NATIONAL ECONOMIC AND SOCIAL COUNCIL

CONSTITUTION AND TERMS OF REFERENCE

1. The main task of the National Economic and Social Council shall be to provide a forum for discussion of the principles relating to the efficient development of the national economy and the achievement of social justice, and to advise the Government, through the Taoiseach on their application. The Council shall have regard, inter alia, to:

(i) the realisation of the highest possible levels of employment at adequate reward,
(ii) the attainment of the highest sustainable rate of economic growth,
(iii) the fair and equitable distribution of the income and wealth of the nation,
(iv) reasonable price stability and long-term equilibrium in the balance of payments,
(v) the balanced development of all regions in the country, and
(vi) the social implications of economic growth, including the need to protect the environment.

2. The Council may consider such matters either on its own initiative or at the request of the Government.

3. Members of the Government will meet regularly with NESC on their initiative or on the initiative of NESC to discuss any matters arising from the terms of reference and in particular to discuss specific economic and social policy measures and plans and to explore together proposals and actions to improve economic and social conditions. Any reports which the Council may produce shall be submitted to the Government, and shall be laid before each House of the Oireachtas and published.

4. The membership of the Council shall comprise a Chairman appointed by the Government in consultation with the interests represented on the Council, and

Five persons nominated by agricultural organisations,
Five persons nominated by the Confederation of Irish Industry and the Irish Employers' Confederation,
Five persons nominated by the Irish Congress of Trade Unions,
Five other persons appointed by the Government, including two from the National Youth Council of Ireland,
The Secretaries of the Department of Finance and the Department of the Public Service.

Any other Government Department shall have the right to audience at Council meetings if warranted by the Council's agenda, subject to the right of the Chairman to regulate the numbers attending.

5. The term of office of members shall be for five years. Casual vacancies shall be filled by the Government or by the nominating body as appropriate. Members filling casual vacancies may hold office until the expiry of the other members' current term of office.

6. The numbers, remuneration and conditions of service of staff are subject to the approval of the Taoiseach.

7. The Council shall regulate its own procedure.

NATIONAL ECONOMIC AND SOCIAL COUNCIL

A Strategy for Development 1986-1990:

Growth, Employment and Fiscal Balance

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PREFACE

Since 1980 the Council has published an annual economic and social policy report*. These reports were generally short term in nature, incorporating a review of the previous year from both an economic and social perspective and a preview of the situation in the following year. These reports also analysed some key issues which the Council considered to be of major importance, both short term budgetary issues and longer term developmental issues.

This year the nature of the report has been changed significantly. It is more comprehensive and it is set in a medium term framework. This change was prompted by a number of factors. The Council was concerned at the evolution of the economic and social situation over the first half of the 1980s and was apprehensive at the implications of a continuation of present policies. The Council was also of the view that the major imbalances which had built up in the economy could not be redressed in a short space of time. Hence the medium term context in which the report is couched. In the context of its overall workprogramme, the Council believes that a more efficient allocation of its resources is possible by moving from the preparation of annual short term reports to a periodic medium-term report dealing with the major issues of economic and social policy.

As this report was being finalised the overall economic and social situation deteriorated seriously in a number of important respects. While this deterioration does not alter in any way the overall conclusions contained in the report it does add a considerable degree of urgency to the recommendations. The recent developments underline the necessity for immediate remedial action. However, the Council wishes to emphasise the point made in the report, remedial action must take the form of an integrated strategy and must be placed firmly in a medium term context.

The fact that the various interests have been able to agree on the major elements of an integrated strategy and on the general policies for the major sectors of the economy should be a substantial help to Government. There remains a clear distinction between policies put forward by a body such as the NESC and the political decision of Government to implement the measures of its choice. In some areas of this report recommendations are made in terms of general principles rather than in the form of a detailed blueprint. The Council sees its role, as reflected in its Constitution and Terms of Reference, as advising on the *principles* relating to the efficient development of the national economy and the achievement of social justice.

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*These were NESC Reports No. 53, 62, 70, 75 and 79.

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INTRODUCTION

(i) Overview of Performance

This introduction begins with a very brief overview of the performance of the economy over the period 1980-85 against a number of key objectives. The key dimensions conventionally used to evaluate the performance of an economy are the rate of growth, inflation, unemployment and current external balance. These are not unambigious indicators of performance and each has to be considered in the context of the evolution of the economy as a whole. For example, external balance can be restored through domestic deflation or through an acceleration in the growth of exports arising from a relative improvement in international competitiveness. Equally, falling unemployment can result from a growth in employment or from a fall in the labour force arising from net emigration.

Real GDP grew at an annual average rate of 1.8 per cent over the 1980-85 period by comparison with a growth rate of 4.6 per cent over the period 1975-80. Thus, on the first dimension of performance a significant deterioration was experienced. This deterioration is also reflected in the relative unemployment performance over the two periods, with the unemployment rate averaging 8.1 per cent over the earlier period compared to 12.6 per cent over the 1980-85 period. The position is reversed in regard to the respective inflation performance over the two periods. The annual rate of increase in the CPI averaged 14.1 per cent over the 1976-80 period, falling to 12.3 per cent over the 1980-85 period. With regard to the current external balance the average performance is almost identical over the two periods.

Before reaching general conclusions about the respective economic performance over the two periods, the performance measures have to be set against the general qualifications outlined above together with a note of caution

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*Following discussions in the Council, the successive drafts of this report were prepared by Jim O'Leary, Tony McCashin and Gerry Danaher of the Council Secretariat. Research assistance was provided by Paul Delaney.

**The Agricultural material in the report is based on background papers prepared by AFT.

***The Secretaries of the Departments of Finance and the Public Service did not consider it appropriate to comment on matters of budgetary policy.

regarding the use of averages when significant changes occur within a period. With regard to the latter, although unemployment averaged 12.6 per cent over the 1980-85 period it has deteriorated appreciably, from 7.3 per cent in 1980 to 17.3 per cent in 1985. The averages also conceal a significant deceleration of inflation and a dramatic improvement in the current account of the balance of payments. A major qualification attaches to the latter, however, because of the particular weakness of domestic demand over the period.

The unemployment deterioration must also be viewed against a background of a significant change in the overall demographic experience in the period 1980-85. This period is characterised by a deceleration in the rate of population growth occasioned by a dramatically changed migration pattern. The 1970s were characterised by a sustained net inflow of population, at an annual average rate of approximately 9,500. By contrast, net emigration is estimated at 75,000 in the five years to April 1986. In addition the rate of emigration appears to be accelerating and is estimated to have reached 31,000 in the year to April 1986 which is greater than the natural increase of 28,000.

In a more general context the performance of the economy over the 1980-85 period marks a major discontinuity with the experience of the late 1970s. Following a period of rapid growth in the late 1970s internal and external imbalances began to appear. These imbalances were due in part to the type of policies pursued (e.g. a widening current account deficit arising from a rapid expansion of domestic demand) but were exacerbated by the second oil shock and the associated international recession. The imbalances were firstly indicated by a significant degree of inflationary pressure, together with record deficits in the external current account and the public sector accounts. The macroeconomic imbalances generally reached a peak in 1981 with inflation and the current external deficit declining rapidly thereafter.

The other major imbalances have, however, proved more persistent. These refer mainly to the unemployment situation, which has deteriorated seriously, and the public finance position which has proved particularly intractable and has given rise to a rapid accumulation of debt. Not surprisingly, policy over the 1980-85 period has been dominated by attempts to reduce these imbalances. Restrictive policy measures reflected in a tightening of fiscal policy in successive budgets were progressively introduced from the middle of 1981. This restrictive policy (achieved mainly through the medium of tax increases) gave rise to some improvement in the major imbalances, except unemployment. Subsequent to 1983 the pace of adjustment in relation to the public finances slowed appreciably. Notwithstanding this, unemployment continued to edge upwards.

A key indicator of social policy developments since 1980 is the share of total social expenditures in relation to GNP. This figure rose by one percentage point in the latter half of the nineteen seventies but the rate of increase accelerated markedly after 1980: the figure rose to 35.6% in 1985 from 29% in 1980. This aggregate figure, however, is not an unambiguous sign of progress. That social expenditure rose in this fashion is due, in part, to the growth of social welfare expenditures; this in turn must be seen as reflecting the relentless rise in unemployment, combined with the improvement in the real incomes of a growing population of social welfare recipients. The deeper realities underlying the aggregate data on social expenditure are therefore mixed; a growing dependence on state transfers due to labour market, demographic and other trends, and the not inconsiderable achievement of sustained real improvements in social welfare payments. Long term unemployment emerged as a particular feature of the unemployment situation and associated with this a range of serious social problems such as family poverty and indebtedness.

In the latter years of the nineteen seventies very rapid increases in social expenditures had taken place. The deterioration in the economic environment in the nineteen eighties did not result in significant curtailment. For reasons already alluded to, social welfare expenditures rose sharply. The share of education expenditure in GNP continued its very gradual rise, and health expenditure stabilised somewhat in the second-half of the 1980-85 period. Trends in health and education expenditure undoubtedly reflected demographically determined demands for services and also the effects of relative prices. It is therefore difficult to specify the changes which took place in the actual quantity and quality of services.

Some achievement in the pursuit of effective redistribution, in the enhancement of the rights of women, and in the development of social services was recorded in the period prior to 1980. The rate of achievement slowed appreciably in the 1980-85 period in the face of serious financial constraints. A realisation emerged that the successful pursuit of social policy objectives requires targetted, co-ordinated policies across the taxation and public expenditure system, rather than exclusively universalist policies which may indiscriminately allocate large volumes of public expenditure.

The problems of unemployment and the public finances provide a focal point for this report. While these are the most visible problems which the economy faces and with which policy makers have to come to grips they cannot be considered in isolation from some of the more fundamental, but less visible, deficiencies in the structure of the economy. In this report therefore, in the context of seeking solutions to the present difficulties, an integrated approach is adopted with a view to linking the major macro-economic imbalances in the economy with deficiencies at the level of the various sectors, with inefficiencies and resource misallocation generated by the tax system and with major inequities in both the public expenditure and taxation systems and in society generally.

(ii) Structure of the Report

The report is divided into four main parts. Part I, which comprises Chapters 2, 3 and 4 contains an in-depth review of the performance of the economy with particular reference to the major problems and imbalances identified above. Chapter 2 contains a review of economic performance from the perspective of output, prices and employment. The Chapter examines in detail why the performance of the economy over the 1980-85 period was disappointing in a number of important respects by comparison with the 1975-80 period.

Reflecting the centrality of the deterioration of the public finances to the evolution of the economy as a whole, a detailed analysis of public expenditure is given separately as Chapter 3. Chapter 4 concentrates on the taxation side of the public finances, describing the principal characteristics of the existing taxation system and analysing the main features of its evolution in recent years.

Part II assesses the prospects for economic growth over the period to 1990 and examines the extent to which these prospects will ameliorate the problems facing the economy. This part of the report comprises Chapter 5 and 6. Chapter 5 constructs a range of plausible scenarios for the evolution of output of the Irish economy on the assumption of broadly unchanged policies over the period to 1990. Chapter 6 then assesses the extent to which these scenarios for output growth might be expected to lead to a resolution or amelioration of the unemployment problem and the major imbalances of the public finances.

Against the background of the review of performance over the 1980-85 period and the likely prospects for 1985-90, Part III of the report considers the most appropriate policy response with which to confront the situation. This part of the report begins with Chapter 7 which provides an overall framework within which the various policy instruments can be integrated. This is achieved through specifying in general terms how the economy operates. The remainder of this part of the report is then devoted to a consideration of the various policy instruments which are available for tackling the problems of unemployment and the public finances.

Chapter 8 addresses issues of macro-economic policy, comprising 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 sets out a programme for reform of the taxation system. Chapter 11 deals with development policies, primarily in the agricultural and industrial policy areas. These chapters should be seen as an integrated policy approach designed to tackle the twin problems of unemployment and the imbalances in the public finances. The chapters are built around three main elements: an acceleration of output growth; a tackling of the imbalances in the public finances; and the pursuit of equity in the structure of social provisions and the mechanisms which finance them. Part IV of the report comprises one chapter which presents the overall conclusions.

PART I: REVIEW

2

REVIEW OF ECONOMIC PERFORMANCE 1980-1985: OUTPUT, PRICES AND EMPLOYMENT

1. INTRODUCTION

This and the following chapter comprise a review and assessment of economic performance over the past five years. Trends in the public finances and in government spending are treated in Chapter 3. The present chapter concentrates on the performance of output, prices, employment and the balance of payments.

2. GNP AND ITS EXPENDITURE COMPONENTS

Table 2.1 sets out the trends in GNP and its expenditure components for the 1980 — 1985 period and compares these trends with those of the five-year period to 1980. In volume terms GNP registered a marginal decline between 1980 and 1985 in contrast to the 1975-1980 period when real GNP grew by a cumulative 20 per cent or 3.7 per cent per annum. A similarly marked divergence between the two periods occurred in respect of GDP which grew at an annual average rate of over 4.5 per cent between 1975 and 1980 but slowed down to under 2 per cent in the five years to 1985.

Domestic demand was particularly weak between 1980 and 1985 declining by almost 1 per cent per annum in volume terms. The volume of public current spending increased somewhat but consumer expenditure declined at an annual average rate of over 1 per cent and investment fell by over 2 per cent annually. Total domestic demand was over 3 per cent lower in volume terms in 1985 than in 1980. This was in marked contrast to the period 1975-1980 when the cumulative increase in the volume of domestic demand exceeded 30 per cent.

Although domestic demand declined, final demand expanded by 2.3 per cent per annum between 1980 and 1985, due to the rapid expansion of exports. The volume of exports grew at an annual average rate of over 8 per cent, increasing especially rapidly in 1983 and 1984 when growth rates of 10.5 and 16.4 per cent respectively were recorded.

Whereas export growth was only moderately less rapid in the period 1980-1985 than during the preceding five years, the growth in imports, at 3 per cent

Table 2.1
GNP and its Expenditure Components, 1976-1985 (Volume Changes)

	1981	1982	1983	1984	1985	1980-85 average	1975-80 average
		—(per cent per annum)—					
Consumer Expenditure	1.7	-7.7	-1.7	-0.5	1.6	-1.4	4.6
Public Current Expenditure	0.3	3.2	0.4	0.1	0.8	1.0	4.9
Fixed Capital Formation	7.3	-5.5	-9.3	-2.7	-0.3	-2.3	8.5
Domestic Demand (1)	**3.0**	**-2.9**	**-4.1**	**1.0**	**-0.4**	**-0.7**	**5.6**
Exports	2.0	5.5	10.5	16.4	6.7	8.1	9.4
Final Demand	**2.7**	**-0.3**	**0.5**	**6.4**	**2.3**	**2.3**	**6.6**
Imports	1.7	-3.1	4.7	9.9	2.8	3.1	10.3
Gross Domestic Product	**3.4**	**1.4**	**-1.9**	**4.2**	**2.0**	**1.8**	**4.6**
Gross National Product	**2.6**	**-1.6**	**-3.4**	**1.8**	**0.2**	**-0.1**	**3.7**

(1) Includes changes in stocks
Source: *National Income and Expenditure*, 1983-84 and 1985, CSO.

per annum, was substantially lower than the growth rate of over 10 per cent annually achieved between 1975 and 1980. This contrast is explained by the markedly different behaviour of domestic demand as between the two periods.

Table 2.2*
Aggregate Components of GNP Growth 1975-1980 and 1980-1985 (at 1980 prices)

	1975-1980 (1) (£m)	1980-1985 (£m)
Domestic Demand (2)	+ 2516.8	-369.0
Net Exports	- 609.4	+ 1234.3
GDP	+ 1869.3	+ 865.3
Net Factor Payments	- 366.0	-911.9
GNP	+ 1482.8	- 46.6

(1) The components do not add to the totals. An explanation is provided on page 4 of *National Income and Expenditure 1983-1984.*
(2) Including changes in stocks.
Source: *National Income & Expenditure* 1983-84 and 1985, CSO.

