission’s view of the role of the tax system in influencing economic choices (Principle 6). The proposed removal of secondary allowances is based on the Commission’s view that direct payments represent a superior method of helping those in need.

In order to attain the desired measure of progressivity in the new direct taxation system while obviating the need for higher marginal rates of income tax, a direct expenditure tax would be instituted.

Savings All forms of savings, with the exception of superannuation contributions, would be treated in the same way for tax purposes, that is, on the basis of interest income adjusted for inflation. Neutrality of tax treatment as between different savings media and institutions would thereby be achieved. Such features of the existing system as the double taxation of dividend income would be removed. Consistency of treatment would require the elimination of general mortgage interest relief. State aid to home buyers would be more selective and concentrated on first-time home buyers. A benefit attracting to the introduction of the proposed direct expenditure tax would be the incentive thereby provided to savings and investment and the removal of certain existing forms of tax avoidance.

Social Security Tax The existing system of employees’ and employers’ PRSI contributions would be abolished, together with the ear-marked taxes: the health contribution and the Youth Employment Levy. PRSI would be replaced by a 5 per cent Social Security tax on all income, including company income. Any shortfall of receipts from the Social Security tax relative to the existing PRSI system would be recouped from excise duties and/or VAT. The proposed abolition of PRSI springs from Principle 8 discussed above while the proposal to remove ear-marked taxes is based on the Commission’s view of assigned revenues (see Principle 7).

Company Income The Commission’s recommendations in respect of company taxation are based on the desirability of achieving neutrality as between (i) dividends and other forms of income; (ii) retained and distributed profits and; (iii) different types of company organisation. Company profits would be charged to tax at the single rate of income tax with full credit given to shareholders for this tax when distributions are made out of company profits. The same arrangements would apply to all financial institutions. The tax liability of companies would be adjusted for inflation in a systematic way.

Taxes on Expenditure All goods and services would be charged eventually to the same rate of value-added tax. In order to generate the same amount of revenue as the existing system the required rate would be considerably lower than the present standard rate of 25 per cent. During the transition period compensatory measures to the extent necessary should be introduced to protect lower income groups. Excise duties would be levied on a wholly specific basis and adjusted quarterly for inflation. Stamp duties would be eventually abolished.

Local Taxation If it were decided that a system of local taxation were desirable, it is recommended that a local property tax be introduced and applied to all residential, commercial and industrial property. Agricultural land would not be liable to the tax but farmhouses would. Compensation through the social welfare system would be effected for people on low incomes while those paying mortgage interest would be permitted to deduct real interest payments. It is envisaged that any additional revenues accruing from the property tax would be used to reduce the burden of income tax.
Inflation A number of the Commission’s recommendations are designed to deal with the undesirable impact which inflation has on the structure and distribution of taxation (see Principle 4 above). These include: (i) the indexing of all income tax bands and credits; (ii) the indexing of specific excise duties; (iii) taxing real rather than nominal interest receipts; (iv) various adjustments to the business taxation code to take account of inflation.

Progressivity The essential redistributive functions of the tax and public expenditure systems would be achieved through direct payments at the bottom of the scale, through the choice of the level of personal tax credits and the tax rate in the middle income ranges, and through the imposition of a progressive direct tax on expenditure at the top of the scale. The decision on each of these questions is a political one and does not affect the structure of the proposed tax system which is designed to accommodate many combinations of tax rates and credits and, different balances between direct and indirect taxation.

(iii) Phasing of Reform
The question of phasing the reforms proposed by the Commission over an appropriate timespan is one of obvious importance for a great number of reasons but principally because of considerations of equity and practicality. The Commission has attempted to demarcate three phases of reform in their reports. Such phases are explicitly identified, and the reforms must appropriately carried out in each listed in some detail in the Commission’s first three reports. In this section we list the principal elements in that set of reforms which the Commission considers could and should be implemented in the first phase, that is, in a timespan of about 5 years.

In discussing the issue of phasing in relation to the recommendations in the first report on direct taxation, the Commission envisage the transition from the existing to the proposed system comprising three stages as follows:
(i) items on which work could start without delay;
(ii) items which are likely to cause greater difficulty;
(iii) steps involved in the final integration of the system of direct taxation.

The discussion of the phasing of the recommendations in the second report on the role of incentives is not structured in a precisely analogous way. A limited number of specific proposals are identified as suitable for implementation in the first phase but the generality of the proposals in the second report are regarded by the Commission as being suitable for implementation only after the first phase of reform of the direct taxation system had been completed.

There is only a limited discussion of phasing in the Commission’s third report on indirect taxation. The most important recommendation here is that a single rate of VAT be introduced and that the transition be effected as quickly as possible.

The most important proposal in the Commission’s fourth report on special taxation relates to the introduction of a local property tax. This proposal is conditional on the political decision that a system of local taxation is desirable. As regards the timespan envisaged for the implementation of this proposal the Commission states that the main requirement is a system which will enable property taxes to be introduced with minimal delay and cost to both sides. On this basis it is proposed that such a tax be introduced on a self-assessment basis.

3. THE FIRST PHASE OF REFORM PROPOSED BY THE COMMISSION
It is important to consider in some greater detail the recommendations of the Commission which it is proposed would be implemented in the first phase of reform. One purpose of this exercise is to ascertain the extent to which the first phase proposals are (i) interlinked with each other and, (ii) linked with the recommendations which the Commission envisage as being capable of implementation only in subsequent phases.

Examining the Commission’s proposals in this way permits the following questions to be answered:
(i) to what extent could a coherent package of tax reforms be put together in the short-to-medium term (i.e. over the next five years) by drawing on a subset of the Commission’s first-phase proposals rather than the totality of such proposals?
(ii) to what extent would the implementation of a subset, or the totality of the Commission’s first-phase recommendations, in the next five years necessitate, on grounds of coherence and consistency, the implementation of all the remaining proposals of the Commission in the longer-term?

It has been asserted that the recommendations contained in the Commission’s reports comprise a single mutually dependent and re-inforcing set of measures which can only be implemented as a totality, and that selective implementation would compromise the integrity of the entire package while possibly giving rise to a tax system even more deficient than the existing one.

Careful analysis of the Commission’s proposals indicates that the situation is not as clear-cut as this. While most of the Commission’s important recommendations on direct taxation, for instance, are interlinked, this is not the case with regard to them all. There are some recommendations which can be assessed separately on their own merits and which, if rejected, do not
compromise the integrity of the Commission's overall approach. Evaluating the recommendations of the Commission therefore is not an exercise the purpose of which is to reject or accept their reports in toto but one which is best conceived as a means of identifying the maximum extent to which the problems and costs associated with the existing system can be resolved by following the thrust of the Commission's approach to tax reform and by implementing a subset, and not necessarily the totality of their proposals.

(i) Personal Income Tax

The Commission's approach to the reform of the income tax system and the proposals advanced for the first phase of reform are illustrated in Figure A. The diagram is a schematic representation of the relationship which exists between high average and marginal tax rates, the income tax base, and the elements in the present tax system which narrow that base.

The Commission's strategy may be conceived as embodying three fundamental elements:

(i) the widening of the tax base;
(ii) the attenuation of the progressive rate structure (in phase 1) leading to the eventual establishment of a single rate of income tax combined with a progressive direct expenditure tax at the upper end of the income spectrum and,
(iii) the gradual convergence of the tax treatment of company income, capital gains and capital acquisitions, with that of earned income, leading to eventual harmonization.

The Commission's strategy is also informed by the view that redistribution must be considered in the context of both the tax system and public expenditure and that, within the tax system, redistribution is best effected by the choice of the level of tax credit and the rate of tax.

The first element (widening of the base) is a prerequisite for the achievement of lower average and marginal tax rates than those currently faced by the generality of taxpayers. The third element is vital to the achievement of neutrality of tax treatment as between different income sources, to the elimination of tax avoidance and, to the fostering of an environment conducive to more efficient resource allocation. It is only in the context of attenuating the progressive rate structure of income tax and moving towards a single rate (the second element) that harmonization of the tax treatment of different income sources can be secured.

_Widening the Base_ Under the first general heading in Table 10.1 are listed those recommendations of the Commission the purpose of which is to widen the existing base for personal income tax. The recommendations are listed under four sub-headings: (a) taxation of income which is currently exempt;
(b) abolition of reliefs/deductions where no compensatory direct payments are envisaged by the Commission; (c) abolition of allowances with provision for compensatory payments and, (d) other recommendations.

In general, proposals to widen the base in respect of income which is currently exempt derive their logical rationale and their justification in equity from the Commission’s definition of income. The recommendation that exemption limits be abolished is influenced by other considerations including the administrative complications which their operation gives rise to and the Commission’s view as to what the proper role of the tax system should be in the area of income distribution.

The proposals to abolish the reliefs and deductions listed at (b) in Table 10.1 derive, in the main, from the view that their availability distorts the allocation of economic resources by discriminating in favour of certain types of expenditure. Their presence also provides a set of mechanisms for tax avoidance and discriminates between taxpayers in a way which is consistent with neither the principles of horizontal or vertical equity.

The rationale for the existence of those allowances the abolition of which the Commission propose and which are listed under (c), is that they provide a measure of discrimination in favour of taxpayers with certain dependency obligations and physical handicaps. The Commission consider that this objective would be more effectively realised by making direct payments to the relevant groups.

The recommendations listed under (d) include the institution of a current year basis of assessment for Schedule D taxpayers and the more stringent definition of allowable business expenses. These are designed to harmonize the tax treatment of employees and the self-employed. The abolition of the Schedule E (PAYE) allowance is proposed as a concomitant to such harmonization.

Structure of Personal Income Tax The Commission’s recommendations which pertain to the structure of the income tax system may be divided into two groups: (i) those which are advanced on the grounds of principle and (ii) those, progress towards the implementation of which depends upon the extent to which the tax base is widened.

Falling within the first category are the recommendations concerning the choice of tax unit, the conversion of tax allowances into credits, and the indexation of tax bands and allowances/credits. The recommendation that the family be regarded as the unit of taxation de facto implies little operational difference from the existing situation. The Commission argue the case for tax credits rather than allowances principally on the grounds that credits impact equally on all taxpayers whereas allowances do not, but also on the grounds that a credit system is easier for taxpayers to understand.

In contrast to these proposals, which can be implemented independently of progress towards the expansion of the tax base, are the Commission’s
recommendations that, in the first phase of reform, income tax rates be lowered and tax bands widened. The Commission is of the view that the implementation of the first-phase recommendations detailed above would be to increase the progressivity of the tax system at existing rates of tax. In particular the elimination of discretionary allowances, coupled with the introduction of tax credits calculated at the standard rate of tax, would significantly reduce disposable income for higher rate taxpayers who currently benefit disproportionately from discretionary reliefs and personal tax free allowances. Accordingly the Commission believes that if these measures are introduced they should be accompanied by the widening of the lower rate bands and, the institution of a top marginal tax rate which should not exceed 50 per cent.

(ii) Capital Taxation and Corporation Tax
In the top right most corner of Figure A the tax treatment of capital gains and company income (along with discretionary trusts and covenants) is identified as a factor which contributes to narrowing the personal income tax base through the conduct of tax avoidance. Accordingly the reform of the tax system as it impinges on income accruing in these forms must be taken in conjunction with reform of the personal taxation system. Moreover the Commission's approach to reforming capital taxation and corporation tax is in many essential respects analogous to the strategy adopted in relation to personal income tax.

Capital Taxation In relation to capital gains tax (CGT) the Commission state that it is necessary to widen the base while the existing capital acquisitions tax (CAT) is described as being characterised by very high nominal rates of charge on a base which is eroded through the granting of exemptions and reliefs and relatively high thresholds.

The recommendations advanced by the Commission in the area of capital taxation and which are considered implementable in the first phase of reform are set out in Appendix 4. These recommendations fall into two broad groups: those which are designed to widen the base for capital taxes (extending the range of chargeable assets, abolition of existing reliefs and, treating death as a disposal, in the case of CGT; aggregation of all gifts and inheritances, discontinuation of relief for productive assets and, reduction of tax thresholds, in the case of CAT) and those which are concerned with reducing the tax rates. The lowering of CAT and CGT rates is contingent upon progress being made towards widening the respective bases.

As regards the actual rates of CAT and CGT to be achieved in the first phase of reform the Commission's view is that they should be set between 25 per cent and the then existing maximum marginal rate of personal taxation, and that they should be correspondingly adjusted as the maximum rate of income tax is reduced. The actual rates should be selected so as to achieve, to the greatest extent possible, neutrality in the treatment of income and realised capital gains, and equity in the relative treatment of income and capital acquisitions.

Corporation Tax The Commission postulate a number of criteria for the evaluation of systems of company taxation.

Included in this set of criteria are the following:
(i) the system should be neutral as between the choice of business organization (i.e. incorporated vs. unincorporated enterprises);
(ii) retained and distributed profits should be treated in the same way;
(iii) tax paid by shareholders and dividend income should be equivalent to that payable on other forms of income and,
(iv) the system should bring forward the desired level and pattern of investment, meaning inter alia that the tax system should not favour equity over debt financing or vice versa.

The existing system departs significantly from each of these criteria. The shortcomings in the existing system in these respects derive not alone from the corporation tax (CT) regime per se but also from the haphazard interaction between CT, CGT and personal income tax. Accordingly the objective of instituting a system of company taxation which embodies the characteristics enumerated above is critically dependent on the eventual achievement of a single rate of tax applying to personal income, company income and capital gains.

Movement towards this goal can be achieved in the first phase, according to the Commission, if certain proposals are adopted including: the introduction of a withholding tax on distributions (ACT); increasing the rate of imputation on dividends (as a step towards full imputation); abolition of the special rate of tax applicable to small companies and, treating companies' capital gains in the same way as other company income for tax purposes. Again, as in the case of capital gains and acquisitions, the Commission envisages the first phase of reform as one in which the rate of CT would be reduced in line with income tax rates.

The relationship between the Commission's proposed reform in the CT area and in the area of personal income tax warrants strong emphasis. The objective is to treat income accruing to companies in the same way as other income. In the Commission's view to do otherwise distorts economic decisions, is unfair, and leads to tax avoidance.

The discussion above indicates that the Commission's recommendations in regard of personal income tax, corporation tax and capital taxation are fundamentally related, ultimately by the objective of achieving a single rate of tax spanning these areas. Progress towards this objective in the first
phase of reform is seen as taking place in a context where reforms in these three areas proceed in tandem and where the result is an increasing degree of harmonization between the three.

(iii) Social Insurance Contributions
The Commission evaluates the existing system of social insurance contributions against the criteria of equity, efficiency and simplicity which are brought to bear on taxes more generally. Their recommendation that the present system be eventually replaced by social security taxes levied at a single uniform rate on all income is predicated on the judgement that, evaluated as a tax, it scores poorly by these criteria.

In the first phase of reform the Commission suggest that progress towards this objective could be achieved by abolishing the separate health contributions and youth employment levy, extending liability for social insurance to the self-employed and, allowing income tax credits to be set against liability for employees' social insurance contributions, in order to benefit the low-paid. It is also envisaged that, in the first phase, the employer's contribution would be phased out and replaced by a social security tax on the income which arises in the first place to companies.