A significant difference between the two periods resides in the respective contributions made by domestic demand and net exports to overall economic growth. Table 2.2 indicates that the change in real GDP which took place in the 1975-1980 period was more than fully explained, on a mechanical basis, by the increase in domestic demand. Indeed the evolution of net exports during this period was such as to restrain the growth in GDP. The 1980-1985 period was characterised by quite the opposite conjunction of events: the growth in GDP was more than fully attributable to the expansion of net exports while the evolution of domestic demand was such as to impart a substantial negative influence to overall economic growth. What growth in GDP took place in 1980-1985 was more than counterbalanced by the increase in net factor payments abroad. In the 1975-1980 period the growth in net factor payments offset the volume increase in GDP also, but to a considerably smaller extent.

3. PRICES AND THE TERMS OF TRADE

A notable feature of Ireland's economic performance since 1980 has been the dramatic deceleration of inflation. The rate of increase in the CPI reached its peak in 1981 at 20.4 per cent. As Table 2.3 indicates, the inflation rate declined in each subsequent year and by 1985 was, at 5.4 per cent, little more that one-quarter of its 1981 rate.

*The table may present a somewhat distorted picture because *inter alia* of the time periods chosen.

The sharp reduction in consumer price inflation was accompanied over the period by the winding down of price increases at the wholesale level. The rate of increase in the general wholesale price index, which was over 17 percent in 1981, fell to only 3.2 per cent in 1985.

The reduction in inflation was facilitated *inter alia* by the deceleration in the rate of increase of import prices which took place, especially in 1982 and 1983. The price of imports, which rose by almost 19 per cent in 1981, increased by only 4.7 per cent in 1983 and although it accelerated again in 1984 the rate of increase was only just over 2 per cent in 1985.

Table 2.3
Inflation and the Terms of Trade, 1980-85

	1980	1981	1982	1983	1984	1985
	(% change per annum)					
Consumer Price Index	18.2	20.4	17.1	10.4	8.6	5.4
Wholesale Price Index	10.5	17.3	11.2	6.2	7.7	3.2
Terms of Trade	-7.7	-2.3	3.5	3.9	-1.2	0.4
Import Unit Values	17.9	18.8	7.3	4.7	9.7	2.3
Export Unit Values	9.8	16.2	11.1	8.8	8.4	2.8

Source: CSO

The evolution of import and export prices taken together resulted in a significant improvement in the terms of trade taking the 1980-1985 period as a whole. The terms of trade improvement was especially marked in 1982 and 1983 when favourable movements amounting to 3.5 and 3.9 per cent respectively took place.

4. THE BALANCE OF PAYMENTS

The current account deficit of the balance of payments fell substantially in each of the years from 1981. By 1985 the current account deficit was £549m, 3.6 per cent of GNP, compared with its peak of £1595m, or almost 15 per cent of GNP reached in 1981. Table 2.4 sets out details of the composition of the current account deficit between 1980 and 1985.

The very large reduction in the current account deficit can be explained by the turnaround which occurred in the balance of trade, which was in deficit to the extent of over £1600m in 1981 but which registered a surplus of over £400m in 1985. The impact of movements in the balance of trade on the overall current account was reinforced by the large increase which occurred in net transfers from abroad, mostly comprising receipts from the EEC. The

value of these transfers doubled between 1981 and 1985 from £524m to £1050m.

Table 2.4
The Current Account of the Balance of Payments, 1980-1985

	1980	1981	1982	1983	1984	1985
Merchandise	-1342	-1698	-1120	-522	-197	+155
Services (1)	+90	+95	+150	+121	+162	+252
Balance of Trade	-1252	-1603	-970	-401	-35	+407
Trading and Investment Income	-368	-516	-938	-1196	-1672	-2006
International Transfers	+582	+524	+593	+671	+818	+1050
Net Balance	**-1038**	**-1595**	**-1316**	**-925**	**-890**	**-549**
(% of GNP)	**(11.5)**	**(14.7)**	**(10.6)**	**(6.9)**	**(6.2)**	**(3.6)**

(1) Includes item: 'Remuneration of Employees'.
Source: *Economic Review and Outlook, Summer 1986.*

The favourable movements in the balance of trade and net transfers were to a significant degree counterbalanced by the evolution of trading and investment income, the net outflow of which quadrupled in size from just over £500m in 1981 to £2bn in 1985, or from 4.8 to 13 per cent of GNP.

The evolution of the balance of payments cannot be viewed in isolation from trends in domestic demand. The recession in domestic demand substantially depressed the volume of imports. As an indication of the likely magnitude of this effect it is worth referring to an exercise conducted by the OECD and reported in their April 1985 *Country Survey* of Ireland where it was estimated that the cyclically adjusted trade deficit in 1984 was some 6 per cent of GNP. This compares with an actual trade deficit of 0.3 per cent of GNP recorded in that year.

The improvement in the trade balance is also partly attributable to the improvement in the terms of trade which occurred over the 1981-1985 period as a whole and more particularly the very favourable terms of trade movements which occurred in 1982 and 1983.

Another point which needs to be made is that the trade balance cannot be viewed in isolation from the evolution of net trading and investment income and more particularly the outflow of profits, dividends and royalties which is recorded as a component of the latter. There is a clear relationship between the activities of export-oriented overseas firms located in Ireland and the remittance abroad of profits and related sums. Table 2.5 sets out details of the composition of the outflow of trading and investment income over the 1980-1985 period.

Table 2.5
Composition of Trading and Investment Income (Debit items), 1980-1985

	1980	1981	1982	1983	1984	1985
			(£m)			
Profits, Dividends Royalties	258	362	499	659	983	1321
National Debt Interest	193	266	526	597	720	795
Other Interest	381	455	499	490	598	612
Total Gross Outflow	832	1083	1523	1745	2300	2728

Source: *National Income and Expenditure, 1985*, CSO.

The outflow of profits, dividends and royalties exceeded £1.3bn in 1985 compared with £260m in 1980. This outflow in 1985 amounted to a sum equivalent to about 22 per cent of the value of manufactured exports compared with a corresponding proportion of 11.5 per cent in 1980. The outflow on foot of National Debt interest payments more than quadrupled from £190m in 1980 to £800m in 1985.

A discussion of recent trends in the balance of payments would be incomplete without referring to the residual item in the accounts. The components of this residual are not identified and the residual therefore cannot be ascribed in whole or in part to either the current or capital accounts. What is disturbing about this item is that, notwithstanding the revisions to the balance of payments statistics which took place in 1984, it has been consistently negative and has grown rapidly since then. In 1984 the net residual amounted to £339m and in 1985 to £630m. For the first six months of 1986 the net residual has been estimated at £991m with an outturn considerably in excess of £1000m in prospect for the year as a whole.

5. GROWTH IN OUTPUT

On an output basis GDP at factor cost increased at an annual average rate of 2.1 per cent between 1980 and 1985, well below the corresponding growth rate of 4.6 per cent achieved over the previous five years. Table 2.6 provides a breakdown of this overall figure between the main economic sectors.

Agricultural output was highly volatile declining by 4.3 per cent in 1981 and by over 2 per cent in 1985 but registering strong growth in 1982 and 1984. Taking the five-year period as a whole, output from the sector rose on average by 3.8 per cent compared with an average annual rate of decline of 1.3 per cent in the five years to 1980.

The performance of the industrial sector was also marked by considerable volatility. Industrial output grew sluggishly in the 1981-1983 period, expanded

Table 2.6
Growth in Output by Sector at Constant (1980) Prices

	1981	1982	1983	1984	1985	Average 1980-85	Average 1975-80
		(per cent per annum)					
Agriculture, Forestry & Fishing	−4.3	11.7	0.9	14.2	−2.3	3.8	−1.3
Industry	2.9	−1.2	2.4	7.9	0.8	2.5	6.6
Services	1.7	0.2	0.9	2.1	1.6	1.3	4.8
Of which:							
– Distribution, Transport and Communications	0.7	−3.3	−1.4	1.6	3.1	0.1	5.1
– Public Administration and Defence	0.9	3.6	−0.4	1.1	0.2	1.1	3.5
– Other Domestic	2.4	1.5	2.4	3.2	1.1	2.1	4.9
GDP (Factor Cost)	1.4	1.0	1.4	5.7	0.8	2.1	4.6

Source: *National Income and Expenditure, 1983-1984 and 1985*, CSO.

strongly in 1984 and registered negligible growth in 1985. On average over the five year period industrial output expanded by 2.5 per cent per annum, substantially below the annual growth rate of 6.6 per cent achieved during the 1975-1980 period. Much of the difference between the two periods can be explained with reference to trends in output from the building and construction sector.

Between 1980 and 1985 services sector output also increased at a rate which was only a small fraction of that attained in the previous five years. The average annual increase in output here between 1980 and 1985 was just over 1 per cent compared with the corresponding figure of almost 5 per cent between 1975 and 1980. Output of the Distribution, Transport and Communications sub-sector displayed negligible growth between 1980 and 1985 whereas this sub-sector expanded at an annual average rate of over 5 per cent between 1975 and 1980. Output from Public Administration and Defence also expanded very much more slowly between 1980 and 1985 than in the previous 5 years.

6. MANUFACTURING INDUSTRY

Output from the manufacturing sector grew in volume terms at an annual average rate of just over 5 per cent between 1980 and 1985. The expansion of output was particularly strong in 1984 when a growth rate of over 13 per cent was attained but slackened appreciably in 1985 to 2.7 per cent. Table 2.7 sets out details of output growth by manufacturing sector and illustrates how markedly the performance of individual sectors diverged.

Output increased rapidly in the Office Equipment, Chemicals and Instrument Enginering sectors at annual average rates of 35, 11 and 10 per cent respectively. In all three sectors especially in Office Equipment there was a pronounced slowdown in 1985. Output from Instrument Engineering actually declined in 1985. Taking these three sectors together output expanded at an annual average rate of almost 16 per cent between 1980 and 1985, corresponding to a doubling time of about 4½ years.*

The performance of the remaining manufacturing sectors taken together was in marked contrast to this: output expanded at an annual average rate of only 0.2 per cent in the five years to 1985. Within this more established category of manufacturing, performance varied across sectors but to an extent which

* The use of 1980 net output weights understates the true magnitude of aggregate output growth from these three sectors, due to the compositional changes in output which took place over the period. Ideally the maximum degree of accuracy in measuring output changes would be achieved by using moving weights.

Table 2.7
Volume Growth in Manufacturing Output by Sector

	1984	1985	Average 1980-1985
	(%)	(%)	(%)
Chemicals	23.9	3.8	10.7
Office Equipment	53.4	2.0	35.0
Instruments	15.8	-1.3	10.1
Total New (2)	**29.1**	**2.7**	**15.9**
Non-Metallic Minerals	5.1	5.9	-1.0
Other Engineering (1)	9.4	3.7	0.7
Food	4.3	5.1	2.7
Drink and Tobacco	1.4	3.9	1.2
Textiles	0.8	-4.4	-3.4
Clothing and Footwear	-0.9	-4.7	-2.8
Timber	-4.5	2.4	-3.0
Paper	-1.6	-0.5	-2.9
Miscellaneous	-1.6	-1.0	-1.1
Total Old (2)	**3.7**	**2.9**	**0.2**
Manufacturing (2)	**13.4**	**2.7**	**5.1**

(1) Engineering other than Office Equipment and Instrument Engineering
(2) 1980 net output weights
Source: CSO

was modest by comparison with the sharp contrast with the newer industries. In the sectors where output rose (Food, Drink and Tobacco, and Other Engineering) the increases over the five-year period were relatively small, although it should be noted that significant rates of growth occurred here in 1984 and 1985.

In the remaining sectors particularly in Textiles, Clothing and Footwear, Timber and Furniture, and Paper, output declined substantially between 1980 and 1985. In only one of these sectors (Timber and Furniture) was the long-term downward trend in output relieved by any appreciable growth in either 1984 or 1985.

Overall the trends in manufacturing production since 1980 have been such that almost all the absolute increment in output over the last five years can be attributed to the Chemicals, Office Equipment and Instrument Engineering sectors taken together.

In what follows an attempt is made to assess the extent to which demand-side and supply-side factors have influenced the performance of manufacturing since 1980. On the demand side the impact of movements in domestic and foreign demand is examined. On the supply-side the evolution of industrial costs which determine the competitiveness of industry in the short-run, and trends in investment which determine the growth of productive capacity in the longer term, are analysed.

Table 2.8
Import Penetration in Manufacturing Industry, 1980-1984

	Domestic Sales /Output (1)	Imports as a proportion of Domestic Market				
	1980	1981	1982	1983	1984
	(%)	(%)	(%)	(%)	(%)
Non-Metallic Minerals	79.5	19.9	17.9	18.8	20.6	23.4
Timber and Furniture	78.0	46.0	47.6	43.3	42.7	49.4
Paper and Paper Products	71.9	60.1	62.2	65.4	65.1	67.9
Tobacco	69.1	16.6	15.6	16.3	19.7	20.2
Food	62.9	18.9	20.7	18.5	20.0	22.4
Drink	62.6	10.6	11.2	10.8	10.5	10.4
Clothing	48.4	63.0	63.7	64.0	66.6	68.2
Leather and Footwear	42.9	66.9	67.5	66.8	69.6	71.5
Textiles	37.4	66.7	64.8	62.2	67.6	70.2
Mechanical Engineering	31.1	74.5	75.6	77.4	76.4	75.8
Motor Vehicles	29.6	76.9	76.1	81.0	86.3	85.4
Plastics	28.1	70.7	71.7	71.7	71.2	68.6
Chemicals	16.2	74.9	72.2	82.5	78.8	81.3
Rubber	13.6	79.7	72.8	72.7	79.4	80.9
Electrical Engineering	6.5	87.2	83.1	82.2	90.5	99.8

(1) Based on 1983 data except for Electrical Engineering: 1982
Source: NESC Secretariat.

(i) Demand-side Factors

The Home Market

The weakness of domestic demand throughout the last five years is likely to have impacted unfavourably on those sectors of Irish industry which are heavily dependent on the home market. It might have been expected that the strong expansion of exports would have provided an offsetting influence through the opportunities afforded to established firms of supplying an increased volume of materials and components to new exporting firms. There are well documented problems in this area however which are discussed later in the report. It is clear however that other factors have been at work including the increased penetration of certain segments of the domestic market by imports.

Table 2.8 sets out import penetration ratios for various sectors of Irish manufacturing industry for the years 1980 through 1984. The estimating procedure used to compute these ratios is one which may impart a significant margin of error to the results. The data in Table 2.8, especially those relating to 1984, should therefore be interpreted with caution.

In all but two of the 15 sectors listed the proportion of the domestic market accounted for by imports was higher in 1984 than in 1980. The significance of increased import penetration is greatest in sectors where domestic firms sell a large proportion of what they produce on the home market.

Accordingly the pronounced upward trend in import penetration in the Paper, Tobacco, Clothing and Leather, and Footwear industries is a particular source of concern and in conjunction with the weakness of domestic demand helps to explain their poor output performance.

Foreign Markets

Foreign markets for Irish exports expanded appreciably between 1980 and 1985. The volume growth of total imports by our twelve main trading partners was 4 per cent per annum on average. Total Irish exports increased considerably more rapidly at almost 8 per cent annually over the same period. The bottom panel of Table 2.9 indicates that in each year since 1980 the volume of Irish exports has increased more quickly than the volume of goods imported by our main trading partners.

The top panel of Table 2.9 illustrates the position in respect of exports of goods covered by SITC Sections 5-8 (equivalent to manufactured goods less food products). The average annual volume increase in such exports from Ireland was 12 per cent between 1980 and 1985 while the corresponding export markets expanded by less than 6 per cent per annum over the same period.

That Ireland's exports of goods and services generally, and of merchandise goods covered by SITC Sections 5-8 more particularly, enjoyed such an increased penetration of foreign markets was due principally to the changing composition of Irish exports rather than to a broadly-based improvement in export performance across commodity groups.

Table 2.9
Growth of Irish Exports and Export Markets, 1980-1985

	1981	1982	1983	1984	1985	1981-1985 % per annum
			(1980=100)			
			SITC Section 5-8			
Irish Exports	110.6	123.2	139.6	165.9	175.9	12.0
Export Markets (1)	99.5	103.6	111.3	124.7	131.8	5.7
Irish Exports relative to Export Markets	111.2	118.9	125.4	133.0	133.4	—
(Change over previous year)	+11.2	+7.7	+6.5	+7.6	+0.4	—
			Total Goods and Services			
Irish Exports	102.0	107.6	118.9	138.9	145.7	7.8
Export Markets (1)	98.3	101.0	105.4	115.8	120.8	3.9
Irish Exports relative to Export Markets	103.8	106.5	112.8	119.9	120.6	—
(Change over previous year)	+3.8	+2.7	+6.3	+7.1	+0.7	—

(1) Weighted average volume growth of imports by our twelve main trading partners.
Source: NESC Secretariat.

This point is brought out in Table 2.10. Exports under SITC Sections 5-8 grew much more rapidly in value terms than did total merchandise exports and their share of the total increased from 54 to 64 per cent between 1980 and 1985. Of the increment of £5.6bn in the value of total merchandise exports over this period, almost three-quarters (£4bn) was accounted for by SITC Sections 5-8. Within this category there were substantial divergences in performance. Exports of SITC Sections 6 and 8 grew sluggishly and their combined share of total merchandise exports declined from 23 to 20 per cent. The shares of Section 5 (Chemicals) and Section 7 (Machinery and Equipment) increased, in the latter case from 19 per cent in 1980 to 30 per cent in 1985.

In terms of their contribution to the absolute increase in the value of total merchandise exports since 1980, Chemicals and, Machinery and Equipment accounted for 44 per cent, while the increase in exports of electronics products alone contributed 28 per cent. Export growth since 1980 therefore has been quite heavily concentrated in a limited number of product categories the rapid expansion of which has been principally responsible for the recorded increase in Ireland's penetration of foreign markets.

Table 2.10
Export Growth 1980-85, Summary Statistics

	1980		1985		1980-1985	
	Value (£m)	Share in total (%)	Value (£m)	Share in total (%)	Increase (£m)	Share (%)
Total Merchandise	4131	100.0	9744	100.0	+5613	100.0
SITC Sections 5-8	2250	54.5	6280	64.4	+4030	71.8
Section 5	520	12.6	1408	14.4	+ 888	15.8
Section 6	520	12.6	904	9.3	+ 384	6.8
Section 7	763	18.5	2889	29.6	+2126	37.9
Section 8	447	10.8	1080	11.1	+ 633	11.3
Division 75	258	6.2	1825	18.7	+1567	27.9

Source: *Trade Statistics of Ireland*, CSO.

Table 2.11
Export Growth and Dependence on the UK Market

	Growth in Value of Exports (% p.a. 1980-1985)	Proportion of Exports Accounted for by UK (1985, %)
Section 5	22.0	18.0
Section 6	11.7	46.0
Section 7	30.5	28.2
Section 8	19.3	38.6
Totals Sections 5 —8	**22.8**	**30.3**

Source: *Trade Statistics of Ireland*, CSO.

Another aspect of recent export performance which is noteworthy is the relationship between the growth of exports and the proportion of exports directed to the UK market. Table 2.11 sets out some data in this regard. It can be seen that the growth in the value of exports at the SITC one-digit level of aggregation between 1980 and 1985 is inversely related to the proportion of exports going to the UK: the broad commodity groups which experienced the fastest export growth over the period (SITC Sections 5 and 7) are those which are least dependent on the UK market, while sluggish export growth was experienced by those commodity groups where reliance on the UK market is considerably greater than the average. This is also generally true of manufactured exports at the SITC two-digit level of aggregation.

Table 2.12
Import Volumes for Ireland's Main Trading Partners: 1985

	Total Imports (1980=100)	Section 5-8 Imports
UK	121.5	141.0
Other Main Trading Partners (1)	118.6	124.8

(1) Simple average of: West Germany, France, Holland, Italy, Belgium, US, Canada, Sweden, Japan, Australia and Switzerland.
Source: OECD *Statistics of Foreign Trade.*

This feature of recent export performance cannot be explained by appealing to the notion that UK imports increased more slowly than imports into our other main trading partners. Table 2.12 shows that the volume of total UK imports and, more particularly of UK imports of SITC Sections 5-8, expanded more rapidly over the 1980-1985 period than was the case for our other main trading partners on average. Rather must the sluggish growth of exports to the UK be ascribed to the fact that Ireland's share of UK imports has receded across a wide range of product groups, particularly those characterised by heavy dependence on the UK market.

Table 2.13
Share of UK Imports for Selected Commodity Groups

	Value of Exports 1985 (£m)	Proportion of Exports to UK 1985 (%)	Ireland's Share of UK Imports 1980 (%)	1985 (%)	1985/1980
53 Dyeing materials etc	16.7	64.7	3.61	2.99	0.83
63 Cork and wood	12.4	83.9	1.53	1.66	1.08
64 Paper products	57.3	68.2	2.02	1.42	0.70
65 Textiles etc	298.3	54.8	8.26	4.74	0.57
72 Specialised machinery	87.7	50.9	3.59	1.95	0.54
81 Sanitary fittings etc	26.8	85.1	11.41	12.24	1.07
82 Furniture	27.2	87.5	4.49	3.33	0.74
84 Clothing	187.4	59.9	5.66	4.55	0.80
85 Footwear	20.1	50.0	2.93	1.31	0.45

Sources: *Trade Statistics of Ireland* CSO; *UK Statistics of Foreign Trade*, HMSO.

Table 2.14
Cost Structure of Manufacturing Industry by Sector: 1982

	Industrial Inputs		Net Output	
	Materials and Services	Fuel and Power	Wages and Salaries(1)	Other(2)
	(% of Gross Output)			
Non-Metallic Minerals	42.4	10.6	21.3 (45.8)	25.6
Chemicals	41.2	4.8	10.4 (19.2)	43.7
Metals and Engineering	54.1	1.8	17.7 (40.2)	26.3
— Office Machines	55.0	0.5	5.8 (13.0)	38.7
— Instrument Engineering	42.6	2.1	18.4 (33.2)	37.0
Food	73.9	3.0	9.1 (39.4)	14.0
Drink and Tobacco	38.7	4.1	18.2 (31.9)	39.0
Textiles	57.9	4.3	18.8 (49.8)	19.0
Clothing, Footwear etc	53.4	1.9	27.5 (61.6)	17.1
Timber and Furniture	53.6	3.2	23.1 (53.6)	20.0
Paper	42.5	2.6	31.4 (57.2)	23.5
Miscellaneous	60.5	3.1	16.4 (45.1)	20.0
Total Manufacturing	59.2	3.4	15.1 (39.3)	23.2
'New' Industries(3)	**46.2**	**3.0**	**9.8 (19.2)**	**41.1**
'Old' Industries	**61.3**	**3.5**	**16.4 (46.5)**	**18.8**

(1): Figures in parentheses represent wages and salaries as a proportion of net output
(2): Principally, profits, interest and depreciation
(3): Comprises Chemicals, Office Machines and Instrument Engineering
Source: *Census of Industrial Production*, 1982

Table 2.13 sets out some relevant data for those commodity groups for which the UK currently accounts for over 50 per cent of Irish exports. The table is not designed to convey a comprehensive picture of export trade with the UK but is included in order to illustrate an evidently widespread trend. In seven out of the nine cases covered, Ireland's share of UK imports has declined since 1980. In the case of Textiles, Clothing, and Specialised Machinery Ireland's share of UK imports had by 1985 declined to about one half of the 1980 level. Significant reductions have also been experienced in respect of exports of Paper products, Clothing, and Furniture.

(ii) Supply-Side Factors

Cost Competitiveness

The cost structure of Irish manufacturing industry is described in Table 2.14. For the manufacturing sector as a whole expenditure on industrial materials and services dominates the cost structure, accounting for almost 60 per cent of the value of gross output, while fuel and power costs amount to no more than 3.4 per cent, wages and salaries to 15 per cent and other items (principally profits, interest and depreciation) to 23 per cent.

The third column of the table indicates the importance of wages and salaries in the cost structure. Of particular importance here is the proportion of net output or value- added accounted for by labour costs since labour costs are the single most important cost element under domestic control. The proportion of net output accounted for by wages and salaries ranges from less than twenty per cent in Chemicals and Office Machines to over 60 per cent in the case of Clothing and Footwear. For the manufacturing sector as a whole the proportion is 39 per cent. The importance of labour costs is considerably greater for the 'old' industries than for the 'new'. In the latter case the proportion is 19 per cent while in the former it is 47 per cent.

Table 2.15 indicates how average weekly earnings have evolved in manufacturing industry over the 1980-1985 period. For manufacturing as a whole the annual average rate of increase was 12 per cent but there was some variation across individual sectors. Taking the full period the rate of increase in weekly earnings was somewhat higher in the 'new' industries, at almost 13 per cent per annum than in the 'old' sectors where the corresponding figure was 11.6 per cent.

Trends in unit wage costs are set out in Table 2.16. They reveal that for total manufacturing, unit wage costs increased sharply to 1982 but declined in the following two years and increased marginally in 1985. However the experience of the 'old' and 'new' sectors of manufacturing evinces a very marked contrast in this regard. In the latter case unit labour costs declined at an average annual rate of almost 2 per cent between 1980 and 1985 due in the main to the sharp increases in recorded output per worker in 1983

Table 2.15
Evolution of Average Weekly Earnings in Manufacturing, 1980-1985

	1981	1982	1983	1984	1985	Average 1980-1985
		(Index, 1980 = 100)				(% p.a.)
New Industries	114.1	132.7	149.1	170.2	183.3	12.9
Old Industries	117.0	130.9	145.9	162.0	173.4	11.6
Total Manufacturing	116.4	130.5	145.8	163.1	177.2	12.1

Source: NESC Secretariat

Table 2.16
Evolution of Unit Wage Costs in Manufacturing, 1980-1985

	1981	1982	1983	1984	1985	Average 1980-1985
		(Index, 1980 = 100)				(% p.a.)
New Industries	96.0	112.8	102.9	90.2	91.2	-1.8
Old Industries	116.6	127.0	131.5	135.0	136.4	+6.4
Total Manufacturing	110.9	120.7	118.1	113.6	115.3	+2.9

Source: NESC Secretariat

and 1984. In the older industries unit wage costs rose by over 6 per cent per annum in the period since 1980, primarily because of a rapid rise in 1981 and 1982.

Unit labour cost movements are somewhat limited in their usefulness as an analytical tool. This is principally for two reasons both of which can be illustrated by the sharply contrasting experiences of the two broad sectors of Irish manufacturing industry identified in Table 2.16.

In the first place movements in unit labour costs in the new industrial sectors capture the large recorded increases in productivity which have taken place in recent years but which reflect, to an extent which cannot be precisely quantified, certain accounting practices of the firms concerned. The net result of these accounting practices is to impart an upward bias to the output data as statistically measured and to generate measures of output which include within them elements which do not reflect returns to factors of production located in the Irish economy.

Secondly, movements in unit labour costs in the remainder of manufacturing industry reflect recorded increases in productivity which have come about because of reductions in employment caused by redundancies or shut-downs. These employment reductions have clearly, in many cases, been effected as a defensive response to competitive pressures. In this connection it is notable that the period 1983-1985, a period when the growth of unit labour costs in the traditional sectors slowed down, was characterised by an acceleration of job losses. Employment in the older industries declined by some 7 per cent between 1980 and 1982 but fell by a further 15 per cent between 1982 and 1985.

For these reasons considerable care needs to be exercised in interpreting trends in unit labour costs for the manufacturing sector as a whole.

Table 2.17 sets out the evolution of hourly earnings and unit labour costs in manufacturing in a common currency relative to our main trading partners. It can be seen that such changes as estimated differ both in direction and magnitude depending upon which measure (hourly earnings or unit labour costs) the series is based on, and which currency or basket of currencies the comparison is made with.

Based on relative hourly earnings and compared with our 19 main trading partners there was little change in the real exchange rate over the 1980-1985 period. However this conceals divergent movements within the index. There was a marked real appreciation against EMS currencies of almost 18 per cent between 1980 and 1985 and a real appreciation against sterling of about half this magnitude between 1981 and 1985. The relative stability of the overall index can be wholly attributed to what happened vis-a-vis the dollar.

Table 2.17
Movements in the Real Exchange Rate 1980-1985

	1981	1982	1983	1984	1985
Relative Hourly Earnings in Manufacturing (Index, 1980 = 100)					
EMS Countries	110.6	110.1	114.3	117.7	Countries
UK	93.0	97.3	100.5	101.5	101.2
US	82.8	78.7	74.3	68.9	69.8
19 Main Trading Partners	95.4	98.5	98.0	97.8	99.7
Relative Manufacturing Unit Labour Costs (Index, 1980 = 100)					
EMS Countries	102.1	104.8	94.8	88.9	89.9
UK	91.4	96.0	93.5	85.6	82.4
US	81.2	75.4	66.1	55.1	53.7
19 Main Trading Partners	93.1	94.8	86.5	78.6	77.7

Note: An increase in the index signifies an appreciation of the real exchange rate.
Source: OECD

Denominated in terms of hourly earnings the Irish Pound experienced a real depreciation of over 30 per cent against the dollar over the 1980-1985 period. That this occurred can be ascribed in full to the movement of the Irish pound-dollar nominal exchange rate. Excluding the dollar from the analysis it is clear that the real exchange rate appreciated significantly in the five years to 1985.

Of particular importance from the point of view of the more established sectors is the evolution of the real exchange rate vis-a-vis the UK. Taking the 1980-1985 period as a whole hourly earnings in a common currency relative to the UK increased marginally but this conceals sizeable year to year changes attributable in the main to the volatility of sterling. Thus there were substantial deteriorations of competitiveness in 1982 and 1983, but a large improvement in 1981. Indeed, between 1979, the year of Ireland's accession to EMS membership, and 1981 the real exchange rate against sterling depreciated by about 13 per cent, a development which should have conferred a substantial boost to the competitiveness of firms exporting to the UK.

The picture that emerges from indices of the real exchange rate computed on the basis of unit labour costs as in the lower portion of Table 2.17 is quite different. On this basis the evidence points to a substantial real depreciation of the Irish pound irrespective of the currency or basket of currencies with which the comparision is effected although, mirroring the pattern which emerges from the relative hourly earnings data, the magnitude of the real depreciation is greatest vis- a-vis the dollar and smallest vis-a-vis the EMS currencies.

In the light of the remarks made above concerning the factors which influence movements in unit labour costs, it is considered that hourly earnings provide a more appropriate basis for monitoring movements in the real exchange rate. That said it must be noted that measures of the real exchange rate based on hourly earnings entirely exclude changes in productivity. It should also be noted that movements in such an index are sensitive to the choice of base. Thus, compared with 1980 the real exchange rate of the Irish Pound vis-a-vis sterling has appreciated by about 1 per cent whereas, if 1981 were chosen as the base year, the extent of the real appreciation would be almost 9 per cent.

Other Costs

Oil prices to industry in Ireland are considerably higher than in our European trading partners. Table 2.18 details the trends in the prices of the relevant oil products relative to the UK and the EEC as a whole. In 1985 heavy fuel oil to industy was 5 per cent cheaper in the UK, and 15 per cent cheaper on average in the EEC, than in Ireland. This represented an improvement on the 1980 position but a marked deterioration vis-a-vis 1984, a year in which the differential between Irish and European prices had been virtually

Table 2.18
Oil Prices to Industry (Ireland = 100)

	1980	1981	1982	1983	1984	1985
	— Heavy Fuel Oil —					
Ireland	100.0	100.0	100.0	100.0	100.0	100.0
Germany	76.1	87.7	84.2	83.3	96.7	84.5
UK	87.1	91.4	91.3	90.0	103.5	95.0
EC Average(1)	78.0	86.7	85.0	85.0	98.4	84.7
	— Light Fuel Oil —					
Ireland	100.0	100.0	100.0	100.0	100.0	100.0
Germany	93.5	87.0	89.0	86.1	91.8	81.1
UK	92.2	91.8	86.6	86.9	88.5	n.a.
EC Average(2)	95.5	91.7	92.2	94.5	100.0	88.4

(1) Simple average of Belgium, Denmark, France, Germany, Italy, Netherlands and the UK except 1985 for which data for the Netherlands are not available.
(2) As in (1) except 1985 for which data for France, Netherlands and UK not available.