(iv) Taxes on Expenditure
The recommendations in the area of indirect taxation which the Commission consider could be proceeded with in the first phase of reform are listed in an Appendix. Summary comments in respect of V.A.T. only are provided here.

The Commission consider a number of options for progressing towards the ultimate objective of levying V.A.T. at a single rate on all goods and services. In their third report they favoured as rapid a transition period as possible subject to the constraint that the removal in one step of the disparity which existed between the higher and lower rates (0 and 35 per cent) at that time would cause serious disruption. Accordingly the first priority as perceived by the Commission was to reduce this disparity and operate a two-tier system in the transition period.

On the question of the distributional consequences of their proposals, in particular the impact of subjecting such items as food, clothing and footwear to V.A.T., they recommended that the extent to which the incidence of taxation would change be monitored, and that compensatory measures be put in place to protect the lower income groups.

4. TAXATION POLICY SINCE 1982
In this section are outlined the most important changes which have taken place in the taxation system since 1982, the year in which the first report of the Commission on Taxation was published. The purpose of doing so is threefold: (i) to ascertain whether government taxation policy in the last four years has followed a coherent strategy; (ii) to assess the extent to which the changes which have taken place have moved the overall taxation system, or elements of it, to a position more closely in tune with that recommended by the Commission; (iii) to identify evidence of administrative or other difficulties involved in implementing the Commission's recommendations which may have emerged in successive Budget documents.

(i) Income Tax
The Tax Base The income tax base has been further eroded since the Commission's report on direct taxation was published in 1982. Three sets of factors may be identified as responsible for this:

- the growth in the total amount of income exempted on foot of the operation of discretionary reliefs, principally the reliefs in respect of mortgage interest*, life assurance premiums and medical insurance premiums;
- the introduction of new allowances and new categories of exempt income in successive budgets in recent years and,
- the fact that budgetary policy has increased the basic personal tax free allowances and certain secondary allowances** by an amount considerably in excess of the rate of inflation.

The latter two factors are explicitly the result of Government's taxation policy and run counter to the recommendations of the Commission. Amongst the new reliefs introduced have been the Business Expansion Scheme (in 1984) which runs counter to the spirit of the Commission's recommendations on the role of the tax system as a vehicle for the provision of incentives; the incentive for investment in research and development set out in the 1986 Finance Bill and, the PRSI tax free allowance which was designed to compensate certain taxpayers for the operation of a discriminatory system of social insurance contributions, the abolition of which is proposed by the Commission.

The over-indexation of personal tax free allowances and most secondary allowances, apart from its impact on the tax base, is at odds with the Commission's view that the tax system should not be used in this way as a vehicle for redistribution, and runs counter to the Commission's view that secondary allowances should be abolished and replaced where necessary by direct payments to the corresponding target groups.

Government policy has however moved in the direction of the Commission's recommendations on the question of the child tax allowances (abolished in

*This, despite the fact that there were significant increases in the numbers imposed on income tax in the Budget of 1983
**All secondary allowances except the Dependents' Relief Allowance have been increased in real terms since 1982.
See Table 5.14.
the 1986 budget) and the institution of a new child benefit scheme along lines similar to that envisaged by the Commission. Apart from this little progress has been made towards extending the income tax base along the lines suggested by the Commission, as outlined in Table 1.1 above. Proposals to subject short-term social welfare benefits to tax have been mooted in a number of budget statements and, most recently, in the Government's economic plan Building on Reality. The only published reason for the failure to implement this proposal has been the administrative complexity attaching to doing so.

**Tax Rates and Bands** Partly as a consequence of the continued erosion of the personal income tax base and the failure to index marginal rate bands in successive budgets (but also, of course, because of the continued increase in tax revenue generally, and income tax in particular, as a proportion of GNP), average and marginal tax rates in real terms have increased substantially since 1981-82 (see Tables 4.10 and 4.11).

At the time the Commission's first report was compiled there were five rates of income tax including a low rate of 25 per cent. In the 1983 budget this number was increased to six with the addition of a top rate of 65 per cent. One of the Commission's short-term recommendations was that the low rate be abolished. This was done in the budget of 1984. The 1985 budget brought further rationalisation with the abolition of the 65 per cent rate and the consolidation of the remaining rates into three: 35, 48 and 60 per cent. The 1986 budget saw a further reduction in the top rate to 58 per cent, and the abolition of the temporary income levy which had been introduced in 1983 after the publication of the Commission's First Report.

As noted in the previous section the Commission have identified two priorities for structural reform of income tax in the first phase:

(i) securing a situation whereby the maximum possible proportion of taxpayers are liable at the standard rate;

(ii) reducing the top rate of tax to a maximum of 50 per cent;

Given the relative cost of these two objectives the first is much more critically dependent on the degree of progress attained in extending the income tax base. The rationale for the second is seen by the Commission as deriving from the need to counter the increased progressiveness which would be imparted to the system by the introduction of tax credits. Exclusions (especially those in relation to discretionary reliefs) and the proposal to replace tax allowances with tax credits. Viewed in this way the Commission's position can be inferred as one which would see the base being widened before the top rate of tax is reduced. After all the fundamental problem is not that our top rate of tax is exceptionally high by international standards but that it is reached too quickly and by too many taxpayers.

Government policy in recent budgets would appear to have prioritised the lowering of the top rate of tax: it has been reduced from 65 to 58 per cent in two years. This has been achieved at very modest cost in terms of revenue foregone and has arguably conveyed the impression of significant change having been achieved, whereas in reality the more fundamental reforms have not been started.

**Other Features** An important feature of the income tax system identified by the Commission as a source of inequity is the differential treatment of employees, and the self-employed and the fact that farmers are subject to a fundamentally different system of taxation than other income earners. The Commission's recommendation that the same general system of taxation be applied to all farmers as to other self-employed persons coupled, with their recommendation that Schedule D tax liability should be determined on a current year basis of assessment, would have the effect of removing this feature.

The new farm tax proposed by Government in Building on Reality runs completely counter to the Commission's approach and recommendations. More generally, and as argued in NESC Report No. 79, it is likely to offend against the principles of equity and simplicity. As regards the current year basis of assessment for Schedule D taxpayers, an announcement to the effect that the necessary legislative provisions would be contained in the 1984 Finance Bill was made in the Minister's budget speech of 1983. In his 1984 Budget speech, however, the Minister announced his decision not to proceed in this direction on the grounds of the extra administrative burden which would be imposed on both taxpayers and the Revenue and, on the grounds that no additional revenue would accrue. The Minister expressed the view that a more effective return from the self-employed could be obtained by improving existing arrangements. Accordingly, the specified amount of tax payable by self-employed persons appealing an assessment was increased from 80 to 85 per cent in 1984. This was further increased to 90 per cent in 1986.

Finally as regards the conversion of allowances into credits this had been the policy of the government as articulated in the Programme for Government (1982). However, the 1983 budget speech indicated that the introduction of tax credits was being considered only as a 'longer-term option'. A more extended discussion of the issue in the 1984 budget speech elaborated government thinking on the subject and revealed that, apart from the pressure on administrative resources, an additional argument against their introduction was that this would be inequitable at a time when income tax rates are high. The Minister concluded by saying that he would keep the question of tax credits under review in the light of changing tax trends.

It should be noted that the Commission on Taxation does not envisage the replacement of tax allowances by tax credits without a compensating reduction in tax rates.
(ii) Capital Taxation

The thrust of government policy in relation to capital taxation as announced in the Budgets up to 1986 was to derive an increased yield from capital taxes, more so by increasing the rates at which the tax is charged in the case of CGT, and by means of a more comprehensive aggregation system in the case of CAT, than by expanding the tax base. Indeed certain changes in capital taxation policy in recent years have had the effect of reducing the capital tax base, for example the four-fold increase in the exemption thresholds for CGT which took place in 1982. The yield from these capital taxes has not increased to the extent expected and this has been attributed in the main to the impact of the recession on capital transactions. However, certain capital taxation thresholds have been set at such a high level that the base was severely constricted from the outset and the threshold in respect of property values under the Residential Property Tax has been defined in such a way as to make the base on which the tax is levied especially sensitive to downward movement in the property market.

The changes in CGT announced in the 1986 Budget have however grafted onto this broad policy thrust a number of selective reductions in the rates of tax, but without any attempt to increase the base. Taking the 1982-1986 period as a whole therefore it is difficult to ascribe coherent strategy to Government policy in relation to the taxation of capital gains.

(iii) Corporation Tax

Rates and Structure

The principal changes in the structure and rates of corporation tax (CT) introduced since 1982 have been as follows:

- the rate of CT increased from 45 to 50 per cent (1982)
- consequential change in the rate of imputation applied to dividends, from 30/70ths to 35/65ths (1983)
- introduction of Advance Corporation Tax (1983)
- maximum tax rate of 25 per cent applied to dividend income from manufacturing companies up to £13,000 (1986)

The introduction of ACT was in line with the Commission's recommendation that a withholding tax on distributions be instituted. However, the Commission also proposed that this be accompanied by an increase in the rate of imputation on distributions. The only increase in the rate of imputation which occurred during the period since 1982 was purely designed to compensate for the increase in the basic rate of CT which occurred in 1982.

As a consequence of these changes in CT there has been no systematic movement of the system of company income taxation towards a position where the various distortions noted by the Commission have been reduced. There has been some amelioration of the disincentive effect of the tax system on distributions from companies subject to the 10% rate of tax on foot of the measures outlined in the 1986 Finance Bill, but these measures are ad hoc in nature.

Other changes

A number of other changes in the taxation system as it impinges on companies have been introduced since 1982. Among these are the following:

- the 20 per cent income tax relief on dividends for shareholders in certain industrial companies was abolished (1983)
- the announcement that new Section 84 lending and artificial preference share financing would not confer a tax advantage (1984)
- restrictions on leasing (1984)
- the imposition of a 12 per cent rate of duty on all interest received under Section 84 loans (1986)
- the restriction of capital allowances to investment expenditure net of capital allowances to investment expenditure net of capital grants received (1986)

The decisions to abolish the 20 per cent income tax relief and restrict capital allowances mirror specific recommendations of the Commission. The intended curtailment of tax-based lending in 1984 reflected the spirit of the Commission's proposals in relation to the provision of incentives through the tax system. However, a measure of the lack of success of the 1984 measures was provided in the Minister's budget speech of 1986, which indicated that the system of tax-based financing was now costing the state £170m annually.

At the same time as attempts have been made to curtail the cost of tax-based financing a range of new 'incentive' reliefs have been introduced and others consolidated in the tax code including:

- the incentive for investment in research and development (1986)
- the incentives for inner-city development (1986)
- the incentives for profit-sharing (consolidated in 1986)
- the Business Expansion Scheme (1984)

Their introduction is at variance with the approach of the Commission to the role of the tax system in the provision of incentives.

(iv) Indirect Taxation

Since the Commission's report on indirect taxation was not published until June 1984 and was based on an assessment of the system as it had evolved up to and including the budget of that year, we focus on the principal changes which have taken place in taxes on expenditure in the two budgets since then under the heading of VAT and Excise Duties.
VAT In 1984 there were six separate rates of VAT spanning the range from zero to 35 per cent. The 1985 budget reduced the number of rates to three: the resultant rates spanned the range from zero to 23 per cent. In this regard the changes effected in 1985 moved the VAT system in the direction recommended by the Commission, although there was some slippage in the 1986 budget in that the top rate was increased again, albeit modestly, to 25 per cent.

At the same time there has been no significant expansion of the base for VAT. A number of services have been granted exemptions from VAT including theatres and live performances (in 1985) and, the services of dental technicians (in 1986). In contrast, adult footwear, previously zero-rated, became liable at the 10 per cent rate in 1985.

Excise Duties Policy in relation to excise duties has changed perceptibly since publication of the Commission's Third Report, principally as a means of bringing the prices of certain goods in the Republic of Ireland more closely in line with their Northern Ireland levels.

In October 1984 there was a significant reduction in the duty on spirits and in the 1985 budget no increase took place in duties on beer, spirits and wine. The same budget halved the excise duty on TVs and the duty on off-course betting. The increases in duties on alcoholic products in the 1986 budget were modest by historical standards.

5. THE COUNCIL'S VIEWS AND RECOMMENDATIONS

(i) Principles

The Council agrees with the Commission on Taxation that a coherent and comprehensive definition of income must be adopted in a reformed system of taxation. As regards the particular definition recommended by the Commission, the Council believes that there is no reason in logic or equity why all accretions of purchasing power including earned income, fringe benefits, lump sum receipts, social welfare benefits and windfall receipts, should not be part of the income tax base. The Council also accepts that any definition of income must be formulated in such a way as to acknowledge the need to maintain the real value of a taxpayer's capital.

The Council supports the view of the Commission that income from different sources should be taxed in the same way. As regards different sources of personal income, the Council believes the existing differential treatment of employee and self-employed income to be a significant source of inequity and concurs with the principle that the same conditions as regards allowable expenses and the time period in which payment of tax is due should apply to both income sources. The Council has previously set out its views on the question of the taxation of farmers in NESC Reports No. 42 and 79.

As regards the recommendations of the Commission that capital gains and company income be eventually taxed in the same way as personal income the Council accepts that this is in principle desirable on resource allocation grounds and on the grounds of minimising tax avoidance, but acknowledges that such a situation could not be secured until a single rate of tax is in place and that certain incentives may be necessary for industrial development. The attainment of a single rate of income tax together with a direct progressive expenditure tax is a long-term option for taxation policy. As indicated earlier there is much that needs to be, and can be achieved in the meantime by way of enlarging the tax base and instituting other reforms.

The Council accepts the Commission's view that the tax system should be neutral with respect to inflation. The impact of inflation which manifests itself because of differential requirements as to the time period when tax payments are made can be eliminated if different sources of income are treated in the same way for tax purposes. The impact of inflation on the tax base can only be removed when the tax bases for business income, capital gains, and investment income are defined on an inflation-neutral basis. Fiscal drag can be eliminated with the adoption of appropriate indexation provisions. This need not tie the hands of Government. Any gains or losses arising from discretionary changes in income tax rates, bands or allowances should be shown with reference to the indexed position.

As regards the role of the tax system as a vehicle for influencing individual or business choices the Council has previously expressed its views on the relative merits of tax-based incentives and direct aid. On the question of using tax breaks as a means of providing incentives to selected types of economic activity the Council had this to say in Report No. 76:

"The Council agrees that, as a first step, it is desirable not to discriminate against investment in traded sector firms through the tax system. There are two ways of removing discrimination: (i) removing the reliefs from the presently favoured areas; or (ii) providing similar reliefs for investment in traded sector businesses. The Council believes that, given the difficulties arising from an already narrow tax base, the former approach is in general more desirable although individual cases may give rise to particular circumstances".*

*The position adopted by the Council in NESC Report No. 42 in that farming profits should be taxed on the basis of actual accounts based on the ability to pay principle. In Report No. 79 the Council saw no reason to change the basic thrust of the views it had expressed in favour of taxation of farming profits on the basis of no more. The Council then pointed out however that it considered the question of a revenue tax on farm land to be a separate issue, related to development policy.

In the same report the Council went on to say that:

"...tax concessions are more difficult to control than direct budgetary expenditures. In general the latter are more desirable on the criteria of transparency, accountability and selectivity."

There are grounds other than those of transparency, accountability and selectivity for evaluating the respective merits of tax-based and direct incentives. They include the relative suitability of the two sets of measures for promoting different types of firm, especially domestic against overseas firms. It is argued in Chapter 11 that direct aid is a more suitable means of assisting indigenous industry while the benefits of tax-based incentives are more relevant to already profitable overseas firms.

It is the view of the Council that the Commission's principle that a tax system should not influence individual or business choices be adopted as a benchmark position for taxation policy and that exceptions or derogations from this principle warrant justification. It is the Council's view that when tax-based incentives are introduced or when a decision is made to retain existing tax-based incentives, explicit reasons for such decisions should be given together with reasons for preferring the tax-based incentive to a corresponding form of direct aid. Moreover the targets which it is hoped will be achieved because of the incentive in question should be indicated at the outset as a yardstick against which success may be measured.

The Council accepts that the distinction between nominal and effective progressivity is fundamental to establishing the role which the tax system can play in changing the distribution of income. The Council also accepts that the intended effect of a steeply progressive structure of personal income taxation may be frustrated by the tax evasion and avoidance to which such a system may give rise. However, the Council would point out that Government action to ensure compliance on the part of tax evaders, and to collect hitherto uncollected taxes can help to realise the objective of a progressive income tax.

The Council agrees with the principle advanced by the Commission that it would be generally preferable to make direct payments to those in need rather than to provide assistance through the tax system. While the Council accepts that the tax system should have a role to play in the redistribution of income, the extent of this role should be determined by the relative efficiency and equity of using the public expenditure system to effect redistributive objectives. The use of the tax system to achieve either horizontal or vertical redistribution creates problems of both efficiency and equity. On efficiency grounds, the greater the degree to which the tax system seeks to redistribute income the more the tax base will be diminished and/or the higher will be marginal tax rates. On equity grounds, it is necessarily the case that it is only taxpayers who can benefit from features of the tax code which are intended to help those in need.

The Council accepts that it is desirable in general that revenue be allocated between the different categories of public expenditure on the basis of desirability and need rather than on the basis of how much revenue is raised under particular tax heads. In relation to the disposition of funds for tackling the problem of unemployment the Council expressed the view in Report No. 82 that priorities should be determined by the needs of the target groups rather than by the sources of funding, and recommended that the constraints imposed by sources of funding be removed. The Council agrees with the view of the Commission that taxes should not be earmarked for specific purposes.

On the question of PRSI the Council accepts the Commission's view that the present system of compulsory social insurance contributions is more appropriately regarded as a tax and should be evaluated by the criteria of equity efficiency and simplicity applied to taxation. It is the Council's view that reform of the existing system should take this judgement as its point of departure.

(ii) Proposals for Reform

The Council accepts that serious problems exist in the administration of the tax code. The discussion in the final section of Chapter 4 draws attention to the scale of these problems particularly in the areas of tax collection and enforcement. Since the publication of the Fifth Report of the Commission on Taxation the Government has announced its intention to introduce measures to improve tax collection and the enforcement of payment. Among the more significant measures were the following:

(i) the imposition of a surcharge where accounts and returns are not submitted to the Revenue within a specified period;
(ii) the expansion of the special enquiry units in the Revenue Commissioners to step up the campaign against tax evasion;
(iii) the establishment of local tax collection units on a pilot basis to pursue arrears of tax prior to enforcement;
(iv) the transfer of tax enforcement functions from County Registrars to newly-established Sheriffs.

The Council considers these to be important and welcome initiatives and hopes that they will be fully implemented.
The Council does not believe however that the existing problems of tax administration, however serious, overshadow the need to reform the tax system. Indeed the Council is of the view that the structure of the present system is itself the cause of many of these administrative problems and that progress towards a simpler, more transparent taxation system will help to resolve or ameliorate the administrative problems which now exist.

In section 3 above, three strands to the Commission's approach to reform of the system of direct taxation were identified as follows:

(i) the widening of the tax base;
(ii) the attenuation of the progressive income tax rate structure leading to the eventual establishment of a single rate of income tax combined with a progressive direct expenditure tax at the upper end of the income spectrum;
(iii) the gradual convergence of the tax treatment of company income, capital gains and, capital acquisitions with that of earned income, leading to eventual harmonisation.

The recommendations of the Commission which have occasioned greatest controversy have been those concerning the introduction of a direct expenditure tax and the institution of a single uniform rate of tax on income. The introduction of a direct expenditure tax owes its importance in the Commission's scheme of things to the achievement of a desirable degree of progressivity in the direct taxation system in the context of a single rate of tax. The importance of achieving a single rate of tax on all income resides in the objective of securing eventual harmonisation of the tax treatment of earned income and the other forms of income mentioned at (iii) above.

The most controversial of the Commission's proposals, therefore, are those the implementation of which is not envisaged by the Commission as taking place until the third phase of reform i.e. until a timespan of 10-15 years has elapsed. Moreover implementation of these proposals is conditional on the Commission's reports on the prior introduction of a wide range of other reforms.

It is the Council's view that it would be entirely invalid to dismiss in toto as impracticable or undesirable the recommendations of the Commission on Taxation on the basis of these long-term proposals. It is important to realise that many of the Commission's proposals may be implemented in the short-term. Moreover the implementation of many of the Commission's first-phase proposals does not necessarily mean that the longer-term proposals must be proceeded with.

While it is true that widening the tax base and attenuating the progressive rate structure of income tax are preconditions for achieving the eventual system of taxation proposed by the Commission, these reforms, which could be effected in the short-term, would leave open a number of options for longer-term reform of the tax system.

The Council believes that the narrowness of the existing tax base is the proximate source of the most serious problems and costs associated with the present taxation system. The Council also believes that the narrowness of the existing base is a serious constraint to developing a system which would be more equitable and which would provide greater incentives to enterprise and wealth generation. These views have been repeatedly expressed by the Council in previous reports (see NESC Reports Nos. 75 and 79).

Accordingly the Council believes that the priority of taxation policy in the coming years must be the widening of the tax base and the simultaneous reduction of tax rates. This applies not alone to personal income tax but also to capital taxation, to the taxation of corporate income, and to value added tax. This belief also extends to the taxation of property in respect of which, in Report No. 80, the Council expressed its agreement in principle with the notion of a property tax, both as a means of providing a measure of revenue autonomy to local authorities and of broadening the tax base.

The relationship between high average and marginal tax rates, the tax base and the various factors which narrow that base was illustrated in Figure A above. It is inescapably true that the only way in which tax rates can be significantly reduced in the medium term, given the outlook for the public finances, is by extending the base, by removing or weakening those factors which currently constrain it.
Although consensus exists about the broad nature of the relationship between the services sector and the rest of the economy, the precise nature of this relationship is only imperfectly understood. This shortcoming is of particular concern given the importance of the services sector as a source of employment: the numbers engaged in services accounted for 56 per cent of total employment in 1985. The NESC is currently undertaking a major study of the prospects for employment growth within services.

As to building and construction there is a clear relationship between activity levels here and the amount of investment carried out in the internationally trading sectors. A recurring theme throughout this report has been the low levels of physical capital formation undertaken in the economy since 1981, and more importantly, the very sharp fall off in investment in agriculture and manufacturing industry. A crucial requirement for renewed and sustained growth in output and employment throughout the economy is that recent trends in investment be reversed.

— INDUSTRIAL POLICY —

2. BACKGROUND

The principal features of the evolution of manufacturing industry over the 1980-1985 period, described in detail in Chapter 2, were the sharply contrasting fortunes of the modern and more established sectors and the sharp decline in manufacturing employment. The growth of manufacturing output and exports was heavily concentrated in a limited number of sectors, principally chemicals, electronics and, instrument engineering.

The source of growth in the buoyant sectors was the large inflow of foreign direct investment which took place in the late 1970’s and early 1980’s. The poor performance of the more established sectors may be explained by the weakness of domestic demand, and the erosion of competitiveness as evidenced by increased import penetration, the falling share of Irish exports in the UK market, and trends in the more conventional indicators of cost competitiveness.

In addition to these factors, the absence of strong linkages between the modern, predominantly overseas firms and the rest of the economy may be cited as a further source of weakness in the more established sectors of manufacturing.

The medium-term scenario for manufacturing industry, developed in Chapter 5, envisaged a deceleration in the rate of output growth from the ‘modern’ sectors, principally on the grounds that the inflow of foreign direct investment has slowed down markedly in recent years.

Growth in the more established sectors will be constrained by a number of factors including: (i) the scrapping of capacity on foot of factory closures and plant rationalisations which occurred in the last five years; (ii) competitive pressures associated in particular with the high value of the exchange rate vis-a-vis sterling, at least in the short term, which will bear most heavily on the exposed labour-intensive industries; (iii) the possible output-dampening effects of CAP reforms on the food processing industry and, (iv) the narrow range of goods produced and of markets served by many of the sectors concerned. Moreover, just as growth in the modern sector will be constrained by the reduction in investment in recent years, the growth potential of the more established sectors is also likely to be circumscribed by low rates of net capital formation.

3. APPROACHES TO INDUSTRIAL POLICY

There are two broad approaches to industrial policy which differ as to the factors considered most important in fostering industrial growth and the most appropriate role of Government in that process.

One approach considers that the overall economic environment, as presented by costs of production, interest and exchange rates and levels of taxation, constitutes the overriding influence on the health and strength of the industrial economy. This approach sees the role of general government macro-economic policies as of crucial importance and the role of more specific industrial policy instruments as being of somewhat less significance. This view was cogently expressed by the National Planning Board:

'A favourable climate for economic activity, in which costs are an extremely important element, is far more important in determining the level and pattern of industrial output and employment than the set of measures that are included in industrial policy. Decisions made by Government about public expenditure, taxation, money supply and charges for the services of State-sponsored bodies ( ...), the evolution of money incomes, and the exchange rate, have a significant influence on the domestic environment for industrial activity'.

The other school of thought assesses the weaknesses of industrial performance principally in relation to structural factors and the position of the domestic economy's industrial structure in a global context. It views industrial policy as being concerned with the formulation and implementation of a strategy for industrial growth based on the identification of industrial activities where the domestic economy, given its existing cost structure, is likely to enjoy defensible and sustainable competitive advantage in the future. This approach sees a role for government which extends beyond that of promoting a

*National Planning Board, Proposals for Plan, April 1981
11

DEVELOPMENT POLICIES

1. INTRODUCTION.
This chapter examines the policies that have been used to date to promote the long-term development of the economy, assesses the extent to which these policies are likely to be adequate for the task of securing continued development in the future, and indicates the changes that are required to make development policies more effective in realising the objectives of sustained output and employment growth.

As indicated in Chapter 7 any strategy for economic recovery must have regard to the fact that the exposed internationally trading sectors are the locomotives of economic growth. Development policies must therefore concentrate on the application of national resources to the maximum extent possible to these sectors. The internationally trading sectors of the Irish economy comprise in the main agriculture and manufacturing industry. Internationally traded services also come within this category as does the tourist industry. The bulk of the private services sector however, the public sector, and the building and construction industry, engage in activities which are sheltered from foreign competition. As such, these branches of economic activity in an economy of Ireland's size cannot be regarded as an independent source of sustainable economic growth. Rather is it the case that the sustained expansion of output and employment in these sectors depends upon the achievement of rapid and sustained growth in the internationally trading sector.

Recent trends in output and employment in both building and construction and the services sector were described in Chapter 2. In Chapters 5 and 6 the likely future performance of these sectors, on the assumption of the broad thrust of government economic policies remaining unchanged, was outlined in relation to both output and employment. It emerged quite clearly in those chapters that the single most important constraining factor on output and employment growth in both building and construction and private sector services would be the rate of expansion achieved by the exposed sectors of the economy. Accordingly, policy in relation to agriculture and manufacturing industry which together comprise the bulk of internationally trading activities can be expected to have profound implications for the services sector and for building and construction.
favourable environment for industry through the pursuit of correct macro-economic policies. It implies a more direct interventionist role by the state in allocating resources within the industrial sector. This approach allows that the State might be required to deploy both 'carrots' and 'sticks' to attain national objectives in the industrial economy. The Telesis Review of Industrial Policy (NESR Report No. 64) is probably the best example, in an Irish context, of an elaboration of this approach.

These two approaches differ principally in terms of emphasis and orientation. This is an important enough distinction but one which should not obscure their potential complementarity. Both approaches are valid given their perspectives.

There can be no doubt that costs are an important element in determining the level and pattern of industrial output and employment. In the exposed sectors of the economy cost increases above those confronted by producers in our main trading partners cannot in general be passed on in prices without reducing market share and output. Often such cost increases must be absorbed in reduced profit margins. In either event the resources available to the firms concerned to finance investment and thereby increase productive capacity will be reduced. As a result cost competitive pressures will not alone tend to reduce output and employment in the short run, but will reduce investment and also reduce the economy's potential growth rate in subsequent years.

Another source of downward pressure on investment comes from high interest rates. The higher the real interest rate the greater the rate of return required to make an investment project commercially viable. The period since 1982 has seen a sharp increase in real interest rates. This in turn has brought with it a situation whereby the relative rates of return on financial and physical assets in Ireland have changed significantly in favour of the former. This is one of the factors which has depressed the rate of physical capital formation in the economy.

It has also been noted in previous chapters that fiscal and monetary policies may crowd out the exposed sectors of the economy via the exchange rate. The rate of the exchange rate may be maintained at a level higher than would otherwise be the case because of inappropriate macroeconomic policies.

These remarks indicate that government macro-economic policies in relation to public spending and taxation, monetary and exchange rate policy and the evolution of incomes, have an important role to play in fostering a favourable environment for industrial activity, as argued by the National Planning Board. However, there are many reasons to believe that getting those policies right will not be sufficient to produce a rate of industrial expansion fast enough to meet aspirations for higher employment and living standards and that there is a role for active intervention on the part of the State. This is not to say that any or all forms of State intervention are either necessary or desirable.

In the first place it would be mistaken to suppose that pressures on the cost competitiveness of domestic industry emanate exclusively from domestic sources. Ireland is part of a global economy in which the increasing mobility of capital and of multinational firms has opened up opportunities for newly industrialising countries to trade in branches of industrial activity which in earlier decades they were effectively excluded from. Such economies are characterised by costs of production, especially labour costs, which are a fraction of those obtaining in Ireland. In the production of those goods, and in the execution of those stages of production, which require unskilled or semi-skilled labour they can achieve competitive advantage, given their low labour costs.

Ireland can no longer secure or sustain competitive advantage in the production of goods where low labour costs are the key to success. Relative to the newly industrialising countries of South East Asia and Latin America, Irish wage and salary levels are high. To achieve comparability in this respect would require the abandonment of the most fundamental objective of economic activity, namely the attainment of higher living standards.

Although the adoption of correct macro-economic policies can help to lower the rate of increase in costs of production there is no set of plausible policies which can reduce costs to a fraction of their existing level. Recognition of this fact must be the point of departure for an industrial strategy which is likely to generate strong and sustainable growth. If Irish industry is to compete successfully in the international market place in the medium to long term, and to generate increased employment and living standards, it can do so only if the goods produced or the stages of production carried out have embody skills the remuneration of which is consistent with existing wage and salary levels.