Source: International Energy Agency, *Energy Prices and Taxes*, 1986 No. 1.

eliminated. As regards light fuel oil, the average of the Belgian, Danish, German and Italian prices in 1985 was 12 per cent below the Irish price.

Table 2.19
Industrial Users: Index of Electricity Prices in Ireland and EEC Member States, 1984 (Ireland = 100)

	500 KW 2,500 HR	1,000 KW 4,000 HR	2,500 KW 6,000 HR	10,000 KW 7,000 HR
Belgium	81.6	81.0	74.9	69.3
Denmark	51.9-71.6	48.6-76.2	48.8-82.2	52.2-77.0
France	68.8	64.0	60.2	52.8
Germany	87.7-105.6	84.0-92.2	71.9-86.7	66.7-85.2
Greece	79.0	83.3	79.6	64.8
Ireland	100	100	100	100
Italy	112.7-113.1	101.9-102.4	86.1-86.5	59.2-59.5
Netherlands	61.0-93.6	62.9-91.3	65.0-96.4	59.2-72.5
Britain (1)	74.4-79.6	72.9-77.3	71.9-79.0	71.3-76.0

(1) At average exchange rate for 1984.
Source: Confederation of Irish Industry.

Table 2.19 reveals that electricity prices for industrial users in Ireland are also much higher than those obtaining in the rest of the EEC. The differential increases with the size of customer demand. At 10,000 KW for 7,000 hours (see fourth column of the table) Irish prices exceed those in France and in parts of Denmark by a factor of almost two-to-one.

Investment

Investment has been especially weak since 1980. Gross fixed capital formation declined in volume terms by an average of over 2 per cent per annum in the five years to 1985. Table 2.20 sets out data on the evolution of fixed investment in greater detail.

It can be seen from the table that investment in both machinery and equipment and in building and construction weakened considerably in 1980-1985 relative to the previous five years.

The volume of building and construction fell by 6.5 per cent per annum compared with an increase of over 7 per cent annually between 1975 and 1980. Capital formation in machinery and equipment increased at a rate of only 1.6 per cent annually between 1980 and 1985 compared with a corresponding figure of almost 10 per cent in the previous five years.

Trends in manufacturing investment are difficult to identify with any precision. The Department of the Environment's review of the construction industry provides estimates of industrial investment in building and

Table 2.20
Trends in Fixed Capital Formation (Volume) 1980-1985

	1981	1982	1983	1984	1985	Average 1980-85	Average 1975-80
	(per cent change)					(per cent)	
Dwellings	1.0	-10.5	8.0	-11.4	n.a.	n.a.	4.5
Roads	19.9	14.1	16.2	-3.3	n.a.	n.a.	7.1
Other Building & Construction	9.8	-2.4	-27.6	-17.1	n.a.	n.a.	9.9
Total Building & Construction	**6.6**	**-4.7**	**-12.2**	**-13.5**	**-7.5**	**-6.5**	**7.3**
Transport Equipment	16.4	-21.5	-11.6	-0.3	n.a.	n.a.	11.8
Agricultural Machinery	6.6	-18.8	-6.3	1.9	n.a.	n.a.	0.7
Other Machinery & Equipment	5.4	0.3	-4.5	10.7	n.a.	n.a.	9.8
Total Machinery & Equipment	**8.1**	**-6.3**	**-6.1**	**8.1**	**5.5**	**1.6**	**9.6**
Total Fixed Capital Formation	**7.3**	**-5.5**	**-9.3**	**-2.8**	**-0.3**	**-2.3**	**8.5**

Sources: *National Income and Expenditure 1985*, CSO. *Quarterly Economic Commentary, August 1986*, ESRI.

construction. Separate estimates of investment by industry in machinery and equipment are not published in any official source. However data published by the IDA on its capital grants payments to industry and on the value of Eligible Fixed Assets (EFA) to which these grants correspond, are of value in indicating broad trends in manufacturing investment. The IDA data cover capital formation in both buildings and plant and machinery. These data must be interpreted with some caution. This is particularly true of the data on EFA for the years 1980 to 1982, because of the estimation technique used.

Table 2.21 indicates clearly that there has been a substantial fall in the volume of capital formation in buildings and construction by the industrial sector over the 1980-1985 period as a whole. The volume of such investment fell in each of the years 1981 through 1985 but particularly heavily in 1983. It is estimated that the volume of building and construction investment undertaken by industry was, in 1985, less than one quarter of its 1980 level.

IDA capital grants in nominal terms peaked at £114m in 1981 and fell in each of the three subsequent years before recovering somewhat in 1985. Capital grants disbursed by the IDA in 1984 were 24 per cent below their 1981 level in nominal terms or about 35 per cent lower in real terms. The evolution of the EFA figure mirrors that of the capital grants to which they correspond, despite year-to-year variations in the ratio of one to the other. The value of EFA peaked at £360m in 1981 and declined in each subsequent year.

In 1985 the nominal value of EFA was over 20 per cent below its 1981 peak. It is clear that the real value of EFA declined to an even greater extent. Applying the appropriate price deflator it is estimated that EFA declined in volume terms at an annual average rate of 12 per cent between 1981 and 1985.

Table 2.21
Trends in Industrial Investment 1980-1985

	1980	1981	1982	1983	1984	1985
			(£ million)			
Building and Construction(1)	178.5	181.1	145.8	58.6	51.2	40.2
IDA Capital Grants (2)	89.5	113.7	106.0	104.3	86.8	97.2
IDA Eligible Fixed Assets (2)	282.7	359.3	335.0	329.0	285.9	283.5

(1) Building and construction investment undertaken by industry (excluding Semi-state Bodies), 1980 prices.
(2) Current prices; manufacturing industry only.
Source: Department of the Environment; IDA.

7. AGRICULTURE*

Table 2.22 sets out the evolution of the key sectoral indicators for agriculture over the 1980-1985 period. The volume of gross agricultural output increased at an annual average rate of just over 3 per cent. An expansion of output occurred in 1982 and 1983 and a particularly sharp increase occurred in 1984 due in the main to an exceptionally good harvest. The poor weather conditions of 1985 had a major adverse effect on the crops sector and a fall of almost 2 per cent in agricultural output was recorded in that year.

Taking the period as a whole the volume of inputs, which increased at an annual average rate of 2.3 per cent, tracked production reasonably closely but the rate of increase in the price of farm inputs exceeded that of farm output by almost 2.5 per cent annually on average. This 'cost-price squeeze' was entirely concentrated in the 1983-1985 period when the price of inputs rose by a cumulative 11 per cent but output prices registered a small reduction.

The nominal value of farm incomes increased at an annual average rate of over 12 per cent between 1980 and 1985, rising continuously up to 1984 but registering a sharp fall of almost 10 per cent in 1985. Real farm income was 17 per cent higher in 1984 than in 1980 but this advance was almost completely wiped out in 1985. Because of the persistent reduction in the numbers engaged in agriculture real farm incomes per capita rose at an annual average rate of 3.5 per cent between 1980 and 1985.

It is useful from a policy perspective to identify the various factors which underlie the nominal income trends. In Chart A the respective contributions to the annual growth in nominal farm incomes between 1980 and 1985 are isolated in respect of the following factors: output prices, input prices, output volume, input volume, subsidies, and a residual item which includes wages, agricultural levies and depreciation. The methodology used in constructing the chart is formally described in Appendix 1.

The chart illustrates several important points which provide an understanding of the key elements at work in recent years and also guideposts as to what might be expected to occur in future years. Firstly, nominal variables (especially output and input prices) account for the bulk of the observed annual changes in farm income. Output price movements, which made a substantial positive contribution to farm incomes in the years 1981 to 1983, made only a modest positive contribution in 1984 and a negative contribution in 1985. The negative impact of farm input costs has gradually abated since 1981 but this abatement was clearly insufficient to compensate for the disimprovements in output prices.

* This section is an edited version of material prepared for NESC by An Foras Taluntais.

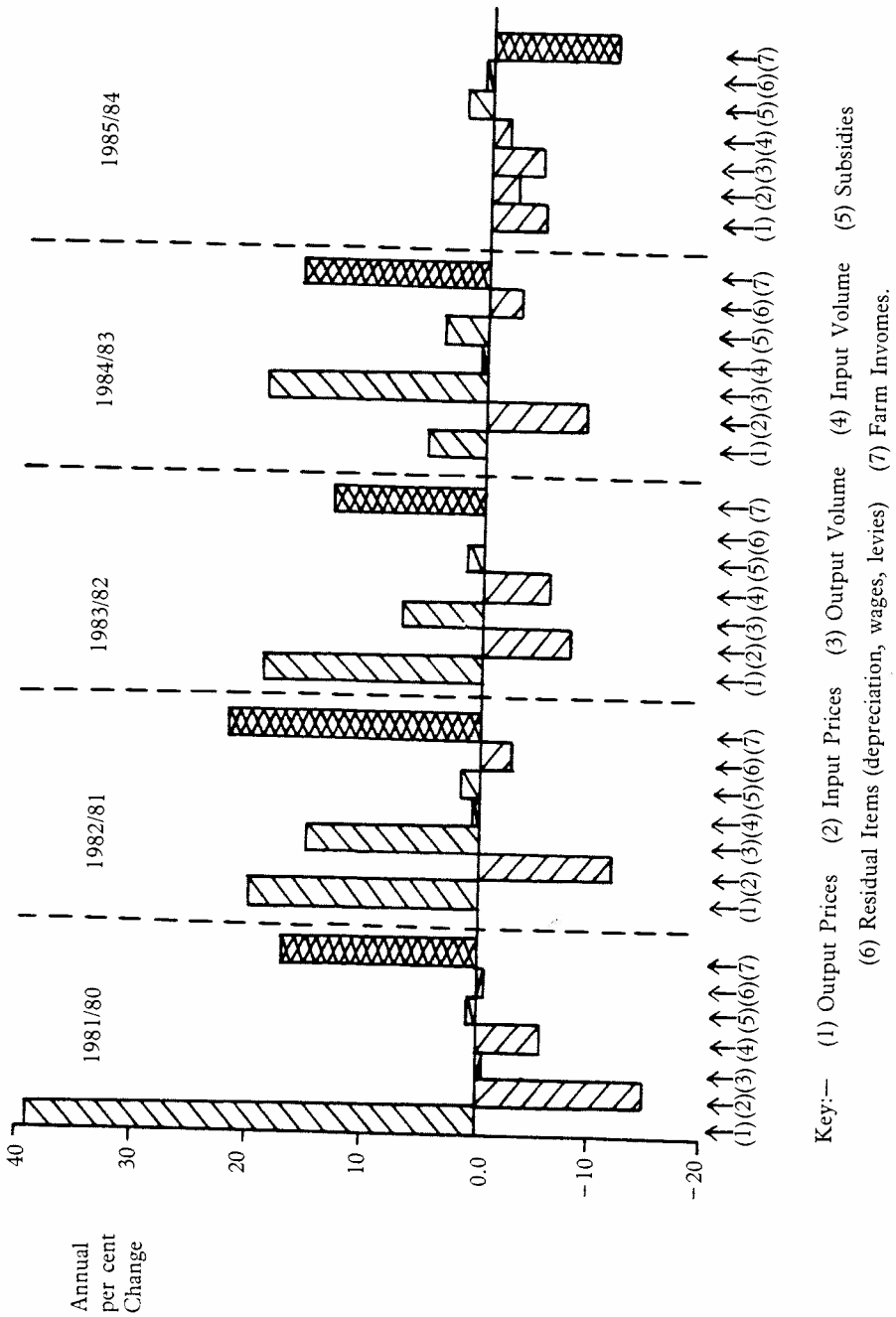
Table 2.22
Evolution of Key Agricultural Indicators. 1980-1985.

	1981	1982	1983	1984	1985	Annual Change 1980-1985 (%)
			(1980 = 100)			
Volume of GAO (1)	99.7	106.0	109.4	118.7	116.8	3.2
Price of GAO (2)	116.4	125.8	136.8	139.6	136.4	6.4
Volume of Inputs	105.6	105.2	111.0	110.6	112.1	2.3
Price of Inputs (2)	114.5	126.5	137.2	150.0	152.6	8.8
Nominal Farm Incomes	118.4	147.9	167.7	198.4	179.2	12.4
Real Farm Incomes (3)	98.3	104.9	107.6	117.2	100.4	0.1
Real Per Capita Farm Incomes (4)	104.9	113.8	119.2	135.2	118.8	3.5

(1) GAO: Gross Agricultural Output
(2) Implicit price indices: these indices are not directly comparable with those published by the CSO.
(3) Nominal Farm Incomes deflated by the CPI.
(4) Real farm incomes divided by a trend estimate of the agricultural labour force (Eurostar (1986)).

Source: An Foras Taluntais.

Chart A
Contribution to annual growth in nominal farm incomes of component factors, 1981/80 — 1985/84



Secondly, the contribution made by movements in the volume of production has been erratic and is clearly very sensitive to climatic conditions. Significantly however, for most of the period, real factors have contributed proportionately less than the associated nominal variables to the evolution of incomes.

A third point to note is the expanding role of subsidies. While in aggregate terms their contribution has been small, it has considerably expanded since 1980. The significance of subsidies is more important than is represented in the chart since they are selective in allocation. Moreover they are likely to assume an even greater significance in the future.

Irish producers prices depend on the common price adopted by the European Commission and the Council of Ministers at the annual price policy reviews, and on the Green Pound exchange rate. The annual price agreements establish common 'target' prices for the main commodities of Irish interest (milk, beef and cereals) and these prices are transmitted to producer prices in the member states via the intervention purchase mechanisms, import levies and export subsidy arrangements.

This transmission process is not perfect however and may not be uniform across the Community, even with unchanged Green exchange rates. This arises because of the differential dependence of different countries on the intervention mechanism. The other key factor influencing the evolution of producer prices is the development of the Green exchange rate. To a significant extent an apparent stiffening in the EEC's price policy, as reflected in common price agreements denominated in ECUs can be nullified by offsetting adjustments in the Green rates.

Table 2.23
Evolution of EEC Common Prices and Irish Producer Prices

	'Target' ECU	Price Agreement (1) Green £ Devaluation	IR£	Irish Producer Prices (2) IR£
	(per cent change)			
1981-82	+9.7	+4.3	+14.0	+17.7
1982-83	+10.4	0.0	+10.5	+8.9
1983-84	+4.2	+4.8	+9.0	+5.6
1984-85	−0.5	+3.9	+3.9	+3.0
1985-86	+0.1	+0.4	+0.4	−2.0

(1) EEC Marketing Year
(2) Calendar Year
Source: An Foras Taluntais.

This point is amply demonstrated in Table 2.23. A clear winding down is apparent in common prices denominated in ECUs since 1982-83 but this has not been entirely reflected in Irish producer prices owing to significant Green Pound devaluations.

Table 2.24
Construction Industry Output, 1980-1985 (1980 Prices)

		1981	1982	1983	1984	1985	Average 1980-1985
			(% change per annum)				(%)
Residential New Construction:	Private	+17.1	-13.6	-8.8	-4.7	-7.9	- 4.1
	Local Authority	- 3.6	+ 1.5	+15.0	- 0.8	- 7.3	+ 0.7
Repairs etc:	Private	-15.7	-36.9	- 2.7	- 1.6	+ 3.7	-12.0
	Local Authority	+ 6.2	+ 0.4	+ 7.0	+ 3.4	+ 7.4	+ 4.8
Total Residential		**+ 8.0**	**-14.2**	**- 3.8**	**- 3.3**	**- 6.1**	**- 4.1**
Industry(1)		+ 1.4	-19.5	-59.8	-12.6	-21.6	-25.8
Agriculture		- 2.3	-14.3	-30.6	-36.3	+34.9	-24.8
Commercial		+ 3.9	-10.2	-26.9	-21.4	-18.5	-15.2
Other		+11.8	+ 9.7	-16.3	- 1.8	- 2.2	- 0.3
Total Non-residential		**+ 6.6**	**- 1.3**	**-25.6**	**- 8.8**	**- 7.8**	**- 8.1**
Total Output		**+ 7.2**	**- 6.8**	**-17.1**	**- 6.3**	**- 7.0**	**- 6.3**

(1) Excluding Semi-state Bodies.

Source: Department of the Environment

8. BUILDING AND CONSTRUCTION

Reflecting the weakness of investment the building and construction industry has experienced an exceptional recession of activity since 1980. In each of the last five years, except 1981, output of the industry declined. In 1985 the volume of building and construction output was 7 per cent below its 1984 level and over 30 per cent down on the level attained in 1981.

Within the industry as a whole trends in output have varied considerably between the different types of activity and between the public and private sectors. The detailed statistics set out in Table 2.24 illustrate this point.

In the first place the volume of non-residential activity has declined more rapidly than residential output. The volume of residential output declined at an annual average rate of 4 per cent between 1980 and 1985 while the corresponding rate of decline in non-residential activity was over 6 per cent.

Within the residential category there has been a very marked divergence between private and local authority building both in respect of new construction and, repairs and maintenance. Private residential construction declined in volume terms by 4 per cent per annum in the 1981-1985 period as a whole, falling particularly sharply in 1982 and 1983. The fall in the volume of private repairs and maintenance activity was even more precipitate — at an annual average rate of almost 12 per cent.

Taking the period as a whole the volume of Local Authority residential building by contrast has expanded, albeit marginally, at an annual average rate of under 1 per cent. The expansion of Local Authority house building was concentrated in those years when private sector activity was weakest: 1982 and 1983. Local Authority activity in the repairs and maintenance category increased in volume terms over the five years to 1985, at an annual average rate of almost 5 per cent.

Turning to non-residential construction, activity has been exceptionally weak in the industrial and agricultural sectors and in commercial development, where the average annual volume declines over the 1980-1985 period were 26, 25 and 15 per cent respectively. In the industrial sector the trend was dominated by a massive 60 per cent fall in 1983 while in agriculture declines of 31 and 36 per cent respectively were registered in 1983 and 1984. Commercial development activity registered especially sharp falls in each of the years 1983, 1984, and 1985.

Other non-residential construction activity has been relatively buoyant with the average annual rate of output decline between 1981 and 1985 at under 1 per cent. Included in this category is investment in Education, Health, Roads, Sanitary Services and Public Buildings, as well as investment by the

Table 2.25
Employment and Unemployment (Mid-April figures)

	1980	1981	1982	1983	1984	1985	Change 1980-1985	Change 1975-1980
			(Thousands)				(Thousand)	
Agriculture	209	196	193	189	181	169	−40	−29
Industry	371	363	355	330	319	305	−66	+34
Services	576	587	598	603	604	600	+24	+78
Total Employment	1156	1146	1146	1122	1104	1074	−82	+83
Labour Force	1247	1272	1293	1305	1308	1299	+52	+90
Unemployment	91	126	147	183	204	225	+134	+ 7
(per cent)	7.3	9.9	11.4	14.0	15.6	17.3	–	–

Source: *Labour Force Surveys*, CSO.

Semi-state Bodies. This investment is undertaken in the main by the public sector under the auspices of the Public Capital Programme.

An important concomitant of the depressed state of the building and construction industry has been the sharp reduction in employment provided by the industry and the associated rise in unemployment amongst building and construction workers. The industry engaged 103,000 workers in 1980 but only 76,000 in 1985. In the same period average annual unemployment in the sector increased from 21,500 to almost 48,000.

The key economic factors which have underpinned the recession in the building industry are not difficult to identify. As far as private residential building is concerned the sharp fall in demand for new houses can be attributed to the fall in real disposable personal income and to the sharp increase in real mortgage rates. The evolution of private sector non-residential construction mirrors the trends in overall physical capital formation discussed earlier in relation to agriculture and manufacturing industry. As to commercial development, the over-supply of office accommodation and the downward pressure on rental values have been key negative factors.

9. EMPLOYMENT AND UNEMPLOYMENT

Total employment declined by 82,000 between 1980 and 1985, that is, at an average rate of over 16,000 per annum. This sharp fall in employment coupled with an increase of 52,000 in the labour force meant that the number of persons unemployed, on a labour force basis, was 134,000 higher in 1985, at 225,000, than in 1980.

The experience of the 1980-1985 period was in marked contrast to that of the previous five years (see Table 2.25) during which total employment expanded by 83,000, the labour force by 90,000, and the numbers unemployed by just 7,000. As a percentage of the labour force, unemployment which was 7.3 per cent in 1980 — the same proportion as in 1975 — had increased to over 17 per cent by 1985.

The rate of employment reduction in agriculture was significantly greater in the 1980-1985 period than in the previous five years. Between 1980 and 1985 agricultural employment fell by 40,000 compared with a fall of 29,000 between 1975 and 1980. In 1985 there were 20,000 fewer persons engaged in agriculture than in 1983 representing an accelerating rate of decline relative to the preceding three-year period and reflecting the very difficult circumstances which faced farmers in 1984 and 1985.

The rate of employment increase in the services sector slowed down considerably over the five years to 1985: in the 1975-1980 period employment

in services expanded by 78,000 but by only 24,000 between 1980 and 1985. Particularly disturbing is the fact that the numbers engaged in the services sector actually declined in 1985 for the first time since the Labour Force Survey was initiated.

It is the industrial sector however which provides the starkest contrast as between the two periods. Between 1975 and 1980 industrial employment increased by 34,000 whereas in the five years to 1985 employment in industry contracted by 66,000. It is estimated that industry engaged just over 28 per cent of the employed labour force in 1985 compared with a peak of 32 per cent in 1980.

(i) Industrial Employment

Within the industrial sector manufacturing employment fell by 39,000 between 1980 and 1985 compared with an increase of 19,000 over the previous five years. The numbers engaged in manufacturing by 1985 had fallen to a level comparable to that prevailing in the late 1960s. Within manufacturing, reductions in employment were concentrated in the more traditional labour-intensive sectors, especially in the Textiles, Clothing, and Footwear industries. Moreover it is noteworthy that the Chemicals industry which had been a source of modest employment growth in the 1970s, and the Office Machines industry which provided a modest net increase in employment up to 1984, have ceased to generate net job gains. In fact, employment in Chemicals registered a slight fall between 1981 and 1985.

Table 2.26
Evolution of Employment in Industry, 1980-85, (mid-April)

	1980	1985	Change 1980-85	Change 1975-80
			(Thousands)	
Mining, Quarrying, Turf	11	10	−1	+ 1
Manufacturing	243	204	−39	+19
Building + Construction	103	76	−27	+14
Public Utilities	14	15	+ 1	0
Total	371	305	−66	+34

Source: *Labour Force Surveys*, CSO.

Employment in Building and Construction fell by over 25 per cent between 1980 and 1985, or by 27,000, compared with an increase of 14,000 over the previous five years.

(ii) Employment in Services

The employment performance of each branch of service sector activity was weaker in the 1980-1985 period than in the previous five years. In Transport and Communications there was a slight decline in employment between 1980 and 1985, which coupled with the very modest increase recorded in the 1975-1980 period, points to a longer term stagnation of employment in this sector. The significant expansion of numbers engaged in Public Administration and Defence which characterised the five years to 1980 was not repeated in the subsequent period and employment in this sector in 1985 is estimated to be only 2,000. higher than in 1980 having declined between 1983 and 1985. The slow-down in recruitment in the wider public sector helps to explain the fact that numbers engaged under the heading of 'other services' increased by only 17,000 between 1980 and 1985 compared with 45,000 in the previous five year period. Included in this category are workers in the health and education sectors as well as a heterogenous collection of personal services such as entertainment, hotels and restaurants and business services embracing accountancy, law, consultancy etc.

Table 2.27
Trends in Service Sector Employment, 1980-1985, (mid-April)

	1980	1985	Change 1980-85	Change 1975-80
			(Thousands)	
Commerce, Insurance & Finance	202	209	+7	+ 21
Transport & Communications	70	68	−2	+1
Public Administration	71	73	+2	+11
Other Services	233	250	+17	+45
Total	576	600	+24	+78

Source: *Labour Force Surveys*, CSO.

The increase in the numbers employed in commerce, insurance and finance activities between 1980 and 1985, at an estimated 7,000 was also extremely low by comparison with the earlier 5-year period when an increase of 21,000 was recorded.

3

THE PUBLIC FINANCES AND PUBLIC SPENDING

1. BROAD TRENDS IN BUDGETARY AGGREGATES

In 1981 the public finances reached their position of most serious imbalance. In that year the Exchequer Borrowing Requirement (EBR) amounted to 15.9 per cent and the Public Sector Borrowing Requirement (PSBR) to 20.3 per cent of GNP. In each subsequent year to 1984 both magnitudes declined relative to GNP, the EBR to 12.4 per cent and the PSBR to 16.4 per cent. A further reduction in the PSBR took place in 1985 while the EBR increased modestly to 12.9 per cent of GNP.

Table 3.1 sets out the evolution of the broad budgetary aggregates between 1980 and 1985 and permits the composition of the reductions in the EBR and PSBR to be identified. Although the EBR over this period declined by three percentage points of GNP the current budget deficit increased from 7.6 to 8.4 per cent. The reduction in the EBR was achieved, therefore, entirely on foot of a fall in exchequer borrowing for capital purposes: the decline being from 8.3 per cent of GNP in 1981 to 4.8 per cent in 1985.

The increase in the current budget deficit over the period was associated with an increase in both current expenditure and revenue as proportions of GNP. The increase in the former was from 44.2 per cent in 1981 to 49.9 per cent in 1985. Current expenditure as a proportion of GNP increased in each of the years 1981 through 1985. In the case of current revenue the increase was from 36.6 to 41.5 per cent of GNP taking the period as a whole. As a proportion of GNP current revenue increased in each of the years 1981 through 1984 and stabilised in 1985.

Within the current revenue total, non-tax revenues have apparently been quite volatile but this is due to the institution of An Post and Bord Telecom Eireann from 1 January 1984 and the concomitant effect this has had on the budgetary arithmetic. Tax revenues increased from 30.5 to 36.7 per cent of GNP between 1981 and 1984 but declined slightly to 36.6 per cent in 1985.

At the level of aggregation represented in Table 3.1 the most significant characteristic of current expenditure growth has been the evolution of expendiure on the Central Fund (mostly debt servicing). The growth in

Table 3.1
Government Revenue, Expenditure and Borrowing as a % of GNP(1)

	1980	1981	1982	1983(2)	1983(2)	1984	1985
CURRENT EXPENDITURE							
Central Fund	8.4	9.3	11.3	12.4	12.7	13.3	14.5
Supply Services	32.7	34.9	36.3	37.5	34.7	35.0	35.4
Total	41.1	44.2	47.6	49.9	47.4	48.4	49.9
CURRENT REVENUE							
Tax	29.1	30.5	32.7	35.0	35.0	36.7	36.6
Non-Tax	5.9	6.1	6.9	7.7	4.3	4.5	4.9
Total	35.0	36.6	39.6	42.8	39.3	41.2	41.5
Current Budget Deficit	6.1	7.6	8.0	7.2	8.1	7.2	8.4
Exchequer Capital Borrowing	7.4	8.3	7.7	6.0	5.7	5.4	4.8
Total Exchequer Borrowing	13.5	15.9	15.7	13.1	13.9	12.6	13.2
Public Sector Borrowing	17.3	20.3	19.9	17.0	17.0	16.4	16.0

(1) Because of rounding the arithmetic in some columns is not internally consistent.
(2) There is a discontinuity in this series because of the impact on the budgetary aggregates of the transfer of responsibilities to An Post and Bord Telecom Eireann from 1 January 1984. The first column for 1983 gives the outturn on the old basis and the second column gives the data on the new basis.

Source: *Budget Booklets, National Income and Expenditure.*

Central Fund expenditure, from 9.3 to 14.5 per cent of GNP between 1981 and 1985 more than accounts for the rise in total current expenditure relative to GNP. Expenditure on supply services, having risen significantly between 1981 and 1983, stabilised as a proportion of GNP thereafter.

2. FISCAL POLICY

The declared objective of fiscal policy since 1981 has been to reverse the sharp deterioration in the public finances which had characterised the preceding period. In the light of the serious imbalance which already existed in 1981 the authorities began to apply a degree of fiscal restraint in 1982 with the EBR budgetted to fall by three percentage points of GNP, from 16.9% to 13.8%. In the event, as a result *inter alia* of a weaker than expected level of domestic economic activity the outturn for the EBR was almost 16%. The 1983 budget was designed to be even more restrictive, with the EBR targetted to fall to 13% of GNP (to be achieved primarily through increases in taxation). This target was achieved.

In 1984 some further fiscal contraction was implemented but was somewhat less than in the previous two years; a fall of over one percentage point, from 13.9 to 12.6 per cent of GNP, being attained. The 1985 budget actually reversed the pattern of adjustment with the EBR targetted to increase from 12.6 to 13 per cent. Fiscal policy therefore, as conventionally measured by the actual EBR, imparted a significant deflationary impact to the economy in 1983*, continued in 1984 but with less strength, and reversed the pattern somewhat in 1985.

However foreign debt interest payments do not stimulate domestic demand:they actually reduce the Government spending multiplier. It is necessary therefore to adjust the EBR for external interest payments in order to provide a more accurate measure of the stance of fiscal policy and its impact on the demand side of the economy. The figures in Table 3.2 show that the

Table 3.2
Trends in the EBR and the Adjusted EBR 1981-1985

	1981	1982	1983	1983(1)	1984	1985
	— (per cent of GNP) —					
EBR	15.9	15.7	13.1	13.9	12.6	13.2
EBR Adjusted for Foreign Interest Payments	13.6	11.5	8.8	9.6	7.9	8.1

(1) See note (2) on previous table.

Source: *Budget Booklets*, successive issues.

*According to OECD estimates the reduction in the cyclically corrected budget deficit amounted to 2 per cent of GNP in 1982 and 4 per cent in 1983.

EBR adjusted for foreign interest payments reached a peak of 13.6 per cent of GNP in 1981 and declined in each subsequent year to 1984. It increased marginally in 1985. The deflationary impact of fiscal policy was therefore greater than the conventional measure suggests. The unadjusted EBR fell by almost three percentage points of GNP between 1981 and 1985 while the borrowing requirement excluding foreign interest payments fell by about 5.5 per cent of GNP.

3. EXPENDITURE ON CURRENT SUPPLY SERVICES

In a later section the evolution of debt service expenditure is analysed in more detail. In this section the composition of supply service expenditure and its evolution since 1981 is described. There are a number of ways in which such a disaggregation might be effected. Their relative merits for analytic purposes depend upon the perspective which it is desired to bring to bear on the issue of public expenditure growth. In what follows current expenditure on supply services is disaggregated firstly by function and then by programme.

Table 3.3 sets out the evolution of current supply services spending on a functional basis using budgetary rather than national accounts data. The table distinguishes between pay and pensions, social welfare transfer payments, and other non-pay spending and shows how these categories have evolved in nominal terms, relative to gross supply service expenditure, and in real terms, over the years 1981-1985. The data in the third part of the table, which attempt to capture the volume growth in the various expenditure categories, should be interpreted with caution because the deflators used to adjust for price changes are not entirely satisfactory.

The fastest growing component of supply service spending in the 1981-85 period was social welfare transfer payments which increased at an annual average rate of 17.5 per cent in nominal terms, or about 7 per cent in real terms. The real increase in such payments reflects in part an increase in the number of recipients over the period (particularly of unemployment compensation) and in part an increase in the real value of per capita payments. This issue is addressed in greater detail below. Such has been the rate of growth in social welfare transfer payments that they accounted for over 32 per cent of gross current supply service expenditure in 1985 compared with under 28 per cent in 1981.