A second set of considerations which must inform Ireland's approach to industrial policy is provided by certain basic features of the economy: the small size of the domestic market; its distance from large and concentrated centres of population and, its technological backwardness relative to the more advanced economies of North America, Europe and Japan. These features of the economy constitute important impediments to industrial development.

The small size of the domestic market means that an export-oriented industrial development strategy is a pre-requisite for the achievement of sustained growth but also renders it extremely difficult in many branches of industrial activity for Irish firms to achieve the economies of scale required to compete successfully on international markets.
Ireland's distance from large population centres and areas of concentrated industrial activity, means that gaining access to those markets involves incurring transportation costs which are high relative to those incurred by many competitors. Moreover, this peripherality discourages the carrying out of marketing, and research and development functions in Ireland — activities which tend to be carried out, in the main, close to the market.

The absence of a well-developed infrastructure of research institutes, universities and firms engaging in the development and application of new technologies, also restricts the pace and pattern of industrial development. It means that new technologies must be imported either directly by licensing or, indirectly through overseas firms with subsidiaries here. It also means that Irish firms are effectively precluded from competing in products which embody the most advanced technology.

These features of the Irish economy, when added to the factors which influence the geographical distribution of industrial activity in a world characterised by capital mobility and dominated by multinational firms, comprise a strong case for an active industrial development strategy. A policy for industry to be articulated solely within the confines of general macro-economic policies is sometimes argued on the basis that industrial development should be left to market forces. This may represent a viable option for very large economies like the U.S. Advocating such a strategy for Ireland would imply that it is domestic market forces alone which determine the allocation of resources to the domestic economy, and that Ireland can be viewed as an entity separate from the rest of the world. Such a view is not consistent with the evidence as to the nature of international industrial activity.

For a small peripheral economy like Ireland an active industrial policy can therefore be viewed as an attempt to change the geographical allocation of resources which would otherwise be the consequence of decisions taken outside the country, including the choice of industrial policy instruments in other countries.

A third reason for believing that policy for industrial development must go beyond the requirement that general macro-economic policies generate a favourable cost environment, is that many of the weaknesses in Ireland's present industrial structure are the product of a particular set of industrial policy instruments which have been in place for a considerable period of time, and not all of the weaknesses can be attributed to the stance of general macro-economic policies. This suggests that an important contribution to resolving the weaknesses in industrial structure and performance might be expected to come from identifying the shortcomings of the existing package of industrial policy instruments and implementing changes.

4. SHORTCOMINGS OF PRESENT INDUSTRIAL POLICY

(i) Results

Until 1984 industrial policy was remarkably successful in achieving growth in manufacturing exports and output. This growth however was characterised by major imbalances between sectors with most of the gains being concentrated in a limited range of product groups. Industrial policy has also generated substantial gross gains in employment but these gains have been more than counterbalanced by job losses and the net result has been a sharp decline in manufacturing employment since 1980. The new industries which have been established in recent years have provided more highly-paid and highly-skilled employment than that available on average in the more long-established industries, but the skill levels have been disappointing relative to what might have been expected.

The industrial development strategy in place for the last two decades has relied heavily on overseas firms and has concentrated, since our accession to the EEC, on a limited number of manufacturing sectors. Notwithstanding their potential contribution to the home economy, reliance on the attraction of new overseas firms involves a number of risks including that attaching to the intensification of international competition for foreign direct investment which has occurred in response to high and increasing levels of unemployment world-wide in recent years. The risks of such dependence are increased if the functions performed by such firms in Ireland are capable of being performed elsewhere, and if the diminishing technology gap between Ireland and the newly industrialising countries makes the location of such functions in those countries, given their low labour costs, increasingly attractive over time. The concentration of the industrial promotion effort in a limited number of industrial sectors carries the risk that a recession of activity in these industries world-wide will have a disproportionate effect on overall manufacturing activity in Ireland. This risk was exemplified by what happened in the electronics industry in 1985.

The essentially footloose nature of many of the overseas firms established in Ireland over the last decade or so is related to the fact that the generality of new foreign companies do not carry out a truly 'stand alone' operation here. Very often the activity carried out here represents but one element or a subset of elements in the manufacturing stage of production. The manufacturing stage in turn (which may involve fabrication, assembly, testing and packaging) is but one of a number of stages in the overall productive

*To describe many of the overseas firms as 'essentially footloose' is a judgment based on the type of elements created and focused on here, that these elements are capable of being carried out elsewhere, and not an assertion about how they are actually located once they commence production in Ireland.
process which typically includes many other stages such as research and development, product design, applications engineering, marketing and market research, and distribution. Again, the generality of overseas firms in Ireland do not carry out these functions here to any significant degree. It should be remarked in this regard that there are several notable exceptions. It might also be noted that gross job losses amongst new overseas firms in Ireland are not proportionately higher than amongst longer-established firms.

In addition to its reliance on overseas firms Ireland's industrial development strategy has not resulted in the development of strong indigenous firms. This has been especially conspicuous in relation to domestic firms operating in tradable goods industries. The data presented earlier in Chapter 2 point to a continuous and rapid decline in output and employment levels in the textiles, timber, paper, and clothing and footwear industries over the 1980-1985 period. The proportions of employment accounted for by indigenous firms in the most rapidly expanding sectors of manufacturing - instrument engineering, office machines, and chemicals - have shown little change, and in 1985 were 6 per cent, 10 per cent and 33 per cent respectively. What output growth did occur in indigenous firms over the 1980-1985 period would appear to have been concentrated almost exclusively in branches of activity that are relatively insulated from foreign competition: drink and tobacco, and certain sub-sectors within engineering.

Another important shortcoming of industrial policy has been its failure to establish stronger linkages between the modern, predominantly foreign-owned sectors of manufacturing and the remainder of the economy. Some of the principal findings of the IDA Expenditure Survey published in 1985 are summarised in Table 11.1. Expenditure on Irish raw materials as a proportion of total raw materials purchases comprised 61 per cent for manufacturing as a whole but only 30 per cent for overseas firms. This is due in part to the concentration of overseas firms in those branches of activity which evince a very low level of linkage, for example electronics where the proportion is 17 per cent, and to the concentration of domestic firms in sectors such as food, drink and tobacco where particularly high levels of linkage occur. However, it is also due to the fact that in all but two of the eleven sectors listed in Table 11.1 expenditure on Irish raw materials as a proportion of total raw materials purchases is higher for indigenous than for overseas firms, the difference being especially marked in clay, glass and cement, chemicals, clothing and footwear and, timber and furniture.

Similar conclusions emerge from an analysis of firms' purchases of services. Expenditure on services in Ireland as a proportion of total purchases of services is 93 per cent in the case of Irish firms and 62 per cent for overseas firms. The average proportion for manufacturing as a whole is 77 per cent but again, is particularly low, at 59 per cent, in the case of electronics.

(ii) Instruments

Many of the shortcomings of industrial policy in attaining its declared objectives may be attributed at least in part to the nature and mix of the policy instruments which have been deployed. The deficiencies may also be attributed in part to inconsistencies between the aims of industrial policy and the effects of more general macro-economic policies. It is arguable for example that some industrial policy incentives have been instituted in order to counteract the unfavourable effects of fiscal policy. It is also arguable that some industrial policy incentives are inconsistent with others.

In the analysis of industrial policy instruments which follows, three sets of issues are examined relating to: (a) the relative merits and disadvantages of direct aid (such as grants and subsidies) and tax incentives in achieving industrial policy objectives; (b) the relative advantages of different forms of direct aid and; (c) certain aspects of existing tax-based incentives and their effects.

Table 11.1

<table>
<thead>
<tr>
<th></th>
<th>All Firms (%)</th>
<th>Overseas Firms (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Clay, Glass &amp; Cement</td>
<td>36</td>
<td>15</td>
</tr>
<tr>
<td>Chemicals</td>
<td>33</td>
<td>20</td>
</tr>
<tr>
<td>Electronics</td>
<td>37</td>
<td>24</td>
</tr>
<tr>
<td>Mechanical Engineering</td>
<td>20</td>
<td>24</td>
</tr>
<tr>
<td>Food</td>
<td>27</td>
<td>24</td>
</tr>
<tr>
<td>Drink &amp; Tobacco</td>
<td>63</td>
<td>73</td>
</tr>
<tr>
<td>Textiles</td>
<td>22</td>
<td>21</td>
</tr>
<tr>
<td>Clothing &amp; Footwear</td>
<td>39</td>
<td>24</td>
</tr>
<tr>
<td>Paper &amp; Printing</td>
<td>33</td>
<td>27</td>
</tr>
<tr>
<td>Timber &amp; Furniture</td>
<td>49</td>
<td>27</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>22</td>
<td>20</td>
</tr>
<tr>
<td>Total Manufacturing</td>
<td>61</td>
<td>36</td>
</tr>
</tbody>
</table>


Direct Aid and Tax Incentives

An important distinction between direct aid and tax incentives is their relative transparency: the ease with which their cost to the Exchequer can be estimated and the benefits accruing from their availability quantified. Another important distinction between them is the relative ease with which they can be deployed on a selective basis. These are important distinctions and are discussed in more detail below in the section on the control and monitoring of industrial policy.

Another important issue for consideration is whether there are systematic differences in the relative suitability of direct aid and tax-based incentives
firms, a practice which may have implications for the meaningfulness of published data on merchandise trade, industrial production and GDP in Ireland.

Although conclusive empirical evidence on this question is hard to find, prima facie evidence would suggest that the 10 per cent manufacturing tax does not encourage the carrying out of marketing and R&D in Ireland by multinationals and may, in certain circumstances, discourage the development of linkages between overseas and domestic firms. The tax regime, however, is not the only, or even the principal factor involved here.

As regards tax-based investment incentives, the most important of which are accelerated depreciation allowances, their existence, combined with that of generous capital grants, and pay-roll taxes (employers' PRSI contributions), has substantially altered the relationship between the cost of labour and the cost of capital in Irish industry in recent years. A study by Ruane and John (1) has attempted to quantify this effect. Their research concluded that the ratio of the effective cost of labour to capital increased four-fold between 1958 and 1982 whereas, in the absence of government intervention, the ratio would have increased by a factor of just over 1.6.

Whether this has led to a bias against employment is a moot point. The balance of economic theory (whatever about empirical research) would suggest such a result to be inevitable. In any event other elements of policy in recent years would suggest that successive governments have been influenced by this argument. Virtually every budget since 1978 has either renewed an existing tax-based incentive or introduced a new one the specific purpose of which was to encourage the expansion of employment in manufacturing firms. These employment reliefs have not proved successful because, inter alia, the reliefs were of little or no value to firms liable to corporation tax at the 10 per cent rate. It should also be noted that the value of tax-based incentives and the volume of funds allocated to capital grants was reduced significantly in 1985 and 1986.

Finally there is the class of reliefs which come under the heading of tax-based lending (Section 84 loans, leasing and artificial preference share financing). Although it is argued that such reliefs comprise a vital element in the overall incentive package for industry it must be acknowledged that the most important of them (Section 84) evolved because of the exploitation of a loophole in the relevant legislation. These reliefs have become extremely expensive to operate, together accounting for £170m of tax revenue foregone in 1985. Their utilisation is concentrated amongst new overseas firms and the largest indigenous companies.


5. CHANGES IN INDUSTRIAL POLICY

(i) Objectives

The over-riding objective of industrial policy must be to generate the maximum number of sustainable jobs in manufacturing industry and in internationally-traded services. A perception exists that employment in industry as a proportion of total employment inevitably declines once a certain stage of economic development is attained and that this stage has already been reached in Ireland. There is a feeling that we must resign ourselves to the prospect of a decline in manufacturing employment.

Such a feeling is not justified. The decline in manufacturing employment which has occurred since 1980 is obviously related to the pattern and pace of output growth and is as much the result of the type of industrial (and other) policies which have been pursued by government as it is the product of any set of immutable historical forces. In this connection it is useful to note that although industrial employment as a proportion of total employment peaked at 33 per cent in 1981 in Ireland, the corresponding proportion when it peaked had reached 49 per cent in Germany (1970), 48 per cent in Belgium (1947) and 43 per cent in Italy (1970). In Germany the industrial share in total employment was still as high as 41 per cent in 1984 whereas in Ireland the share had already fallen to under 30 per cent.

Maximising the number of sustainable jobs in manufacturing will require:

- the maximisation of value-added in industry;
- the maximum retention of the wealth thereby created for further employment-creating investment;
- the development of a strong internationally competitive set of Irish-owned manufacturing firms;
- the forging of much stronger linkages than currently exist between overseas firms and the rest of the domestic economy, and
- the continued attraction of overseas firms.

(ii) Instruments

The over-riding requirement in deploying industrial policy instruments is that they be selective. This means that incentives must be focussed to the maximum degree possible on the sectors which are to be encouraged, on the firms which are deemed best-positioned to benefit most from the incentives, and on the disadvantages and penalties which it is desired to offset.

The more focused are the incentives the more effective they will be. As incentives become more disparate and prolific they lose their effect. If incentives are applied to all activities they have no net effect but simply impose a burden on the tax-payer and on the agencies disbursing them.

The more selective application of incentives was announced as an intention of government policy in the White Paper. Practical expression has been given
Industrial Policy indicate that in 1983, 78 per cent of direct aid was towards physical capital formation in machinery and factory construction. In 1978 the corresponding proportion was 89 per cent. The bulk of the remainder is accounted for by training grants. In 1983 no more than 4 per cent of direct aid to industry was for marketing and 5 per cent for research and development. Within the capital grants total a significant proportion is accounted for by overseas firms, and before the discontinuation of re-equipment grants in 1984, a further substantial share was absorbed by firms operating in the sheltered sectors.

Some of the more telling criticisms of Irish industrial policy made by Telesis were of the distribution of direct aid by category, and between new overseas and other projects. Telesis considered that the average capital grants offered to overseas firms were too high by reference to the potential benefits that could be secured from alternative use of the money concerned. Accordingly, they recommended that a greater proportion of industrial policy resources be directed to the promotion of indigenous industry. This recommendation was grounded in Telesis' view that no country has succeeded in generating self-sustaining industrial growth without a foundation of strong exporting indigenous firms.

The fostering of strong indigenous firms can, in Telesis' view, be best effected by designing the grants system to address specific cost penalties with a view to the long-term resolution of those penalties. According to Telesis the capital grant is overstated in Ireland, does not address the key competitive cost problems faced by Irish firms, and causes a distortion in the allocation of resources towards capital-intensive and away from knowledge-intensive businesses. In particular, capital grants do not encourage investment in research and development or in marketing.

**Tax-based Incentives**

The existing panoply of tax-based incentives which comprise an important sub-set of industrial policy instruments may be divided into four categories: (i) relief on profits; (ii) investment incentives; (iii) employment incentives; (iv) mechanisms which facilitate tax-based lending.

The most important relief on profits is the reduced (10 per cent) rate of tax on manufacturing profits. A commitment to maintain this relief to the year 2000 has been entered into. To tamper with this commitment is considered an imprudent option on the grounds of the potential damage this would do to the confidence of foreign direct investors past and prospective. It is well to acknowledge the disadvantages of the relief while recognising its importance. Its importance may be gauged with reference to the fact that surveys have indicated it to be the most powerful factor in attracting foreign direct investment to Ireland. The disadvantages include the incentive which it may provide to the practice of profit-switching transfer pricing by multinational

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in different circumstances and in relation to different types of firm. To answer this question it is useful to compare the way in which the two types of incentive impact on the risk-reward ratio.

With the exceptions of Section 84 and leasing financing, tax-based incentives are of value only to firms which have a tax liability. As such the benefits accrue to profitable firms and not at all to firms which make no profits or which are loss-makers. Tax-based incentives therefore enhance the rewards accruing to commercial success but in general do nothing to foster the conditions which lead to, or ameliorate the factors which inhibit, that success.

In contrast, direct aid in the form of grants and subsidies may reduce the amount of capital which the sponsor of an industrial project must put up to finance that project, or may be used to counteract cost penalties or overcome barriers which the firm faces. As such direct aid acts principally through the medium of reducing the risks inherent in commercial activity. The risk to the firm is reduced by the State accepting some of the risk exposure.

In general, direct aid is a more suitable instrument in circumstances where the enterprise is risky. Firms contemplating risky ventures require a reduction in risk rather than an increase in reward if they are to proceed. This is the position that many Irish-owned firms are in when faced, for example, with the option to develop an export market or to expand into new foreign markets. By contrast, the setting up by an overseas firm of a plant in Ireland is relatively risk free. In general, such firms already have secure markets and large amounts of capital. In general their interest is not in reducing risk but in increasing reward. It is for that reason that they find tax-based incentives more attractive.

Available data indicate that about 60 per cent of the cost of the present set of industrial incentives in Ireland is accounted for by tax reliefs. The most comprehensive estimate of the cost of direct aid to industry in 1985 is £120m of which £180m represents administration and other current costs. The estimated cost to the Exchequer of tax-based financing mechanisms in the same year was £170m on a revenue foregone basis. The cost of Export Sales Relief, capital allowances, Shannon Relief and the reduced rate of tax on manufacturing profits, taken together, has been estimated at £437m in the 1984-85 fiscal year. This is an official estimate. However, it should be pointed out that the validity of any estimate of the cost of the tax reliefs in question must have regard to the way in which it is derived. A much lower figure would result if it were assumed that a significant proportion of the beneficiary firms would not have located in Ireland in the absence of these reliefs.

**Direct Aid by Type**

It is important to look at the distribution of direct aid by type as well as its absolute magnitude at present. Direct aid is overwhelmingly composed of investment grants. Data provided in the Government's White Paper on
to this intention through, inter alia, the restrictions which have been imposed on Section 84 lending and leasing and, the discontinuation of re-equipment grants. However, a number of new incentives have been introduced which do not conform to the requirement that state support be confined to the internationally-traded sectors of the economy, notably the package of measures announced in respect of the building and construction industry in October 1985. Moreover, the declared objective of the White Paper of applying incentives more heavily to indigenous firms was not accompanied by any quantification of the orders of magnitude involved.

The White Paper also stated that there would be a shift in State resources from fixed asset investment to technology acquisition, research and development, and marketing. If indigenous firms are to be effectively promoted this resource reallocation will be vital since it is in these areas that they face the most significant cost penalties. The importance of this point is paramount and it is worth quoting the Telesis Report at some length on the issues involved:

"The emphasis of grant allocations on capital investment assistance provides the crucial leverage required for competitive success to only a few businesses... Our evaluation of the structural problems of Irish indigenous industry has shown that many obstacles to development involve not production facilities but other areas of cost.... Overall, the emphasis on capital grants in total Irish expenditure may be too great. It does not provide an adequate battery of mechanisms to overcome the whole range of investment barriers confronted by potential indigenous exporters".

and again:

"The fact that the only way to reduce the cost of capital and therefore increase the return on net assets in Ireland is to invest in fixed tangible assets, distorts the allocation of resources towards capital-intensive businesses and away from knowledge-intensive businesses. A proper definition of investment is any expenditure whose impact is felt beyond one year... For many companies the large share of investment is not in equipment and plant but in areas normally reported as expenses on income statements rather than investments on balance sheets, such as product and process technology, overseas marketing, skill development, application engineering etc".

On these grounds Telesis recommended the introduction of a set of new grants which would more specifically address these areas. Many of the initiatives recommended by Telesis were adopted in the White Paper but, given that

only very general guidelines as to the consequent resource reallocation were provided in the White Paper, it is difficult to quantify the extent of the commitment and, in the absence of an industrial policy budget it will prove difficult in the future to measure the extent to which the declared intentions have been translated into action.

There are other grounds for concern about the excessive reliance on capital grants. It has already been noted that they, along with certain other instruments of industrial policy and certain features of the tax code, have reduced the cost of capital relative to labour. Not alone may this have led to some labour saving bias in the manufacturing stage of production in sectors which would, in any event, have been relatively capital intensive, but it is likely to have discouraged the establishment in Ireland of labour-intensive branches of activity, such as computer software, and the establishment of facilities carrying out the more labour-intensive stages in the productive process, such as marketing and R&D. The role of the personal income tax system in this regard is of considerable importance. High marginal tax rates reached at relatively low income levels are not conducive to labour-intensive activities.

The following points should be borne in mind in determining the broad thrust of industrial policy:

- access to capital for physical investment is not per se an inhibiting factor in industrial development in any but the most underdeveloped countries of the world because of international capital mobility. Consequently the acquisition or building up of capital-intensive industries will not guarantee Ireland self-sustaining industrial growth.
- the international distribution of industrial activity is perhaps better understood by analysing it in terms of the stages of production (research, product design, applications engineering, manufacturing, marketing, distribution etc.) carried out in different countries rather than the physical attributes of the end-product (chemicals, instruments, clothing etc.)
- high levels of capital investment are not, in general, required for knowledge-intensive industries or the knowledge-intensive functions within industries.
- high skill content employment and by extension, high wage and salary levels are associated with knowledge-intensive rather than capital-intensive industries and activities.
- one of the most important factors restraining output growth in Irish industry and throughout the economy in recent years has been the low level of linkage between the rapidly expanding manufacturing sectors and the rest of the domestic economy.

(iii) Direct State Investment in Industry

In Section 2 above it was argued that getting the generality of government macro-economic policies right would not in itself be sufficient to stimulate
growth in the industrial economy at the rate required to realise national aspirations for increased employment and living standards. The factors adduced in support of this argument were the small size of the domestic market and the technological backwardness of Irish industry relative to the advanced industrial economies.

In Section 3 the more conspicuous weaknesses in the Irish industrial structure were noted, prominent amongst which is the particular weakness of the more established, principally indigenous firms. The bulk of such firms are engaged either in non-traded sectors of manufacturing or in internationally trading activities which are labour-intensive and extremely vulnerable to cost competitive pressures.

These weaknesses can be attributed in part to the overall environment for enterprise which has been created by the pursuit of inconsistent macro-economic policies in recent years and in part to the choice of industrial policy instruments. With regard to the latter it has been argued that tax-based incentives and grants for fixed asset investment are not adequate to the task of developing a strong and vibrant indigenous industrial sector, and that excessive reliance on these instruments has contributed to the failure to develop a sufficient number of indigenous firms capable of competing in international markets. Accordingly it has been argued, as it was in the White Paper on Industrial Policy, that a reallocation of resources within the Industrial Policy budget should be effected.

The question arises as to whether the development of a strong indigenous industrial sector can be achieved by simply redistributing resources within the present system of State assistance to industry (that is from tax based incentives to direct aid and, within direct aid, from capital grants to grants for non-fixed asset investment), or whether there is a need for State involvement of a more direct character.

At a general level, the following arguments may be advanced to support the direct involvement of the State in undertaking commercial activities:

(i) certain activities are of such a scale or have such social implications that only the State has the capacity to undertake them;

(ii) the existence of potential business enterprises that could become profitable but only with a time lag or risk factor unacceptable to private investors.

The validity of the first argument depends on such factors as the size of the country and the social preferences of the people. The smaller the economy the more compelling are considerations of scale. The validity of the second argument depends on how well developed are capital markets. This too may be related to the size of the economy.

The most important characteristic of the Irish economy from the point of view of industrial development is the small size of the domestic market. This makes exporting an essential activity for firms which aim to sustain output and employment growth. The necessity of exporting in turn makes the functions of market development and marketing vitally important. In the long-term the competitiveness of exports can only be secured by the application of new technologies to product and process design and to the development of new products. This is achieved by research and development within the firm or by the acquisition of new technologies from without, either by licensing new products and processes or by direct importation of machinery and equipment which embody the latest technology. With the principal exception of the latter, most of the ingredients in the achievement of long-term international competitiveness comprise investment in entities other than fixed assets.

Much of the available evidence points to the absence of an adequate capital base on the part of indigenous Irish firms for the purposes of engaging in marketing and the other non-fixed asset investments essential to their sustained growth in international markets. There appears to be an inability on the part of existing firms to raise the finance for this type of investment because the payback periods involved are longer and involve greater risks than those acceptable to financial institutions. As far as new or prospective Irish firms are concerned, there are difficulties involved in raising the finance necessary for initial product research and development ("seed capital"); for similar reasons.

Again, the same factors militate against the development of resource-based industries especially in the areas of food processing and forestry. The principal problems inhibiting the further development of food processing have to do with the seasonality and irregularity of supplies from primary producers to processors thereby causing uncertainties which can only be resolved by the institution of long-term contracts, which involve financial costs and risks.

NESC Report No. 76* gave extended consideration to the financing constraints inhibiting the development of industry in Ireland and made numerous recommendations on the loosening of these constraints. The removal of tax biases which direct the allocation of capital away from manufacturing and towards Government gifts and property was one such proposal. Another was the development of a more vibrant and autonomous Irish Stock Exchange. Another proposal of the consultants in Report No. 76 was the dismantling of the bank cartel as a step towards fostering greater competition in the banking system. Such proposals, if implemented, together with the further development of the private venture capital market in Ireland would improve the prospects

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* The Role of the Financial Services in Financing the Industrial Sector, NESC Report No. 76, October 1981.
for indigenous manufacturing firms of securing their financial requirements. However, the time which might be expected to elapse before such developments would have a significant impact is likely to be such that many profitable opportunities would be foregone in the meantime.

On these grounds there appears to be a tenable case for more direct state involvement in the development of indigenous industry than has hitherto occurred, with the emphasis placed on the provision of state equity investment in existing and prospective enterprises which would otherwise experience severe difficulties in financing the development of new products and markets, and the acquisition of new technology. The National Development Corporation (NDC), set up by the Government in 1986, is a body whose remit includes these functions.

However, it must be recognised that the operation of the NDC will necessitate the expenditure of public moneys. It is essential that this expenditure be rigorously evaluated in terms of future rates of return to the Exchequer. If the moneys expended by the NDC do not yield a rate of return at least equal to the cost of borrowing the corresponding funds its establishment will serve only to exacerbate the imbalances in the public finances. Accordingly if the activities of the NDC are to generate increased income and wealth for the economy great care will have to be taken to ensure that the Corporation acts without political interference, makes decisions on the basis of sound commercial criteria, and conducts its business in a manner responsive to market forces.

The NDC has been given a statutory role in relation to existing State-sponsored commercial enterprises to act as a catalyst where new ideas are put forward. Amongst the principal objects of the NDC as set out in the Act are the following:

- to manage and assist in the establishment, promotion and development of, or to invest in, profitable or potentially profitable enterprises including those partly or wholly owned by State-sponsored commercial enterprises;
- to assist, manage or act as a holding company for any profitable or potentially profitable State-sponsored commercial enterprise established after the passage of the Act.

However there is no mention of the NDC acting as a holding company for existing State-sponsored commercial enterprises although this was at one stage envisaged as an important function of the Corporation. The economic significance of the State-sponsored commercial bodies cannot be underestimated. Together they provide employment to over 80,000 people, that is, almost 8 per cent of the total at work. Amongst them are the largest single employers in the State: An Bord Telecom, CIE and the ESB. Their aggregate turnover is now estimated at £4bn annually. They have individually

and collectively made an enormous contribution to the national economy over several decades.

A number of these enterprises have been facing grave problems in recent years and have recorded large losses. Some of these difficulties are attributable to factors which have generated output and employment losses in the private sector, namely the recession in domestic and international economic activity, high real interest rates and upward pressure on costs more generally. Other factors have also been at work including a lack of clarity about the enterprises' financial targets and in some cases an inappropriate financial structure.

The large potential positive contribution which can be made by State sponsored commercial enterprises to the national economy in the future can only be fully realised if these problems are resolved.

6. INDUSTRIAL POLICY: MONITORING AND CONTROL

A crucial determinant of the success of industrial policy in attaining its objectives will be the effectiveness of the monitoring and control mechanisms which are put in place.

The sentiments expressed in the Government's White Paper accord with the broad strategic thrust of industrial policy as recommended by Telesis. However, there is a danger, if policy instruments capable of translating the changed orientation of stated industrial policy into action are not devised and implemented, that nothing more than a transformation of the vocabulary of the bureaucracy will occur.

Industrial policy should be articulated by government in such a way as to obviate undue discretion in the interpretation of that policy by State agencies whose statutory function is confined to policy execution. The institution of a set of monitoring and control mechanisms comprising the following elements:

- an industrial policy budget,
- regular published reviews of industrial policy achievements in relation to objectives and,
- the application of performance criteria to State agencies, would form a solid foundation for the articulation of industrial policy in such a way.

An industrial policy budget would set out the overall allocation of state resources to industrial development and indicate the breakdown of total expenditure (including tax expenditures) between the various categories of direct aid and tax reliefs. Such a budget would specify the purpose for which each element in the overall package of State assistance existed and the targets which were expected to be reached in the budget period in relation to each
policy instrument. Additional allocations of resources in subsequent budgets or the introduction of new measures would be required to be justified in the same way, as would reallocation of resources within the overall budget.

A criticism made by NESC in Report No. 79* was that the declared intention of concentrating resources more heavily in forms of state support other than fixed asset investment and in directing an increased share of resources to indigenous firms, was quantified only in very loose terms. An industrial policy budget would provide the ideal medium through which to give practical expression to such intentions, and with which to assess the extent of their subsequent realisation.

A number of difficulties would arise in operating a budgetary procedure along the lines suggested. Given that state expenditure on industrial development depends on such factors as the flow of suitable new projects, an element of flexibility might need to be introduced especially as the budget period was to be longer than one year. However, problems in this regard are not, in essence, any different from those which arise in setting out expenditure targets under the more general rubric of the Public Capital Programme. In any event the desired degree of flexibility could be introduced into the budget framework by means of a contingency reserve the purpose of which would be to provide means of accommodating an unplanned flow of desirable projects.

The publication of regular reviews of industrial policy is essential to evaluate performance and would be a complementary exercise to the industrial policy budget. The White Paper envisages such reviews being carried out and published every three years by the Department of Industry, Trade and Commerce. The question arises as to what criteria will the Department use to evaluate industrial policy and whether the existing corpus of available industrial statistics will be adequate to the task of constructing satisfactory and comprehensive indicators of performance. In this connection NESC Report No. 66** contained an appendix a list of recommendations on data provision and collection, and expressed the belief that a clear distinction be made between indigenous and overseas industry in the publication of data.