Expenditure on exchequer pay and pensions has increased at an annual rate of not much more than half of that which has characterised transfer payments, or somewhat in excess of 9 per cent per annum in nominal terms. Expenditure on this item, which accounted for over 42 per cent of the gross total in 1981, comprised less than 37 per cent by 1985. In real terms (using the CPI as deflator) the Exchequer pay bill declined at an annual average rate of almost

Table 3.3
Evolution of Current Supply Services Expenditure, 1981-1985 by Functional Category

	1981	1982	1983	1984	1985	Change 1981-1985
			— (£million) —			(% per annum)
Pay and Pensions	1,729	1,982	2,175	2,319	2,479	9.4
Social Welfare Transfer Payments	1,146	1,559	1,803	1,991	2,188	17.5
Other Non-pay	1,234	1,550	1,768	1,962	2,086	14.0
Gross Supply Service Expenditure	4,109	5,091	5,746	6,272	6,753	13.2
Appropriate in Aid & PRSI Receipts	697	916	1,095	1,250	1,352	18.0
Net Supply Service Expenditure	3,412	4,175	4,651	5,022	5,401	12.2
			— (per cent of Total) —			(% points)
Pay and Pensions	42.1	38.9	37.9	37.0	36.7	−5.4
Social Welfare Transfer Payments	27.9	30.6	31.4	31.7	32.4	+4.5
Other Non-pay	30.0	30.4	30.8	31.3	30.9	+0.9
Gross Supply Service Expenditure	100.0	100.0	100.0	100.0	100.0	
			— (volume growth, per cent)(1) —			(% per annum)
Pay and Pensions		−2.1	−0.6	−1.8	1.4	−0.8
Social Welfare Transfer Payments		16.2	4.8	1.7	4.3	6.6
Other Non-Pay		11.6	4.0	2.1	−0.2	4.3
Gross Supply Service Expenditure		10.0	2.9	0.4	1.1	3.5
Net Supply Sevice Expenditure		8.7	1.6	−0.7	1.0	2.6

(1) CPI used to deflate Pay and Pensions, and Social Welfare Transfer Payments; Public authorities' net expenditure deflator used for other aggregates.

Source: *Book of Estimates*, 1985 and 1986.

1 per cent between 1981 and 1985 reflecting significant real reductions in 1982 and 1984 and a slight increase in 1985. As in the case of transfer payments, the evolution of aggregate pay expenditure reflects trends in the number of recipients (employees) and in average per capita earnings. What data exist indicate that average per capita income of those covered by the Exchequer pay bill declined by 0.7 per cent per annum in real terms between 1981 and 1985.

The category 'other non-pay' is rather heterogenous comprising as it does subsidies and grants, and expenditure on goods and services other than pay. In nominal terms an average increase of 14 per cent per annum in this item was recorded between 1981 and 1985 and its share of total gross current supply service expenditure increased slightly. Using the overall public expenditure deflator yields an annual average increase in real terms of over 4 per cent, in this item, comprising substantial though decelerating rates of volume growth in 1982, 1983 and 1984, followed by a small volume reduction in 1985.

It is noteworthy that the growth of gross current supply service expenditure outstripped that of the corresponding net figure over the 1981-1985 period. The difference between these two aggregates comprises PRSI receipts and appropriations-in-aid, the latter composed of receipts from the EEC and payments for services, in the main. Appropriations-in-aid and PRSI contributions together increased by 18 per cent per annum on average. The corresponding rate of growth of PRSI contributions alone was 16.3 per cent.

In Table 3.4 gross current supply services expenditure is disaggregated by programme area. It can be seen from the middle portion of the table that the social services programmes (Health, Education, Housing and Social Welfare) are dominant by a very wide margin indeed, accounting for almost three-quarters of the total in 1985, a proportion which has displayed little variation since 1981. In terms of nominal expenditure growth rates the social services have been exceeded by economic services and infrastructural services (see top section of Table 3.4). However such is the predominance of social services in overall current expenditure that they accounted for almost 75 per cent of the absolute increase in nominal gross current supply service spending between 1981 and 1985. Trends in social expenditure are analysed in greater detail in Section 7.

The bottom portion of Table 3.4 sets out estimates of expenditure growth by programme in real terms. As with the analogous figures in Table 3.3 a caveat must be entered about the satisfactoriness of the deflator used. Bearing this qualification in mind it would appear that real expenditure growth characterised each programme category (except that labelled "Other") taking the period as a whole, with expenditure on economic and infrastructural services respectively growing most rapidly in real terms and expenditure on security growing most slowly. Real social services expenditure has grown

Table 3.4
Evolution of Gross Current Supply Services Expenditure, 1981-1985 by Programme

	1981	1982	1983	1984	1985	Change 1981-1985
		— (£ milion) —				(% per annum)
Economic Services	404	475	607	665	724	15.7
Infrastructure	53	64	82	90	103	18.1
Social Services	2934	3685	4175	4536	4885	13.6
Security	420	491	529	568	622	10.3
Other	298	376	353	413	419	8.9
Total Gross Supply Services Expenditure	4109	5091	5746	6272	6753	13.2
		— (per cent of total) —				(% points)
Economic Services	9.8	9.3	10.6	10.6	10.7	+0.9
Infrastructure	1.3	1.3	1.4	1.4	1.5	+0.2
Social Services	71.4	72.4	72.7	72.3	72.3	+0.9
Security	10.2	9.6	9.2	9.1	9.2	−1.0
Other	7.3	7.4	6.1	6.6	6.2	−1.1
Total	100.0	100.0	100.0	100.0	100.0	
		— (volume growth, per cent)(1) —				(% per annum)
Economic Services		4.4	16.5	0.8	2.2	5.8
Infrastructure		7.2	16.8	1.0	7.5	8.0
Social Services		11.5	3.3	0.0	1.1	3.9
Security		3.8	−1.8	−1.2	2.8	0.9
Other		12.1	−14.4	7.6	−4.7	−0.4
Total		10.0	2.9	0.4	1.1	3.5

(1) Deflated by public authorities' net expenditure deflator.

Source: *Book of Estimates*, 1985 and 1986.

by almost 4 per cent on average over the period. The year-on-year changes indicate a marked deceleration in real spending growth between 1982 and 1984 and a modest re-acceleration in 1985.

4. PUBLIC CAPITAL SPENDING

Table 3.5 sets out details of the evolution of the Public Capital Programme between 1981 and 1985. In nominal terms total spending under the PCP was only £39m higher in 1985 than in 1981 although in the intervening period PCP spending rose to considerably higher levels.

In volume terms the PCP fell at an annual average rate of 5.6 per cent between 1981 and 1985. The time profile of this trend reveals important variations in the year-on-year changes: a volume increase of almost 4 per cent was recorded in 1982, followed by volume declines of 14, 4 and 7 per cent in 1983, 1984 and 1985 respectively. Capital spending is of its nature lumpy in incidence comprising large discrete changes in capital formation which may reflect different stages of the investment cycle for large individual projects. Accordingly large year-on-year changes as measured are heavily influenced by factors such as the timing of capital projects. Notwithstanding this certain trends may be identified.

It is notable, for instance, that the volume of sectoral economic investment (principally, agriculture and industry) has declined in each of the years 1981-1985 at an annual average rate of almost 14 per cent. This category of public investment is demand-determined in the sense that the investment plans of private sector enterprises in agriculture and industry heavily influence the amount of public monies disbursed under this heading. Accordingly the volume decline in sectoral economic investment reflects the recession in business confidence and the general trading environment which has characterised the period since 1981.

In real terms investment in productive infrastructure has also declined over the period, though less dramatically, at an annual average rate of 5 per cent. Within this category the decline in the volume of expenditure on capital formation in telecommunications has been particularly steep, reflecting the drawing to a close of the telephone modernisation programme. Real expenditure on capital formation in the energy and transport areas has also fallen sharply since 1982. In contrast the volume of expenditure on roads and sanitary services increased by about 7 per cent per annum on average between 1981 and 1985.

Alone of the three broad PCP categories, investment in social infrastructure has increased in volume terms, taking the 1981-1985 period as a whole, though marginally, at an average rate of less than 1 per cent per annum. There were however modest declines recorded under this heading in 1983 and 1984. The

Table 3.5
Public Capital Programme, 1981-1985

	1981	1982	1983	1984	1985	Change 1981-1985
			— (£ million) —			(% per annum)
Sectoral Economic Investment	527	541	438	413	384	−7.6
Productive Infrastructure	667	780	709	758	701	1.3
Social Infrastructure	456	537	562	563	604	7.3
Total	1650	1858	1709	1734	1689	0.6
			— (per cent of total) —			(% points)
Sectoral Economic Investment	31.9	29.1	25.6	23.8	22.7	−9.2
Productive Infrastructure	40.4	42.0	41.5	43.7	41.5	+1.1
Social Infrastructure	27.6	28.9	32.9	32.5	35.8	+8.2
Total	100.0	100.0	100.0	100.0	100.0	
			— (volume: 1980 = 100) —			(% per annum)
Sectoral Economic Investment	97	91	69	62	54	−13.6
Productive Infrastructure	133	192	121	123	108	−5.1
Social Infrastructure	121	130	128	122	124	+0.6
Total	116	120	103	99	92	−5.6

Source: *Public Capital Programme*, 1986.

relative buoyancy of capital formation in social infrastructure is due to public investment in housing which increased by 11 per cent in 1982 and roughly maintained its 1982 level in subsequent years.

5. FINANCING THE EXCHEQUER BORROWING REQUIREMENT

There have been significant changes in the pattern of financing the EBR in the period since 1981 as Table 3.6 indicates. In this connection there is an important distinction to be made between monetary and non-monetary financing. It is also worth differentiating net foreign borrowing by the Exchequer from the other modes of financing. The significance of these distinctions resides in the differential impact which different patterns of financing are likely to have on the balance of payments, on the exchange rate, and particularly on domestic interest rates.

In 1981 the EBR was financed predominantly by monetary means: 84 per cent of the EBR being financed in this way. Between 1981 and 1983 the proportion of the EBR financed thus declined and reached 58 per cent in 1983. The proportion rose temporarily in 1984 to 71 per cent but fell again sharply in 1985, to 48 per cent. The mirror image of this trend was a continuous increase in the non-monetary component, interrupted only in 1984. From this perspective therefore there has been a remarkable turnaround in the pattern of EBR financing: no more than one-sixth of the EBR having been financed by non- monetary means in 1981; but in excess of one-half of the EBR being financed in this way in 1985.

Paralleling the increase in non-monetary financing there has been a steady rise in sales of government securities to non- bank residents, again interrupted only in 1984, from £200m in 1981 to £680m in 1985. At the same time the declining importance of monetary financing has been mirrored by a significant fall in net foreign borrowing by the Exchequer from almost £1.3bn, 75 per cent of the EBR in 1981, to £800m in 1985 or, 40 per cent of the EBR.

It is worth pointing out at this stage that the reduction in foreign borrowing as a proportion of the EBR and the concomitant increase in reliance on domestic credit markets to fund the EBR, characteristic of the 1981-1985 period, has been associated with a sharp increase in real domestic interest rates and more particularly a marked increase in domestic real rates of interest relative to those obtaining in our main trading partners.

Table 3.7 sets out the evolution of nominal and real rates of interest in Ireland and in selected other countries for the years 1981 through 1985. The top panel of the table demonstrates that nominal interest rates in Ireland had, by 1985, fallen by an amount relative to 1981 which was broadly comparable to (though somewhat greater than) the fall which occurred over the same period in West Germany, the Netherlands and the US, and considerably greater than that which occurred in France and the UK.

Table 3.6
Financing of Exchequer Borrowing, 1981-1985

	1981	1982	1983	1984	1985
			— (£ million) —		
Sales of Securities to Non-bank Residents	204	504	591	375	680
Small Savings	76	83	142	161	371
Non-Monetary Financing	**280**	**587**	**733**	**536**	**1051**
Net Foreign Borrowing by Exchequer	1285	1148	793	649	806
Sales of Securities to Non-bank Non-residents	-30	-18	35	121	83
Sales of Securities to Banks	120	237	225	418	240
Other	67	-9	-30	101	-165
Monetary Financing	**1442**	**1358**	**1023**	**1289**	**964**
Memorandum:			— (per cent of EBR) —		
Non-Monetary Financing	16.3	30.2	41.7	29.4	52.2
Monetary Financing	83.7	69.8	58.3	70.6	47.8
Of which: (Net Foreign Borrowing)	(74.6)	(59.0)	(45.2)	(35.6)	(40.0)

Source: *Current Economic Trends*, Department of Finance, May 1986.

The bottom panel of Table 3.7 indicates however that Ireland's experience of real interest rate movements over the same period diverged significantly from that of all the other countries listed. Between 1981 and 1985 the real interest rate in Ireland moved from -5.2 to +5.3, an increase of 10.5 points. The next highest increase was experienced in France: 5.6 points. In West Germany, the Netherlands and the US real interest rates fell between December 1981 and December 1985.

6. NATIONAL DEBT AND DEBT SERVICING COSTS

By December 31 1985 Exchequer debt outstanding amounted to the equivalent of 134 per cent of GNP of which foreign debt accounted for 55 percentage points and domestic debt for 79. If the indebtedness of the State-sponsored bodies is taken into account total public sector foreign debt outstanding would be equivalent to approximately two-thirds of GNP.

Table 3.7
Evolution of Nominal and Real Interest Rates 1981-1985

Panel A: Nominal Rates (December)(1)

	1981	1982	1983	1984	1985	Change 1981-1985 (% pts.)
Ireland	17.00	14.00	12.75	14.75	10.50	- 6.50
West Germany	13.00	8.75	7.75	7.75	7.25	- 5.75
United Kingdom	15.50	11.00	10.00	10.50	12.50	- 3.00
United States	15.75	11.50	11.00	10.75	9.50	- 6.25
France	14.00	12.25	12.25	12.00	10.60	- 3.40
Netherlands	12.00	6.25	7.00	6.25	6.25	- 5.75

Panel B: Real Rates(2)

Ireland	-5.2	+1.5	+2.2	+7.4	+5.3	+10.5
West Germany	+6.3	+4.0	+4.6	+5.6	+5.4	- 0.9
United Kingdom	+3.0	+5.3	+4.5	+5.6	+6.4	+ 3.4
United States	+6.5	+7.3	+6.8	+6.6	+5.5	- 1.0
France	0.0	+2.3	+2.7	+5.0	+5.6	+ 5.6
Netherlands	+4.6	+1.9	+3.8	+3.4	+4.5	- 0.1

(1) Commercial bank lending rates to Prime Borrowers
(2) Nominal Rates deflated by CPI

Source: Morgan Guaranty Bank.

Table 3.8 sets out the evolution of exchequer debt, distinguising between its domestic and foreign components, over the 1981-1985 period. In nominal terms total exchequer debt outstanding doubled over the period from £10.2bn to £20.4bn. The rate of increase in the stock of foreign debt was somewhat greater. Relative to GNP the total increased from 94 to 134 per cent.

The growth in the value of foreign debt reflects not only net additions to the stock outstanding because of net foreign borrowing by the Exchequer, but also valuation changes arising from exchange rate movements. Thus, although net Exchequer borrowing abroad declined in 1982 and 1983, the absolute increase in the value of foreign debt outstanding itself increased, because of the sharp depreciation of the Irish Pound against those currencies in which the debt is predominantly denominated namely, the US dollar and the DM. Taking the period as a whole the increase in foreign debt outstanding greatly exceeds the cumulative sum of net foreign borrowing, principally because of exchange rate movements. There was however a marked deceleration in the growth of the stock of foreign debt in 1984 and 1985 — partly a reflection of the diminishing reliance on foreign borrowing as a means of financing the EBR.