The application and publication of performance criteria for the state agencies involved in executing industrial policy would improve effective policy monitoring and control. Performance criteria for these agencies would not yet appear to have been developed. It is only with such criteria in place that the information system needed to monitor and evaluate industrial policy will be complete. If this is not done the likelihood is that the agencies concerned will operate to their own performance criteria. Such a practice would not be compatible with the execution of policy in an efficient and coherent manner.

7. THE FOOD PROCESSING INDUSTRY

The food processing industry is a major source of manufacturing output and employment in Ireland. The sector engages over 20 per cent of those employed in manufacturing industry, and net output from food processing accounts for about one-fifth of total net output from manufacturing. The contribution of the food industry to the overall economy is significantly greater than these figures imply: the value of gross output from food processing accounts for over one-third of manufacturing gross output. A large proportion of the raw material inputs used in food processing are sourced in the domestic economy.

Within the food-processing sector the most important branches of activity in terms of both output and employment are those involving the processing of intervention commodities. Gross output of the meat, dairy products and grain industries taken together, accounts for three-quarters of gross output in the food processing sector as a whole. Their corresponding share in employment in the sector is 54 per cent.

The food processing industry has attracted the attention of a succession of reports in recent years.* The most important requirements for expansion of the sector identified in these reports have been:

(a) the securing of better synchronisation between food industry supplies and market needs;
(b) redesiging the problems of seasonality amongst primary producers;
(c) the introduction of long-term supply contracts between primary producers and processors.

A common theme of these reports was the need to re-orientate food production towards higher value-added products. Since their publication the question of the availability of raw materials to the food industry has become more critical because of the reforms, both actual and impending, of the Common Agricultural Policy. It now appears that the supply of raw materials to the main sector of the Irish food processing industry will be more restricted over the medium-term than was earlier assumed. Only in the case of sheepmeat are supplies likely to be greater in 1990 than is currently the case.

Accordingly the emphasis on re-orientating production towards higher value-added products is an essential ingredient for sustained expansion of output.

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and employment in the food industry must continue to be to the forefront in policy design and execution. The data presented in Table 11.2 provide some indication of the scope for improvement in this regard.

Table 11.2
Gross Value-Added Per Employee in Food Processing, Ireland and EEC (1980)

<table>
<thead>
<tr>
<th></th>
<th>Ireland</th>
<th>EEC(1)</th>
<th>IRE/EEC (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vegetable and Animal Oils</td>
<td>8,400</td>
<td>21,009</td>
<td>41.0</td>
</tr>
<tr>
<td>Meat Processing</td>
<td>8,067</td>
<td>10,376</td>
<td>77.9</td>
</tr>
<tr>
<td>Dairy Products</td>
<td>8,291</td>
<td>10,501</td>
<td>78.7</td>
</tr>
<tr>
<td>Fruit and Vegetables</td>
<td>14,314</td>
<td>9,779</td>
<td>146.4</td>
</tr>
<tr>
<td>Fish Processing</td>
<td>10,887</td>
<td>10,824</td>
<td>100.0</td>
</tr>
<tr>
<td>Grain Milling</td>
<td>16,048</td>
<td>18,780</td>
<td>87.7</td>
</tr>
<tr>
<td>Bread and Flour</td>
<td>7,265</td>
<td>10,831</td>
<td>66.8</td>
</tr>
<tr>
<td>Sugar, Chocolate etc.</td>
<td>14,494</td>
<td>14,901</td>
<td>98.6</td>
</tr>
<tr>
<td>Animal and Poultry Foods</td>
<td>15,616</td>
<td>17,379</td>
<td>89.9</td>
</tr>
<tr>
<td>Other (2)</td>
<td>78,135</td>
<td>20,287</td>
<td>385.1</td>
</tr>
<tr>
<td>All Food</td>
<td>12,405</td>
<td>13,271</td>
<td>93.5</td>
</tr>
<tr>
<td>All Food (excl. Other)</td>
<td>10,128</td>
<td>12,522</td>
<td>80.9</td>
</tr>
</tbody>
</table>

(1) ECUs
(2) The very large figure for Ireland may be due to the accounting practices of certain firms operating in this sub-sector.

For the food processing sector as a whole value-added per employee in Ireland in 1980 was 93.5 per cent of the EEC average. Excluding the category 'other' which is a clear outlier this figure falls to just over 80 per cent. There is considerable variation around this by sub-sector but what is significant is that in meat processing and dairy products, the two most important branches of the industry in Ireland and the branches most seriously threatened by prospective limitations on raw materials supplies, Irish levels of value-added per employee are less than 80 per cent of the EEC average. A comparison with Denmark is even more telling. In Denmark in 1980 value-added per employee was 18,048 ECUs in meat processing and 23,945 ECUs in Dairy Products, respectively 2.2 and 2.9 times the corresponding Irish levels.

For agriculture the primary concern of state intervention should be to ensure a sustained increase in value-added in the sector. (The enhancement of value-added is even more important given the imposition of a quota on a major sector of the industry and the threat of additional supply management measures in the future). As demonstrated in Chapter 5 the evolution of value-added is critically dependent on the path of the price-cost squeeze and on the scope for productivity improvements. The constraints on achieving this objective can be conveniently considered under three headings:

- EC agricultural policies;
- The macro-economic environment;
- Structural deficiencies in the industry.

However, there are structural problems peculiar to the food processing industry and these revolve around the relationship between processing firms and the primary producers. The most pressing of these concerns the insecurity and seasonality of supplies, an important contribution to the resolution of which could be made by the introduction of long-term supply contracts between primary producers and processors.

—AGRICULTURAL POLICY—

8. BACKGROUND

The scale of the prospective output and income problems posed for the agricultural sector in Chapter 5 together with its implications for the rest of the economy is the background against which the appropriate policy response must be judged. The menu of agricultural policy measures which impinge on the sector are part EEC sourced and part domestic. The objectives of policy as implied by the various forms of intervention are a mixture of efficiency and equity objectives. The efficiency objective stresses the desirability of increasing value-added per capita (excluding transfer payments from the national exchequer) in the agricultural sector in a manner which improves the competitiveness of the sector and generates wealth for society in general. The equity objectives emphasise the persistent low farm income problem in parts of the industry and various forms of intervention are designed to alleviate hardship. A subsidiary objective of policy, certainly at EEC level, is the concern to preserve the fabric of rural society and to maintain intact our environmental heritage.

For agriculture the primary concern of state intervention should be to ensure a sustained increase in value-added in the sector. (The enhancement of value-added is even more important given the imposition of a quota on a major sector of the industry and the threat of additional supply management measures in the future). As demonstrated in Chapter 5 the evolution of value-added is critically dependent on the path of the price-cost squeeze and on the scope for productivity improvements. The constraints on achieving this objective can be conveniently considered under three headings:

- EC agricultural policies;
- The macro-economic environment;
- Structural deficiencies in the industry.

9. EC AGRICULTURAL POLICIES

Before discussing the appropriate Irish policy response to CAP changes some features of the Community budgetary situation generally and of the CAP are outlined.
(i) Expenditure on CAP

Never in the history of the Common Agricultural Policy has there been such an emphasis on reform and adjustment as in recent times. Much of this is in response to the increasing public perception of the CAP in public awareness and the task facing policy makers in attempting to reconcile the need to maintain a substantial number of people in agriculture with the necessity to solve some of the major problems in the operation of the CAP. Among the many problems facing the future of the CAP, there is hardly any more significant or conspicuous than its perceived cost, much of it related to financing market surpluses. In the Commission's "Green Paper" it is stated that Community agricultural expenditure cannot grow at rates comparable with the past. The introduction of the new constraint that expenditure on agriculture is to increase less rapidly than "own resources" reduces considerably the margin for further increases in agricultural expenditure.

The European Agricultural Guidance and Guarantee Fund (FEOGA) has two sections: expenditure for supporting prices and markets derive from the Guarantee Section while the Guidance Section finances socio-structural policies. Table 11.3 shows the pattern of gross expenditure from 1981 to 1986 and also net expenditure, after deduction of ordinary levies and sugar levies.

It is expected that gross expenditure in 1986 will be almost double the 1981 level. In the years preceding 1983 a certain degree of stability characterised budgetary expenditure. Market imbalances were held in check and world prices were quite buoyant. Indeed it was in July 1983 that the Commission first seriously proposed quantitative restrictions on milk production as growth in deliveries resumed at a strong upward pace and internal demand displayed little growth. The new pattern emerging in 1983 was strongly maintained subsequently. In 1985 some of the expenditure was financed on the basis of extra funds, beyond the "own resources", being placed at the disposal of the Community by an inter-governmental agreement.

The share of FEOGA gross expenditure in the total EEC budget is shown in Table 11.4 for recent years. While CAP expenditure began to increase again in proportionate terms in 1983, it is noteworthy to point out that it was considerably greater in the seventies, and FEOGA Guarantee expenditure as a proportion of the budget reached 88 per cent in 1975. The cost of the budget is, however, a subject of controversy particularly when viewed against the background of financing market surpluses.

When the main socio-structural policies were being considered in the early seventies it was envisaged that about one-quarter of FEOGA would be committed to structural policies. This however has never materialised and in recent years the proportion spent on Guidance has fallen below five per
Table 11.4
FEOGA Expenditure in EC Budget, %

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>FEOGA</td>
<td>64.6</td>
<td>63.1</td>
<td>66.7</td>
<td>69.9</td>
<td>72.6</td>
<td>68.6</td>
</tr>
<tr>
<td>Guarantee Section</td>
<td>61.4</td>
<td>59.9</td>
<td>63.7</td>
<td>67.4</td>
<td>70.3</td>
<td>66.2</td>
</tr>
</tbody>
</table>

(1) On the basis of the Community’s budget for 1984-85.
(2) On the basis of the EC’s budget for 1985.

Source: Commission of the European Communities (1986).

It is evident in the case of Ireland also that Guarantee forms the dominant part of FEOGA receipts, accounting for about 94 per cent in 1985. This level of support is of strategic importance to the Irish agricultural sector and in relative terms was equivalent to 64% of gross agricultural product at market prices in 1985.

In order to compare the relative importance of FEOGA across the Community the level of payments in nine Member States is shown in Tables 11.6 and 11.7. The most striking aspect of Table 11.6 is the difference in the levels of support per holder across Member States. Over the five year period the Netherlands was invariably at the top of the league.

Table 11.5
Subsidies and Grants Received by Ireland
(including moneys for work on behalf of the Community)

<table>
<thead>
<tr>
<th></th>
<th>1981</th>
<th>1982</th>
<th>1983</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amounts Received (IR£m)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FEOGA - Guarantee Section</td>
<td>111.10</td>
<td>61.40</td>
<td>80.10</td>
</tr>
<tr>
<td>- Guidance Section</td>
<td>61.30</td>
<td>41.00</td>
<td>55.80</td>
</tr>
<tr>
<td>European Social Fund</td>
<td>95.70</td>
<td>85.10</td>
<td>141.00</td>
</tr>
<tr>
<td>European Regional Development Fund</td>
<td>158.20</td>
<td>85.20</td>
<td>79.00</td>
</tr>
<tr>
<td>EMS Interest Subsidies</td>
<td>12.00</td>
<td>12.00</td>
<td>12.00</td>
</tr>
<tr>
<td>Research and Investment Projects</td>
<td>1.00</td>
<td>0.10</td>
<td>0.00</td>
</tr>
<tr>
<td>Projects on the Energy Sector</td>
<td>0.17</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>0.74</td>
<td>0.10</td>
<td>0.10</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>301.99</strong></td>
<td><strong>143.91</strong></td>
<td><strong>112.90</strong></td>
</tr>
</tbody>
</table>

Note: Receipts also arise as a result of the Community Regulations on social security for migrant workers until 1983 Ireland’s receipts from the UK under this heading were £8.50 million.

In order to compare the relative importance of FEOGA across the Community the level of payments in nine Member States is shown in Tables 11.6 and 11.7. The most striking aspect of Table 11.6 is the difference in the levels of support per holder across Member States. Over the five year period the Netherlands was invariably at the top of the league.

Table 11.6
FEOGA Payments per Holder by EC Member State, 1980-84

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>3073.5</td>
<td>2470.8</td>
<td>2194.9</td>
<td>1746.4</td>
</tr>
<tr>
<td>France</td>
<td>2440.70</td>
<td>2600.4</td>
<td>2474.2</td>
<td>3079.7</td>
</tr>
<tr>
<td>Italy</td>
<td>885.1</td>
<td>770.4</td>
<td>970.4</td>
<td>1160.4</td>
</tr>
<tr>
<td>Netherlands</td>
<td>10,751.5</td>
<td>8172.8</td>
<td>9841.9</td>
<td>11,906.4</td>
</tr>
<tr>
<td>Belgium</td>
<td>5231.5</td>
<td>4955.1</td>
<td>4606.8</td>
<td>5173.2</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>2107.2</td>
<td>1213.3</td>
<td>1811.2</td>
<td>959.0</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>3948.8</td>
<td>4770.6</td>
<td>5190.6</td>
<td>7161.5</td>
</tr>
<tr>
<td>Ireland</td>
<td>2721.7</td>
<td>2326.52</td>
<td>2621.0</td>
<td>3162.5</td>
</tr>
<tr>
<td>Denmark</td>
<td>5206.1</td>
<td>4114.7</td>
<td>4647.1</td>
<td>5677.9</td>
</tr>
</tbody>
</table>

Note: The number of people with holdings in 1980/81 used in the denominator in the 1981.


Along with the Dutch and Danish, Belgian and UK producers retain the top four positions in terms of support. The support per holder is ten times greater in the Netherlands than it is in Italy and nearly four times greater than in Ireland, France or Germany.

A somewhat similar pattern is observed when the support is expressed per unit of utilised agricultural area (Table 11.7).

The Dutch producers received the greatest level of support per hectare in each of the years considered. In addition, the Belgian and Danish producers also received higher levels of support. By contrast UK producers received the lowest support per hectare, reflecting their large farm size. The Irish maintained a fairly constant position in the ranking and received only one-seventh of the support per hectare of their Dutch counterparts. In summary, whether the analysis is undertaken on a per unit area or per holder basis,
there are large divergencies in the levels of support received across Member States. This is, of course, a consequence of support being provided through a pricing mechanism.