Table 3.8
Exchequer Debt Outstanding 1981-1985 (Year End)

	1981	1982	1983	1984	1985
			— (£ million) —		
Domestic	6401	7527	8753	10,566	11,976
Foreign	3794	5290	7017	7926	8441
Total	10,195	12,817	15,770	18,492	20,417
			— (per cent of GNP) —		
Domestic	59.0	60.7	65.5	73.1	78.5
Foreign	35.0	42.7	52.5	54.9	55.3
Total	93.9	103.4	118.1	128.0	133.8

Source: *Current Economic Trends*, Department of Finance

In tandem with the increases in the stock of national debt there has been a sharp rise in the associated servicing costs. As shown in Table 3.9 total servicing costs increased in nominal terms from just under £900m in 1981 to almost £2bn in 1985, or from 8.2 to 12.9 per cent of GNP.

It is important to distinguish between servicing costs arising on foot of domestically-held debt and foreign debt respectively. The first constitutes a redistribution of income within the economy while the second represents an unambiguous loss to the domestic economy. The cost of servicing foreign debt has increased very much more rapidly than domestic debt servicing costs over the 1981-1985 period: in the former case the increase has been more than threefold in nominal terms, from £250m to £780m or from 2.3 to 5.1 per cent of GNP; in the latter case the increase has been less than twofold, from £635m to £1190m or, from 5.9 to 7.8 per cent of GNP.

Table 3.9
Cost of Servicing the National Debt, 1981-1985

	1981	1982	1983	1984	1985
			— (£ million) —		
Domestic	635	733	877	1,003	1,186
Foreign	250	516	579	702	781
Total	885	1,249	1,456	1,705	1,967
			— (per cent of GNP) —		
Domestic	5.9	5.9	6.6	6.9	7.8
Foreign	2.3	4.2	4.3	4.9	5.1
Total	8.2	10.1	10.9	11.8	12.9

Source: *as for Table 3.8*

The evolution of foreign debt servicing costs in recent years has been heavily influenced by movements in exchange rates and by the sharp increase in international real interest rates which have taken place. Table 3.10 quantifies the impact which movements in real international interest rates and exchange rates together have had on the cost of servicing exchequer foreign borrowing over the 1981-1985 period. It can be seen that the increase in real interest rates world- wide which characterised much of this period and the associated exchange rate movements, especially the depreciation of the Irish pound against the dollar, have had the effect of substantially increasing the cost of foreign debt servicing, and at an accelerating rate, over the period. Had real international interest rates and the exchange rate for the Irish Pound remained throughout at their end-1980 levels the foreign debt servicing bill in 1985 would have been £343m lower than was actually the case.

Table 3.10
Impact of International Interest Rate and Exchange Rate Movements on Exchequer Foreign Debt Servicing Cost, 1981-1985 (£m)

	1981	1982	1983	1984	1985
Interest on Foreign Debt:					
—Actual	250	516	579	702	781
—Estimated(1)	210	353	426	442	438
—Difference	-40	-163	-153	-260	-343

(1) Estimated on the basis that real international interest rates and exchange rates were maintained constant at their end-1980 levels. These figures were kindly provided by John FitzGerald of the ESRI.

The importance of the debt servicing item in the budgetary arithmetic generally, and more particularly as a component of current expenditure, suggests that it is important to look at recent trends in budgetary aggregates such as the current budget deficit and the EBR, netting out national debt interest. This is done in Table 3.11. It can be seen that when national debt

Table 3.11
Evolution of the Current Budget Deficit and the EBR Net of National Debt Interest, 1981-1985

	1981	1982	1983	1984	1985
Current Budget Deficit (1)					
(£m) (2)	-27	-121	-264	-527	-543
(% of GNP)	-0.2	-1.0	-2.0	-3.6	-3.6
EBR(1)					
(£m)	927	802	504	259	188
(% of GNP)	8.5	6.5	3.8	1.8	1.2

(1) Less expenditure on national debt interest.
(2) Minus signs denote surpluses.

interest payments are excluded, the current account of the budget has been in surplus since 1981 and that the surplus has increased significantly both in absolute terms and relative to GNP. The surplus was £543m in 1985 or 3.6 per cent of GNP, up from £27m, or 0.2 per cent of GNP in 1981.

Similarly when national debt interest payments are netted out of the EBR it emerges that the adjusted EBR has declined sharply since 1981 both absolutely and relative to GNP. Excluding interest payments the EBR in 1985 was £188m, just over 1 per cent of GNP compared with £927m or 8.5 per cent of GNP in 1981.

7. SOCIAL EXPENDITURE

Social expenditures assumed greater economic significance in the 1980-1985 period.* As the data in Table 3.4 reveals, social services expenditure grew in volume terms at 3.9% annually and accounted for almost three quarters of all supply services expenditure. Almost one third of GNP (32.2%) was accounted for by social expenditures at the beginning of the decade, and by 1985 the figure had increased to 35.7%, as the final row in Table 3.12 shows. The functional classification of supply services expenditure suggests that social welfare transfer payments were growing very rapidly: the lower panel of Table 3.3 shows that the volume growth per annum in this particular expenditure programme was 6.6%.

(i) Composition and Growth of Social Services Expenditure

Social services expenditure is disaggregated in Table 3.12 for the years from 1980 to 1985. The relative importance of social welfare is the feature of this table: social welfare, health, education and housing is the order of the magnitudes of the specific sub programmes. Over the 1980-85 period social welfare grew very significantly relative to other sub- programmes and relative to GNP, in 1985 social welfare, comprised almost 43% of total social spending or over 15% of GNP. Social welfare is, therefore, both the largest and the most rapidly growing programme of social expenditure. By definition the relative importance of the sub programmes differs as between capital and current expenditures: housing bulks very large in the social capital programme, followed by education and health. Reflecting policy commitments in that regard subsidies diminished in relative importance.

The magnitudes of current and capital social spending, and changes in these, in nominal terms are also shown in Table 3.12. Considering current spending separately, social welfare made up 55% of the increased spending, and its dominance in the expenditure is not significantly diminished when capital

*In this section 1980 is used as the initial year for the period under review, for technical reasons.

Table 3.12
Social Expenditure 1980-1985 (Current Prices m)

Category	1980	1981	1982	1983	1984	1985	Change £m 1980-85	% Change 1980-85	% Share of change current only	% Share of change capital only	% Share of change all
Social Welfare											
—Current	897	1202	1639	1909	2130	2315	+1418	+158.1	54.7		50.0
—Capital (1)	—	—	—	—	—	—					
—Total	897	1202	1639	1909	2130	2315	+1418	+158.1	54.7		50.0
—Total as % of all	34.5	36.0	39.4	40.8	42.2	42.6					
Health											
—Current	656	764	883	973	1022	1094	+ 438	+ 66.8	16.9		15.4
—Capital (1)	35	45	49	53	56	57	+ 22			8.9	0.8
—Total	691	809	932	1026	1078	1151	+ 460				16.2
—Total as % of all	26.6	24.2	22.4	21.9	21.3	21.2					
Education											
—Current	470	604	730	804	881	950	+ 480	+102.1	18.5		16.9
—Capital (1)	61	82	93	89	82	94	+ 33			13.4	1.2
—Total	531	686	823	893	963	1044	+ 513				18.1
—Total as % of all	20.4	20.6	19.8	19.1	19.1	19.2					
Housing											
—Current	64	87	109	143	173	204	+ 140	+218.8	5.4		4.9
—Capital(1)	202	276	334	365	377	393	+ 191			77.6	6.7
—Total	266	363	443	508	550	597	+ 331				11.7
—Total as % of all	10.2	10.9	10.6	10.9	10.9	11.0					
Subsidies(2)											
—Current	214	277	324	346	357	332	+ 118	+ 55.1	4.5		4.2
—As % of all	8.2	8.3	7.8	7.4	7.1	6.1					
All											
—Current	2301	2934	3685	4175	4536	4895	+2594	+112.8	100		
—Capital (1)	298	403	476	507	515	544	+ 246	+ 88.8%		100	
—Total	2599	3337	4161	4682	5051	5439	+2840	+109.3%			100
Total as % of GNP	28.9	30.7	33.6	35.1	35.0	35.6					

(1) Capital refers to Public Capital Programme
(2) Includes CIE subsidy, food subsidies, rates support grant
Source: Book of Estimates, National Income and Expenditure

and current figures are aggregated. Exactly half of the nominal increase in all social spending is attributable to social welfare, education ranks second in its contribution to the increases in relation to current spending, capital spending, and total spending. Further analysis is given below of the growth in social welfare expenditures.

(ii) Social Welfare Expenditures 1980-1985

In Table 3.13 the amount of the individual schemes within the social welfare programme are given for 1980 and 1985, along with nominal changes in the expenditure on these schemes and the contribution of these changes to the overall expenditure growth. That unemployment made such a large contribution to the growth in expenditure is unsurprising in the light of the growth of unemployment. However this trend is difficult to overstate: the growth in unemployment related social welfare payments contributed over 31.4% of the total nominal change in social welfare expenditure costs, an increase of almost £460 million. Schemes for the retired and elderly were second in their contribution, accounting for 25.4% of the nominal change. A further appreciation of the role of unemployment in determining expenditure growth can be observed in the fact that whereas the respective share of old age pensions and unemployment in total social welfare expenditure were 35.8% and 18.8% respectively in 1980, the respective shares in 1985 were 29.3% and 26.6%.

(iii) Growth of Social Welfare Expenditure

A number of factors need to be considered in examining the growth of social security costs. *Firstly*, legislative and regulatory changes which may widen the entitlement to the services. Such changes were of very minute significance in the 1980-85 period. No new schemes* were introduced and no important modifications were made to pre-existing schemes.

Secondly, changes in the amounts of payments per recipient in nominal and real terms: social welfare payments were increased on a regular basis during the period and this resulted (as Table 3.14 shows) in real increases in the value of these payments: long term pensions for the widowed and elderly increased in real terms by 20%, and short term payments for sickness and unemployment by 10%.

Thirdly, growth in the numbers of beneficiaries due to the evolving social, economic and demographic situations. As Table 3.15 shows, there has been

*Family income supplement was introduced in the Autumn of 1984 the expenditure in this scheme was only £2.2m in 1985.

Table 3.13
Distribution of Social Welfare Expenditure By Expenditure Programme
(000's)

Expenditure Programme	Expenditure 1980	Expenditure 1985	*Increase in Expenditure 1980-85* Amount	% increase	% of increase
Old Age/Retirement Pensions(1)	319,189	688,595	369,406	115.7	25.4
Unemployment	168,041	625,392	457,351	272.2	31.4
Disability, etc(2)	130,026	335,664	205,638	158.2	14.1
Widows/Orphans pensions	100,791	235,000	134,209	133.2	9.2
Children's allowance	75,400	173,750	97,950	129.9	6.7
Administration	37,599	91,809	54,210	144.2	3.7
Deserted wives etc(3)	20,484	69,870	49,386	241.1	3.4
Invalidity pensions	23,382	71,120	47,738	204.2	3.3
Miscellaneous(4)	5,803	31,136	25,333	436.6	1.7
Other medical(5)	10,821	24,390	13,569	125.4	0.9
Total	891,536	2,346,726	1,454,970	163.2	100

(1) Includes; Free fuel scheme, free travel, free electricity, free T.V. licences, free telephone rental, free bottled gas, butter voucher scheme, combat poverty.
(2) Deserted wives benefit plus social assistance allowances
(3) Disability benefit and occupational injuries and proportionate share of pay related benefit
(4) Maternity, treatment and death payments
(5) Free school meals and supplementary welfare allowance

Table 3.14
Examples of Real Increases in Social Welfare Payments 1980-85
(Index 1980 = 100)

Category	1980	1981	1982	1983	1984	1985
Unemployment Disability Benefit	100	100.5	108.8	108.8	108.6	109.7
Unemployment Assistance	100	100.4	108.6	108.7	108.5	109.5
Widows and Orphans Contributory Pension	100	104.7	114.3	115.4	116.2	117.6
Old Age Pension Contributory	100	105.2	116.5	117.7	118.5	120.0
Old Age Pension Non Contributory	100	105.2	116.3	117.5	118.4	119.9
Childrens Allowances	100	113.4	133.8	130.6	124.6	122.1

Table 3.15
Number of Recipients of Key Social Security Payments 1980-85

Category	1980	1981	1982	1983	1984	1985	1980-85 % Change
				(000's)			
Old Age Retirement Pensions	227.5	228.8	231.2	231.4	233.1	235.0	3.3
Widows Pensions	81.2	84.0	86.9	87.9	90.0	95.3	17.4
Unemployment Payments	68.1	118.8	145.5	188.2	211.0	219.2	221.9
Sickness Payments	84.6	90.9	92.9	93.7	95.8	102.7	21.4
Social Security (Women)	11.9	15.5	17.4	18.3	20.2	23.6	98.3
Childrens Allowances	1,188.4	1,209.0	1,199.1	1,188.0	1,197.0	1,208.4	1.7

Notes: Row 1 includes contributory, non contributory and retirement: Row 2 includes contributory and non-contributory: Row 3 refers to Unemployment Benefit and Assistance: Row 4 contains Disability, Invalidity, Occupational: Row 5 includes Unmarried Mothers, Deserted Wives, Prisoners Wives.

Source: Department of Social Welfare, Reports and Statistical Supplements

very significant growth in recipient numbers in some categories, notably unemployment. Over the 1980-85 period there was an increase of over 220% in unemployment payments. The only other rapidly growing schemes are the payments (as listed in row 5) which overwhelmingly pertain to one parent families — their numbers doubled. One point to note is that until 1980 childrens allowances beneficiaries had been increasing: since then there has been a downward trend to 1984 reflecting the fall in the birth rate, but this trend appears to have halted in 1985*.

Table 3.16 summarises the pattern of social welfare expenditure growth. The left hand columns show real expenditure increases in the main schemes and the shares of the schemes in the total real increases; the right hand columns give the results of calculations which decompose the expenditure growth into average real payment increases, on the one hand, and increases in the total number of recipients on the other**. Unemployment features very strongly in the table both in terms of its overall share of expenditure growth (43.8%) and in terms of the impact of increased recipients on unemployment expenditure. In the case of unemployment benefit, over 90% of increased expenditure is attributed to a growth in recipient numbers, while the figure for the assistance scheme is 81%. Very large increases in numbers also apply to the residual medical category (treatment benefit, maternity) and to the schemes in respect of desertion and single parenthood. These schemes are relatively insigificant in the context of the total expenditure. It should be noted, however, that the numbers of recipients of the one parent family payments (desertion, single parenthood) have grown at an extremely rapid rate — 98% cumulative growth from 1980-1985, and the growth is projected to continue to 1991†.

The decomposition results in relation to the very largest recipient group — pensioners —are in marked contrast to those for unemployment. Real increases in payments very largely account (83%) for the growth in pensions expenditure. The virtual 50/50 apportionment for all expenditure between real payments and increased numbers conceals, therefore, considerable diversity between the schemes in the relative significance of these two factors.

(iv) Other Current Social Expenditure

Health services expenditure is the second largest "social item" in government current expenditure, accounting for about £1.2 billions in 1985 (current prices).

*The Department of Social Welfare advise that the recent data on the Childrens Allowance scheme is not wholly accurate.
**The methodology of this exercise is an adaptation of the methods used by the OECD in their analysis of the growth of social expenditure. See OECD, Social Expenditure: Problems of Growth and Control, Paris, 1985. It should be noted that the calculations suppress the interaction effects.
†NESC, Report No. 72, Social Welfare, The Implications of Demographic Change, Stationery Office, Dublin, 1983.

Table 3.16
Percentage Decomposition of Real Expenditure Growth in Social Welfare Payments, 1980-85 Average

Programme	Real Increase in total expenditure	% Share of real increase in total expenditure	*% of Increase due to* Average real increase in payments	Increase in recipient numbers
Old age pensions	66,939	16.5	83.0	17.0
Widows/Orphans pensions	30,985	7.6	40.1	59.9
One parent families	18,695	4.6	23.6	76.4
Unemployment benefit	61,820	15.2	8.6	91.4
Unemployment assistance	116,122	28.6	19.4	80.6
Disability etc	58,197	14.3	51.2	48.8
Invalidity pension	16,498	4.1	32.2	67.8
Other medical	2,856	0.7	−316.5	416.5
Childrens allowance	21,806	5.4	58.6	41.4
Miscellaneous	11,656	2.9	81.5	18.5
Total	405,574	100.0	49.6	50.4

Notes: Old age pensions include various non cash schemes. Miscellaneous schemes comprises largely supplementary welfare, other medical refers to treatment benefit and maternity schemes. Unemployment and disability include pay related benefit, one parent families includes deserted wives, unmarried mothers, single women's allowance, prisoners wives allowance.