Table 11.7
FEOGA Payments per Hectare of Utilised Agricultural area by EC Member State, 1980-84

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>ECUs</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td>215.6</td>
<td>180.9</td>
<td>175.2</td>
<td>202.8</td>
<td>233.3</td>
</tr>
<tr>
<td>France</td>
<td>93.99</td>
<td>103.2</td>
<td>95.2</td>
<td>118.3</td>
<td>116.5</td>
</tr>
<tr>
<td>Italy</td>
<td>109.6</td>
<td>124.9</td>
<td>155.0</td>
<td>171.0</td>
<td>231.0</td>
</tr>
<tr>
<td>Netherlands</td>
<td>274.76</td>
<td>298.12</td>
<td>312.3</td>
<td>280.0</td>
<td>971.2</td>
</tr>
<tr>
<td>Belgium</td>
<td>411.3</td>
<td>358.12</td>
<td>377.9</td>
<td>431.8</td>
<td>481.5</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>98.9</td>
<td>49.2</td>
<td>35.5</td>
<td>37.8</td>
<td>60.5</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>51.03</td>
<td>64.47</td>
<td>72.5</td>
<td>99.0</td>
<td>120.8</td>
</tr>
<tr>
<td>Ireland</td>
<td>106.8</td>
<td>87.73</td>
<td>102.9</td>
<td>124.1</td>
<td>167.6</td>
</tr>
<tr>
<td>Denmark</td>
<td>222.9</td>
<td>184.72</td>
<td>198.9</td>
<td>243.1</td>
<td>317.7</td>
</tr>
<tr>
<td>EC 9</td>
<td>129.45</td>
<td>125.81</td>
<td>144.29</td>
<td>168.8</td>
<td>195.7</td>
</tr>
</tbody>
</table>


(iii) EEC Policy in an International Context

Although it is difficult to make precise forecasts over the next ten to fifteen years it is broadly agreed that demand for agricultural products in the Community and most other industrialised countries will expand at a very slow rate. Unless disasters cut back production, world food supplies are likely to continue in excess of effective demand.

The Community has now become the major exporter of dairy produce and beef, and the second major exporter of cereals and sugar. This reflects the continuing increase of European agricultural production. However, it also arises because of the continuation of the export arrangements made at a time when the Community was less than self-sufficient in most agricultural products. These export arrangements essential involve extending the same conditions available for produce sold on the internal Community market to produce sold on the world market. Disposal of surpluses rather than responding to demand is therefore the main rationale for such trade flows. This inevitably leads to trade tensions between the EEC and its trading partners.

In addition to viewing the Community's role in the world market from an export perspective, its role as an importer also deserves attention. Of particular interest is the relationship between imports, particularly of feeding stuffs, and the resulting exports of final products.

At the time of the original setting up of the Common Agricultural Policy (CAP), a protection arrangement based on variable levies for the staple Community farm products was designed while little or no protection was instituted against products in which the Community was far from self-sufficient. These arrangements have two main consequences. Firstly, the Community has had to introduce aids to ensure the price supported Community product can compete with the imported product. The second main consequence relates primarily to feeding stuffs and is well described in the following extract from the Commission's Green Paper:

"... imports of products subject to low or zero protection, especially various feeding stuffs, have expanded considerably because of their price advantage and have resulted in a discouragement of the use of Community cereals in animal feed, and have contributed to growing surpluses of certain livestock products, particularly milk products and beef, and have thus, contributed to increasing the Community's exports of these products" (Perspectives for the Common Agricultural Policy, page 43).

Given the international dimension which attaches to the internal agricultural problems of the Community, the Council is of the view that any solution to these problems must also incorporate an international dimension. In particular, the Council believes that any restrictions imposed on Community producers to reduce the Community contribution to worldwide agricultural surpluses should be matched by similar steps in non-Community countries.

The differential protection arrangements against various products outlined above, were originally negotiated within GATT. They were negotiated as a package with protection against some items being offset by low or nil protection against other items. Any changes in these arrangements would therefore have to be re-negotiated as a package since raising low or zero rates of protection will impact adversely on some trading partners, who may not benefit from the reductions in other rates. Altering these rates will also, of course, have differential effects within the Community. Given (i) the international dimension to the problem of surpluses together with the importance which the Council attaches to restrictions being shared by the various trading blocs, (ii) the need for a better organisation of the world market, (iii) and the fact that trade in certain products is subject to GATT rules which can only be changed through negotiations with trading partners, the Council believes that the Community should initiate a series of multilateral trade negotiations to be carried under the aegis of GATT.
The Council wishes to emphasise, however, that it does not envisage these negotiations being used as an excuse for inertia on the part of the Community in addressing the internal problems in the Community. In fact the Council sees these multilateral negotiations proceeding hand-in-hand with internal reform. The Council believes that the two sets of reform should actually complement one another with the Community improving its negotiating position by demonstrating its willingness to seriously tackle its internal agricultural problems.

(iv) The Internal Community Context

In listing the problems which are associated with the CAP, the huge surpluses with the high costs incurred in storing intervention products and the export subsidies necessary to dispose of these surpluses are to the forefront. There are, however, a number of associated issues which do not receive the same prominence. Two in particular arise:

(i) EEC consumers are paying high prices for food in relation to its world market price, even if one allows for the depressing effect on world prices of EEC exports.

(ii) Price support to farmers goes mainly to those with high levels of output and hence is ineffective in dealing with the low income problem in farming.

With regard to (i) it has been estimated that in 1984 the consumer 'cost' of the CAP was over 30 thousand million ECUs, compared with the transparent EAGGF expenditure of 17 thousand million ECUs. With regard to (ii), in the 13 years 1973 to 1985 average real per capita farm incomes in the EC-10 have been static, while the low incomes and disparity in incomes among farmers persisted. The CAP mechanism has singularly failed to resolve the problem of low income farmers. The main result of high prices is to boost the incomes of high output, high income farmers and recent Community-wide data show that larger farms (in terms of business size) accounted for 24 per cent of numbers, but 60 per cent of output and of income. Income disparities within the sector are glaring. Data for 1981/82 indicate that the range between the average income of the top 5 per cent income bracket and the bottom 25 per cent group was 1 to 20 for the EC-10 and 1 to 8 for Ireland. Some available data give an indication of the distribution of support across the Community. Table 11.6 showed the FEOGA payments per holder by EC Member State. In 1984 the relative levels of support were:

<table>
<thead>
<tr>
<th>Country</th>
<th>NVA/AWU (000 ECUs)</th>
<th>NVA/AWU %</th>
<th>NVA/AWU %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Netherlands</td>
<td>22.52</td>
<td>31.3</td>
<td>53.18</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>17.09</td>
<td>22.4</td>
<td>32.64</td>
</tr>
<tr>
<td>Belgium</td>
<td>8.66</td>
<td>11.6</td>
<td>41.74</td>
</tr>
<tr>
<td>Denmark</td>
<td>8.43</td>
<td>29.1</td>
<td>36.90</td>
</tr>
<tr>
<td>Germany</td>
<td>5.67</td>
<td>15.4</td>
<td>35.92</td>
</tr>
<tr>
<td>France</td>
<td>4.61</td>
<td>19.7</td>
<td>32.53</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>3.47</td>
<td>14.8</td>
<td>54.07</td>
</tr>
<tr>
<td>Italy</td>
<td>1.59</td>
<td>24.1</td>
<td>6.14</td>
</tr>
<tr>
<td>Ireland</td>
<td>0.36</td>
<td>30.0</td>
<td>4.52</td>
</tr>
<tr>
<td>Greece</td>
<td>0.05</td>
<td>5.8</td>
<td>1.09</td>
</tr>
</tbody>
</table>


Payments per holder in the Netherlands were three times those in Ireland, and in the UK were twice for Ireland. This is an inevitable consequence of support which is directly related to production. Table 11.8 shows the importance of 'very large' and 'large' farm businesses* in the farm structure of the Member States in the EC-10. Ireland is very low in this respect.

Clearly, supporting farms regardless of business size is really working in the interests of Dutch and UK farmers. The case for reducing support to larger farm businesses is clear and, viewed from an EC perspective, could be relatively favourable for Ireland.

Broad options for modification of CAP

At this point the broad options for modification of the CAP are outlined. This will provide a framework for discussion of alternatives and highlight the contrasting features of different approaches to tackling the CAP issues outlined above. Evaluation of these alternatives requires assessment in relation to a wide range of objectives, to costs and to factors related to political acceptability.

---

*The Economic Unit that has very large farm businesses is over 50 and has less than 10 thousand ECU of standard (1972-74) gross margin.
One of the options favoured by the Commission is the co-responsibility levy. This means that the artificially supported price is only guaranteed for production up to a specified guaranteed threshold. This threshold is based on internal EC demand, so that surplus production, in excess of the threshold, has to be exported or stored for later consumption or export. A co-responsibility levy is levied on all production at a rate designed to fund the cost of disposing of the surplus production. Since it is charged on all production the levy is not very high unless the surplus is large relative to the guaranteed threshold. Small levies are relatively ineffective in limiting production, particularly from farms which are highly capitalised and have a low marginal cost for additional production. Thus, while co-responsibility levies substitute producer levies for public expenditure, they still leave the problem of large surpluses for subsidised sale on export markets. The magnitude of this problem depends on the extent to which producer prices net of levy exceed ‘world prices’. Indirect transfers (via high prices) from EC consumers to producers remain, since they are determined by the difference between producers’ gross price (before levy is deducted) and ‘world prices’. These transfers are regressive, since producers benefit in proportion to their level of production.

Another option is a high guaranteed price for a fixed quota of production and a severe (“super”) levy on production in excess of quotas. Examples are the current regimes for milk and sugar. In this arrangement the levy applies only to production in excess of quotas and is at a high enough rate that it discourages much excess production and pays for its disposal. A high price is maintained for production up to quota levels. This approach also makes it possible to allocate highly valued quotas to those with limited farm resources, so giving them preferential access to opportunities for producing highly profitable products. However, high valued quotas with ‘super’ levies have been used to only a very limited extent to give more transfers to small producers, even though EC consumers are paying large excesses on the price of these highly supported products. The super-levy approach is quite effective in controlling production of products with relatively high price support, which are also final farm produce. It is much more difficult to operate for products such as cereals, which are also intermediate farm products. It would also be inappropriate to extend this to a wide range of farm products as it would give rise to shifting surpluses from restricted to as yet unrestricted products (the ‘corset effect’).

Another alternative would be to have market clearing prices established under free trade, with limited public storage and deficiency payments or other direct transfers. The limited storage would be aimed at stabilising markets by offsetting seasonal and other non-structural fluctuations. Additional support for producers could be provided in a number of ways. Deficiency payments could be given to bring receipts up to a higher level and the level of deficiency payments to a producer could be limited. Direct transfers could be given, either related to production (as in headage payments), or unrelated to production but related to need. Any change to such a system would be gradual, with the reduction in the EC’s common tariff wall and deficiency payments being phased in. The advantages of this approach are that it moves towards a market oriented agriculture with free trade in agricultural products. EC consumers get food at competitive prices, while there would be no restriction on commercially viable production. Transfers to producers would become explicit and hence easier to direct towards low income farmers.

However, a move towards market clearing prices would involve a drastic reduction in institutional prices. Such a policy would also have a very uneven impact on incomes across the Community. Such a policy, however, has been in place with various degrees of severity since 1977. Table 11.9 bears testimony to this policy. Between 1977 and 1985 the EEC-9 experienced a decline of almost 40% in real agricultural prices. The table also shows that by far the greatest real reduction (34%) was experienced by Ireland.

The effectiveness of a significant reduction in prices in reducing surpluses also needs to be questioned. Such price reductions would probably have only limited effects on consumption because of the relative inelasticity of demand for agricultural products. On the supply side production would be likely to respond, but somewhat slowly. This is because resources employed in agriculture only gradually respond to changes in relative costs and prices. The initial reaction to price reductions may sometimes even take the form of increases in production as attempts are made to maintain income levels. This implies that quite severe reductions could be necessary in some cases. For example, in 1983 when the Commission imposed a super levy on milk production it indicated that the alternative was a price cut of 12%.

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<tr>
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<tbody>
<tr>
<td>W. Germany</td>
<td>10.8</td>
<td>10.6</td>
<td>5.4</td>
</tr>
<tr>
<td>France</td>
<td>11.5</td>
<td>9.2</td>
<td>21.5</td>
</tr>
<tr>
<td>Italy</td>
<td>11.9</td>
<td>8.3</td>
<td>24.4</td>
</tr>
<tr>
<td>Netherlands</td>
<td>10.5</td>
<td>9.3</td>
<td>11.9</td>
</tr>
<tr>
<td>Belgium</td>
<td>9.9</td>
<td>5.1</td>
<td>11.5</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>10.1</td>
<td>10.7</td>
<td>10.3</td>
</tr>
<tr>
<td>UK</td>
<td>12.6</td>
<td>9.7</td>
<td>10.4</td>
</tr>
<tr>
<td>Denmark</td>
<td>12.5</td>
<td>8.6</td>
<td>15.1</td>
</tr>
<tr>
<td>Ireland</td>
<td>16.6</td>
<td>17.9</td>
<td>11.6</td>
</tr>
<tr>
<td>EEC-9</td>
<td>12.3</td>
<td>9.4</td>
<td>19.6</td>
</tr>
</tbody>
</table>

Notes: Prices received by farmers defined as a combination of output prices and prices granted.
From both the Community and Irish perspective there is a need for caution regarding a modification of the CAP in this direction. From a Community perspective if the 'hidden' support via higher consumer prices is made overt (as deficiency payments or direct transfers) it may be less acceptable even though total support could be reduced by reducing the transfers to large scale producers. From an Irish perspective pursuit of such a policy would have severe implications. As recently pointed out the losses to producers from falling prices would be offset by gains to consumers from cheaper food only in a self-sufficient economy. However, for an economy with a significant proportion of agricultural output being exported there would be a net loss to the State. Another difficulty with this approach is that agricultural price support whether by higher consumer prices, intervention buying or export refunds, is financed almost entirely by the Community as a whole. Where price support is replaced by, for example, hedging payments, losses could accrue to the economy since co-financing is generally a feature of these payments. Similarly with compensation through the regional and social funds. There is therefore a danger that reduction of price support would give rise to nationalisation of agricultural policy with individual Governments initiating their own support arrangements. As net exporters of food with a relatively low national income and high dependence on agriculture we are net beneficiaries from favourable terms of access for our food products and from Community financial support for agriculture.

The appropriate domestic stance
Having outlined the broad options for modification of the CAP together with some of their implications for both the Community and Ireland we now examine the most appropriate stance for Ireland to adopt. The essential first step in devising a strategy which Ireland might adopt is to acknowledge that the CAP as currently designed with high price support for unlimited production is not defensible in view of the large surpluses generated and the associated budgetary costs, and is in need of reform.

If we persist in defending what is economically and politically unsupportable within the EEC we may fail to increase support for common policy measures. In this situation member states are likely to resort to national measures to deal with emerging economic and social problems. We need to pay attention to the balance of interests within the Community as well as to our own national and agricultural interests. There is little point in seeking support for national interest policies which cannot gain political acceptance at EEC level. Such an approach may in fact be counter productive. This approach involves considering what are acceptable EEC policies and how the prospects for Irish agriculture can be enhanced within an acceptable EEC framework.

The promotion of policies which have wider political support within the Community as a whole requires a focus on policy objectives which command support within the Community. Such a perspective requires a focus on policy objectives which can win support among food consumers as well as producers and on policy measures which ensure that public financial support for agriculture is used effectively in meeting agreed objectives.

Securing support for the CAP will require an acknowledgement that high food prices entail a cost to the consumer as well as a benefit to the producer and that support should be directed more towards solving the low income problems of farming. Equally it will entail acknowledging that sacrifices will be necessary from all members of the European Community. However, the distribution of sacrifices must have regard to the present maldistribution of support across the member states. The distribution of sacrifice must also take into account the importance of agriculture in member states and the economic and social dislocation which would result from major and rapid adjustments in agricultural support. Finally, the reform of the policy must have regard to the fundamental objectives of the Community as set out in the Treaty of Rome.

Against the background of (i) the principles which should guide the stand which Ireland might adopt towards reform of the CAP, and (ii) the broad options for modification of the CAP outlined earlier, we now outline the most appropriate strategy for Ireland to adopt.

In the view of the Council the extent of future increases in common prices must have regard to the high costs borne by the consumer and to the level of surpluses being generated by the existing price level. Regard must also be had to the efficiency of real price reductions in achieving greater market balance and the degree of dislocation which would result from the reduction in prices necessary to bring about market balance. In general, therefore, the Council believes that while a realistic price policy is necessary, price policy should not be the only instrument used to bring about greater market balance.

If pricing policy is not to be the only instrument utilised in bringing demand and supply for agricultural products into greater equilibrium then quantitative restrictions will be necessary. The use of quantitative restrictions should not be viewed as a long term solution to the problem of market imbalance. They are useful because of their immediate effect on market balances and in obviating the need for significant price reductions for some products. However, they are not attractive in other than a short term context because of their adverse implications for efficiency and economic performance.

In the context of considering production restraints a number of other issues should be borne in mind. In particular, as pointed out earlier, price support to farmers goes mainly to those with high levels of output and incomes and
hence is ineffective in dealing with the low income problem in farming. Any revised arrangements should therefore be devised with the objective of dealing more effectively and systematically with the income problems of low income farmers. Since the Council has eschewed the use of pricing policy in isolation as a solution to the problem of the CAP, preferential access to production opportunities may have to be devised in order to achieve this objective. This strategy, as indicated earlier, could be relatively favourable for Ireland.

As indicated above the distribution of sacrifices across the community must have regard to the importance of agriculture in the individual states and the dislocation effects which could result from the adjustment. It is estimated that approximately one fifth of GNP is supported by the agriculture and food sectors in Ireland. The contribution which the agricultural industry makes to economic activity is detailed in Appendix 5.

Finally, in any reform of the CAP regard must be had to the fundamental objectives of the Community as articulated in the Treaty of Rome. These objectives are:

(a) to increase agricultural productivity by promoting technical progress and by ensuring the rational development of agricultural production and the optimum utilisation of the factors of production, in particular labour;
(b) to ensure a fair standard of living for the agricultural community;
(c) to stabilise markets;
(d) to assure the availability of supplies;
(e) to ensure that supplies reach consumers at reasonable prices.

The Treaty also indicated that in designing policies to achieve these objectives account would be taken of:

(a) the particular nature of agricultural activity, arising from the social structure of agriculture and disparities between various agricultural regions;
(b) the need to offset the appropriate adjustments by degrees;
(c) the fact that in the Member States agriculture constitutes a sector closely linked with the economy as a whole.

It was pointed out earlier that CAP has had a high degree of success in achieving these objectives. In attempting to resolve the difficulties which the CAP now faces it is essential that all efforts are made not to jeopardise these achievements, in particular, that the policy continues to fulfil the objective of assuring a fair standard of living for the agricultural population. In the context of production restraints the importance of agriculture in the Irish economy must be taken into account by our Community partners particularly because of the regional disparities in the European context. In 1984 the Community formally recognised the importance of the dairy industry’s contribution to GNP and the limited scope for developing alternatives to milk production as giving Ireland a special claim to milk quotas on the grounds of (a) and (c) above. The Council would draw attention in this context to the significant divergences in the levels of support received across member states in spite of severe regional differences as for example, between the West of Ireland and the Netherlands.

It is generally the case that the EEC regions highly dependent on agriculture also have low per capita incomes. It is sometimes argued that a weakening of agricultural support for these regions should be compensated for by equivalent regional and social policy support. While an integrated community social, regional and agricultural policy is desirable, particular caution should be exercised in considering this option from a national perspective since regional and social policy support require partial national financing. A move from 100% Community financing (i.e. agricultural guarantee support) to partial Community financing for non-agricultural measures could result in a net reduction of the resource transfer from the Community to Ireland.

10. THE MACRO-ECONOMIC ENVIRONMENT

For the commercial sector of agriculture the climate for investment and risk taking, generated by the stance of the State monetary and fiscal authorities, is of pivotal importance in the maintenance of competitiveness. As noted by the National Planning Board “...no amount of juggling by the State with specific agricultural policy measures can be a substitute for an appropriate macro-economic strategy” (p 171). The range of macro-economic policies which affect the climate for wealth creation is extensive, encompassing public expenditure, taxation, interest rates, cost of services provided by State monopolies, incomes policy and exchange rate policy. All of these policies are considered in detail in Chapter 8. However, in this section the role of interest rates in influencing developments in the agricultural sector are considered.

Investment in cost-saving technologies, in activities which are not subject to significant pressure for CAP reform, is one of the key elements which can combat the looming farm income difficulties. Given the pervasiveness of the beef industry in the farm economy, one of the central objectives of policy ought to be the stimulation of productive investment and development in cattle production. Returns from the main cattle systems are low as indicated in Table 11.10. Among the many factors responsible for this situation, the principal are the low price levels obtained in Ireland (relative to European norms) and the low degree of capitalisation.
Table 11.10
Costs and Returns - Wide Use Range

<table>
<thead>
<tr>
<th></th>
<th>Suckling</th>
<th>Mainly double to multiple</th>
<th>Mainly artificial rearing to store</th>
<th>Calf to beef</th>
<th>Finishing all year round</th>
</tr>
</thead>
<tbody>
<tr>
<td>Per Livestock unit</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Output</td>
<td>251</td>
<td>280</td>
<td>414</td>
<td>475</td>
<td>317</td>
</tr>
<tr>
<td>Direct costs</td>
<td>76</td>
<td>104</td>
<td>174</td>
<td>206</td>
<td>134</td>
</tr>
<tr>
<td>Gross margins</td>
<td>175</td>
<td>176</td>
<td>240</td>
<td>269</td>
<td>183</td>
</tr>
<tr>
<td>Forage acres</td>
<td>1.76</td>
<td>1.58</td>
<td>1.73</td>
<td>1.44</td>
<td>1.69</td>
</tr>
<tr>
<td>Per acre</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross margins</td>
<td>100</td>
<td>112</td>
<td>118</td>
<td>106</td>
<td>108</td>
</tr>
</tbody>
</table>

Source: National Farm Survey files, AIT

The high level of interest rates in Ireland (Table 11.11) places Irish beef producers who wish to intensify at a competitive disadvantage relative to their European counterparts. Convergence of Irish interest rates to European levels has not materialised to anything like the same degree as the inflation rate. A combination of high nominal interest rates with low inflation rates places a severe capital cost restriction on any intended farm development.

Moreover, the funding arrangements for farm borrowings compound the disadvantages suffered by high interest rate levels. Funds for livestock and working capital employed in systems with a production period longer than one year would normally be provided on a term loan basis. This contrasts with short-term cattle systems which require only annual borrowing and hence do not have a long-term cash-flow problem. For longer production systems with high working capital requirements the economics of investment may be sound, as reflected by rate of return estimates, but where investment funds have to be borrowed the income remaining after interest and loan repayments would not be sufficient to encourage development.

The policy issues are two-fold. First, the need is apparent to tackle the high level of interest rates and second, repayment schedules tailored to the needs of a long-term farm development programme need to be designed. The first issue is heavily influenced by the stance of domestic macro-economic policy and has already been addressed in that context. A recent initiative in this area is the Euro Loan Scheme with borrowers contributing 2% or 2.5% on the £35m development scheme against possible exchange rate losses and any additional exchange rate loss being met by the Exchequer*. However the Council would not be in favour of general subsidisation of agricultural lending rates. In fact, as pointed out in Chapter 8 one of the reasons for relatively high real interest rates in Ireland is the Government’s borrowing requirement which would be further increased if the State involved itself in further interest rate subsidies.

The introduction of repayment schedules tailored to the needs of a long-term farm development programme is essential. The Council has already indicated that there is a need for some form of long-term credit facility for agriculture which would reflect the long payback period of some farm investment. The National Planning Board also proposed that "the financial institutions, and particularly the ACC, should introduce lending instruments which confront the problem of the disproportionate burden of repayments in the critical early years of the investment which occurs under conventional repayment schedules. Specifically, consideration should be given to the provision of house-mortgage type finance of index-linked repayment schedules (or some variant thereof which would relieve the repayment burden in the early years while preserving some gradual lowering of repayments over the duration of the loan)."

11. STRUCTURAL DEFICIENCIES IN THE INDUSTRY

The assertion that the primary sector could, in normal circumstances, expand at a faster rate implies that agriculture is not realising its "potential". Numerous studies have shown that in physical terms the output of agriculture could be expanded appreciably. This fact is frequently used to portray the industry as being less than "efficient" against the background of considerable achievement on the part of a minority of farmers. There is probably an incomplete understanding also of the wide variation which exists in practice in total resource endowment or quality, or of the array of structural, economic, social or institutional factors which impinge on the development of agriculture as a whole.

* No contribution is required on the £35m working capital and other financing scheme.
In this section the main focus is on the structural obstacles in farming. In the final report of the Inter Departmental Committee on Land Structure Reform it was stated that "barriers to agricultural development are traceable to aspects of land tenure, land mobility, farm size, demographic structure and public policies which impinge on land structure". The alleviation of the impact of these factors is a formidable challenge even to judge from the difficulties encountered to date in introducing meaningful and effective measures. There has been quite a number of studies showing strong relationships between structural and demographic variables and farm performance. These other studies have shown that (inter alia),

(i) small farms with poor household structure and low labour input are making little or no contribution to agricultural growth;
(ii) part-time farmers have lower net product per acre than full-time farmers, due to a lesser concentration in dairying, but are as efficient as full-time drystock farmers;
(iii) age on assuming managerial responsibility or ownership affects farm performance;
(iv) our land tenure system probably inhibits structural adjustment and land mobility; and
(v) conflicts may in fact exist between the objectives of some policies introduced to redress particular socio-structural problems.

Technological and economic forces exert relentless pressure for changes in the structure of agricultural production. Continuous mechanisation, greater reliance on purchased inputs and higher debt servicing have increased the costs of production. Related to this is the tendency for the size of the individual farm business to increase in scale. Modern commercial farming also involves a reduction in the number of enterprises per farm and the concentration of production in a narrowing span of farm sizes.

Although the threshold of farm viability has clearly been rising there has been comparatively little change in farm structure, i.e. in the size and distribution of farms. There is some reason to believe that change has in fact slowed down, as the rates of change in holding numbers over the 1970s were lower than for those of the 1960s, for all regions. In any event structural change at this level is a slow process and manifests itself only in the longer term.

Farm retirement schemes (especially Directive 160) have been unsuccessful in prompting changes in farm structure. Directive 160 yielded only 21,000 acres and little of this land went to development farmers. Part of the reason for this failure was that the incentives available were not sufficient to offset the alternative benefits available to small farmers, i.e. the Smallholders Unemployment Assistance and the Non-contributory Old Age Pension.

However, the low incidence of land letting indicates an unwillingness to give up farming, even by those with low returns from farming.

In the 1970s the need or incentive for restructuring was lessened by commodity price increases and by the growth of part-time farming. Obviously, off-farm employment meets income needs while enabling the farm operator to retain his holding. Another factor of relevance here is that since the early 1970s the Land Commission scaled down its land acquisition and farm enlargement activities. This was due in great part to the rising cost of this work.

Thus, there were many factors operating over the last decade or so which inhibited the rate of farm structural change. It might also be noted here that EEC socio-structural policy has not been any more successful elsewhere in Europe. The EAGGF budget has not reflected a firm commitment to structural reform.

In relation to demographic structure it is interesting to note that, despite what has been said about farm structural change, there have been some improvements in the structure of the Irish farm population. Between 1971 and 1981 male farmers under 35 years, as a percentage of all male farmers, increased from seven per cent to 16 per cent while those over 65 years declined from 26 per cent to 18 per cent. Some of this change may be due to changes in self classification (sons of farmers calling themselves farmers as distinct from 'relatives assisting') but it is very likely that there has been a tendency to earlier retirement, given the improvement in the Old Age Pension Scheme.

Apart from the structural constraints some recent changes in the EEC price and market policies are also impeding growth. While the general moderation in price levels is making farming less profitable, undoubtedly the major market adjustment in recent times was the introduction of the super-levy. As stated earlier no other enterprise has so dominated the pattern and evolution of agricultural output in Ireland or played such a major role in decision-making and resource allocation. The growth in milk production accounted for about 90 per cent of the expansion in agricultural output in the decade up to the introduction of the dairy quota. There seems little likelihood of any other enterprise being in a position to compensate for the effect of the limits in milk production and the further reduction in the guaranteed quantities in 1987/88 and 1988/89 will make the position even worse.

In the context, therefore, of severe constraints on the price and market features in the CAP, there will be increasing emphasis on socio-structural measures in the future to cushion the impact of the more market-oriented price policy on small producers. Nevertheless, the structural transformation of the agricultural sector, in the sense of the continuing substitution of capital for labour, will probably continue, spurred on by developments in bio-technology.
In spite of this, however, the need for structural reform is considerable given
the large contribution of agriculture to GDP here and the considerable
dependence on Guarantee Funds for income generation. Structural
improvement is essential for a number of other reasons also.

Firstly, although the structural problem in Ireland is not as great as in
Mediterranean regions, the fact is that the Irish rates of structural change
are the lowest in the EEC. The 1975-83 rate of annual change in farm numbers
at -0.4 per cent compare with -2.4 per cent in Germany, -2.0 per cent in
the Netherlands and -3.6 per cent in Denmark.

Secondly, of the 13.3 million acres of land in agricultural holdings, about
4.7 million acres are operated by persons over 55 years, and 1.5 million acres
by persons over 65 years. Those without successors in the farming household
are reckoned to be operating 2.0 million acres in the case of persons over
55 years and 0.8 million acres for those aged 65 and over.

Thirdly, various forms of leasing schemes have been prepared by different
agencies. These could be activated by a good structural policy. Such a policy
should contain a bigger incentive than that of earlier EC schemes, and greater
than the benefits suggested in the Commission's Green Paper. From a
structural perspective any strategy for the agricultural sector must incorporate
instruments to encourage effective land use. Structural change is the key to
the growth of any sector with resources being reallocated from less efficient
to more efficient usage, with consequential growth in the sector as a whole.
While ceilings on the growth of the sector as a whole or particular segments
of it change the context within which an efficient land use policy must be
developed, they do not remove the rationale for such a policy.

While the trends in the CAP, such as quota restrictions on milk and declining
price support generally, restrict the scope for development, they put increased
emphasis on cost efficiency and effective use of land, in both conventional
and non-conventional (e.g. forestry) enterprises. The existence of a ceiling
on output does not imply that one should be indifferent about the efficiency
of resource use in producing up to the ceiling. In fact, efficiency in the primary
sector will be a key component in ensuring a more effective relationship
between primary producers and processors*. In particular, the reorientation
of food production towards higher value-added products will require secure,
non-seasonal supplies of uniform quality from the primary producer. Efficiency
at the primary level will be a key requirement for this. Similar remarks are
relevant in a situation of more restricted availability of intervention as an
outlet for farm produce.

* This relationship is one of the key issues underpinning the expansion of the food processing sector in the medium
term (see Chapter 11).