Table 3.17
(a) Net Current Expenditure on Health Services 1980-85

Year	Current Prices	Constant (1980) (1) Prices £m	% Real Change	Index of Real Value
1980	666.0	666.0	—	100.0
1981	822.7	687.3	+3.2	103.2
1982	948.0	702.7	+2.2	105.5
1983	1,033.0	698.0	−0.6	104.8
1984	1,090.0	677.4	−3.0	101.7
1985	1,169.3(2)	682.2	+0.7	102.4

(1) Deflated by the implicit price index of public net current expenditure.
(2) Provisional.
Source: Book of Estimates.

(b) Per Cent Distribution of non Capital Health Expenditure 1980-85

	1980	1981	1982	1983	1984	1985
Community Protection	2.3	1.8	1.6	1.6	1.5	1.6
Community Health	13.0	13.4	14.3	12.8	12.7	13.0
Community Welfare	6.6	6.4	7.2	7.6	7.8	7.6
Psychratric Programme	12.2	12.3	12.0	12.0	11.9	11.8
Programme for Handicapped	8.7	7.7	9.2	9.9	9.8	9.9
General Hospital	51.9	53.4	50.8	51.2	51.3	51.2
General Support	5.3	5.0	4.8	5.0	5.0	4.9
Gross Non Capital Total	100	100	100	100	100	100

Source: Book of Estimates, various years

Table 3.18
Pay Items in Health Services Current Expenditure

	£m Current									*Manpower Data*		
	Health Boards	Other Health Bodies	GMS	Handi-capped	Other	All	Pay as % Total	Real Pay (1)	Real Pay (2)	Total Health Board and Public Voluntary Hospital Staff	GMS Doctors	GMS Pharma-cies
1980	281.6	113.6	21.9	22.9	18.7	461.7	64.0	461.7	461.7	55,647	1,319	1,106
1981	312.4	128.6	28.0	28.0	25.8	526.3	62.6	437.1	439.7	58,030	1,375	1,116
1982	360.8	155.2	33.1	27.3	29.2	609.0	62.1	431.9	451.4	57,468	1,418	1,115
1983	393.9	172.6	32.9	30.5	45.7	680.0	62.9	436.5	459.5	57,500	1,440	1,114
1984	420.5	181.4	37.7	33.3	40.1	717.8	63.2	424.2	446.1	57,583	1,463	1,110
1985	454.3	192.9	41.6	37.4	42.5	768.6	63.8	430.8	448.4	56,500		
1985 as % 1980	161.3	169.8	190.0	163.3	227.3	166.5	——	93.3	97.1			

Notes: 'Other Pay' refers to the item 'Balances for Previous Year' in respect of specific pay items being funded by grant aid from Department of Health to Health Boards and other agencies. Deflator 1 is the CPI, Deflator 2 refers to net current expenditure of Public Authorities. The denominator for calculating the pay/expenditure ratio is gross non capital expenditure for Department of Health vote.
The category total Health Board and Public Voluntary Hospital Staff includes mostly Health Board employees (70%), and the bulk of remainder are in public voluntary hospitals. The Department of Healt advise that changes in the method of compiling data on manpower were made during the period under review. The 1985 figure for manpower is provisional.

Sources: Estimates for Public Services, Statistical Information Relevant to Health Services.

The data on these programmes (Table 3.17) reflect the fiscal retrenchment to which they have been subject. In the first two years of the decade these expenditures grew in real, as well as in nominal terms: 3.2% and 2.2% real growth in 1981 and 1982 respectively. However, in the years since then this growth has been eroded: there were volume reductions in two successive years, and in 1985 there was a very marginal increase of 0.7%. The index of the real value (1980 = 100) of expenditure peaked at 105.5 in 1982, and by 1985 had declined to 102.4. In relation to the growth of current expenditure on social services, current health expenditure accounts for £438 millions (in nominal terms) of the 1980-85 growth, or 16.9% (Table 3.12).

Table 3.19
Net Current Expenditure on Education 1980-1985, by Sector of Education

	1980	1981	1982	1983	1984	1985
Primary						
Current Prices (£m)	180.1	231.8	266.8	296.0	319.9	340.3
Constant Prices (£m)	180.1	193.7	197.8	200.0	198.8	198.5
Index of Constant Prices	100.0	107.5	109.8	111.0	110.4	110.2
% of Total	37.1	37.2	37.2	37.8	38.9	38.6
Post Primary						
Current (£m)	211.5	274.4	316.5	340.8	350.4	370.4
Constant (£m)	211.5	229.2	234.6	230.3	217.8	216.1
Index of Constant Prices	100.0	108.4	110.9	108.9	103.0	102.2
% of Total	43.6	44.0	44.1	43.6	42.6	42.1
Third Level						
Current (£m)	52.3	67.7	76.5	82.5	85.4	91.4
Constant (£m)	52.3	56.6	56.7	55.8	53.1	53.3
Index of Constant Prices	100.0	108.1	108.4	106.6	101.5	102.2
% of Total	10.8	10.9	10.7	10.6	10.4	10.3
Other						
Current (£m)	41.5	49.4	56.6	62.2	67.0	77.7
Constant (£m)	41.5	41.3	42.0	42.0	41.6	45.3
Index of Constant Prices	100.0	99.4	101.1	101.3	100.3	109.2
% of Total	8.6	7.9	7.9	8.0	8.1	8.8
Total						
Current (£m)	485.4	623.3	717.4	781.5	822.7	879.8
Constant (£m)	485.4	520.3	531.8	528.0	511.3	513.3
Index of Constant Prices	100.0	107.2	109.6	108.8	105.3	105.7
% of Total	100.0	100.0	100.0	100.0	100.0	100.0

Notes: Other includes Office of the Minister and Department and Special Schools. Real prices deflator is net current expenditure of public authorities
(e)estimate

Source: Book of Estimates, various issues

The internal distribution of health services expenditure between sub-programmes was generally stable during the 1980- 85 period. General hospitals programmes still incur over half of all current expenditure, and the psychiatric programme, extensively hospital based, incurs a further 11.8%. The intractable problems of shifting health care resources towards primary care and community care are therefore reflected in the expenditure trends from 1980 to 1985 (Table 3.17).

A second point of note in relation to health expenditure is the significance of pay items: in all of the years since 1980 these items have accounted for over 60% of total expenditure (Table 3.18). However aggregate real pay has fallen during the period: the 'pay' data, it should be noted, includes wages/salaries, employers PRSI contributions as well as superannuation, and fees for pharmacists and doctors in the GMS scheme. A precise disaggregation of the trend in the total pay item is not possible, but the manpower data show that although GMS doctor numbers rose continuously the total for health boards (and ancillary bodies) was less in 1985 than in 1981.

Expenditure on education accounts for one fifth of social expenditure and the general trend of expenditure is similar to that for health services (Table 3.19). In the earlier part of the period expenditure rose, but declined in 1983 and 1984, and stabilised in 1985. The shares of the various levels of the education sector remained broadly similar, with second level education comprising over 40% of the total. There is some slight indication that primary education expenditure was not subject to the same real expenditure reductions as other levels of education: the index of real expenditure for this level of education continued to increase until 1983 and is still only very marginally less than the 1983 level. The relative declines in real expenditure at different levels of education is reflected in a very slight increase in the share of primary sector in total expenditure.

(v) Expenditure on Housing and Social Capital Expenditure

Current expenditure on housing is of relatively minor significance in total social expenditure. As Table 3.12 indicates it is small relative to total social current expenditure, and although expenditure in nominal terms grew very rapidly (+218.8%) from 1980-85, the growth contributed only five percentage points of the nominal increase in social current expenditure (Table 3.12). Summary data on housing expenditure, both current and capital, given in Table 3.20, indicates that in marked contrast to other areas of social expenditure current housing expenditure has risen continuously throughout the 1980-85 period. The index of real expenditure stood at 184.1 in 1985, representing an annual average growth rate of almost 13%. The dominant

Table 3.20
Current and Capital Expenditure on Housing 1980-85

	Net Current Expenditure			*Capital Expenditure*			
	Current Prices	Constant Prices	Index of Constant Prices	Current Prices	Constant Prices	Index of Constant Prices	% for Local Authority Housing
	£m	£m		£m	£m		
1980	64	64	100	216.5	216.5	100	52.5
1981	87	72.7	113.6	277.2	232.9	107.6	52.2
1982	109	80.8	126.3	326.8	241.0	111.3	57.3
1983	143	96.6	151.0	365.1	248.4	114.7	50.8
1984	175	108.8	169.9	376.8	233.7	107.9	55.7
1985	202	117.9	184.1	390.3	217.2	100.3	49.1

Notes: Deflators for capital and current respectively are the House Building Cost Index and the net current expenditure of public authorities deflator.
Source: Book of Estimates, Quarterly Bulletin of Housing Statistics.

Table 3.21
Social Capital Expenditure 1980-1985

	Housing			*Health*			*Education*		
	Current	Constant	Index of Constant	Current	Constant	Index of Constant	Current	Constant	Index of Constant
	£m	£m	£m	£m	£m	£m	£m	£m	£m
1980	202	202	100	35	35	100	61	61.0	100
1981	276	231.9	114.8	45	39.4	112.6	82	71.9	117.9
1982	334	246.3	121.9	49	38.9	111.1	93	73.9	121.1
1983	365	248.3	122.9	53	39.8	113.7	89	66.8	109.6
1984	377	233.9	115.8	56	39.3	112.3	82	57.8	94.8
1985	393	218.7	108.3	57	38.1	108.9	97	62.1	101.8

Notes: Health and Education data are deflated by the capital goods price index for building and construction and Housing by the House Building Cost Index
Source: Public Capital Programme

item in current expenditure is the general local authority housing subsidy which accounts for 63% of the current expenditure. This item, which refers to the subsidy to local authorities on foot of loan charges payable on borrowings, has increased very dramatically — from £80m in 1980 to £152 million in 1984, or two thirds of the nominal increase in net current expenditure on housing.

Capital expenditure on housing continued to increase in volume until 1983 —thereafter falling significantly. The volume level in 1985 is virtually the same as for 1980. A considerable part of the increase during the 1982-84 period is attributable to the Housing Finance Agency, established in 1982. In that year the HFA commitment was £15.6 millions, this increased by 254% to £55.2m in 1983, and a further increase of 14% took place from 1983 to 1984. The declining share of capital allocated to local authority dwellings is probably associated with the establishment and growth of the HFA.

Social capital expenditure from 1980-85 across the major programmes — housing, education and health is summarised in Table 3.21. Social capital expenditure is 10% of all (current and capital) gross social expenditure, and accounts for 8.6% of the nominal change in gross total social expenditure.

The social capital data conform very closely to the current expenditure trends. Until 1983 the volume of expenditure was rising but in the two successive years the volume has fallen significantly. For all three programmes the 1985 volume is less than the figure for 1981.

(vi) Summary of Social Expenditure Trends

Social expenditure grew relative to GNP during the period under review. Social Welfare expenditure has grown at a very rapid rate and contributed very significantly to the increase in current public expenditure on social services. This increase was determined partly by real increases in payments and partly by an increase in recipient numbers. The relative importance of increased payments and increased numbers, however, varied among sub programmes within social welfare. Pensions for the elderly and payments to the unemployed offer a contrast in this respect. Real increases in payments were the major determinants of expenditure growth on pensions, whereas the growth in recipient numbers was the key factor in the case of unemployment. Other social expenditure grew in the first half of the period, but in the latter half the main services —education, health, experienced real expenditure declines. However, in order to assess the effects of volume reductions in the level and quality of service, regard must be had to productivity improvements and demands on the services, arising for instance from demographic change.

4

STRUCTURE AND EVOLUTION OF THE TAX SYSTEM

1. INTRODUCTION

This chapter describes the principal characteristics of the existing taxation system, and analyses the main features of its evolution in recent years. In section 2 the evolution of the overall tax burden is described and its changing composition outlined. Sections 3 and 4 look at the principal features of the systems of capital taxation and corporation tax respectively. Section 5 sets out a detailed description and analysis of the system of personal income tax. Section 6 considers the issues of tax evasion, collection and enforcement.

2. THE OVERALL TAX BURDEN

There has been a sharp rise in the overall burden of taxation in the period since 1980. Total tax revenue as a proportion of GNP increased from 29 per cent in 1980 to 36.7 per cent in 1984 (see Table 4.1). It is estimated that this proportion stabilised in 1985.

Tables 4.1 and 4.2 provide details of the growth in tax revenue over the years 1980 through 1986 and indicate how the composition of the overall tax burden has changed over that period. Table 4.1 shows that the two principal sources of revenue are taxes on personal income and taxes on expenditure, which together will provide about 95 per cent of total tax revenue in 1986.

Table 4.2 indicates that the share of total tax revenue attributable to expenditure taxes, capital taxation and the 'other' category, have remained virtually unchanged since 1980. However, there has been a significant shift in the composition of expenditure taxes away from customs and excise duties towards VAT.

The proportion of total tax revenue accounted for by taxes on personal income increased from 38.7 per cent to 40.5 per cent betwen 1980 and 1986, or by an amount which was almost fully counterbalanced by the diminished share of corporation tax. The increased share of personal income tax is attributable to the Youth Employment Levy introduced in 1982, and the temporary income levy, introduced the following year but abolished from April 1986.

Table 4.1
Growth of Tax Revenue by Source, 1980-1986 (£ million)

	1980	1981	1982	1983	1984	1985	1986[1]
Taxes on Personal Income	**1014.3**	**1243.4**	**1493.3**	**1778.1**	**2128.0**	**2259.9**	**2474.4**
—Income Tax	1014.3	1243.3	1459.1	1664.2	1966.5	2103.1	2356.4
—Youth Employment Levy	—	—	34.2	73.8	83.3	82.9	87.0
—Income Levy	—	—	—	40.1	78.2	73.9	34.0
Taxes on Corporate Income	**139.8**	**200.0**	**231.8**	**215.0**	**209.7**	**217.2**	**249.9**
Taxes on Expenditure	**1443.3**	**1845.1**	**2297.5**	**2650.3**	**2918.8**	**3056.8**	**3341.8**
— Customs and Excise	898.2	1118.9	1194.7	1260.1	1334.2	1412.9	1481.7
— VAT	471.6	619.9	946.1	1192.6	1361.6	1402.3	1562.4
— Stamp Duties	48.0	67.4	85.9	103.9	112.2	119.5	167.0
— Motor Vehicle Duties	25.5	38.9	70.8	93.7	110.8	122.1	130.7
Capital Taxation (2)	**17.7**	**19.2**	**22.2**	**26.6**	**30.1**	**32.6**	**35.0**
— Capital Gains and Acquisitions	14.6	16.4	20.5	24.0	29.1	n.a.	n.a.
Other(3)	**4.6**	**6.8**	**8.3**	**11.4**	**17.4**	**14.5**	**13.0**
Total Tax Revenue	**2619.7**	**3314.5**	**4053.1**	**4681.4**	**5304.0**	**5581.0**	**6117.0**
(as % of GNP)	**29.1**	**30.5**	**32.7**	**35.0**	**36.7**	**36.6**	**n.a.**

(1) Budget estimates.
(2) Including Estate Duties (1980-1983), Resource Tax (1980-81), and Residential Property Tax (1983-1986).
(3) Agricultural Levies.
Source: *Budget Booklets* 1981 and successive years.

Table 4.2
Composition of Tax Revenue 1980-1986

	1980	1981	1982	1983	1984	1985	1986
				— (per cent of total) —			
Taxes on Personal Income	38.7	37.5	36.8	38.0	40.0	40.5	40.5
— Income Tax	(38.7)	(37.5)	(36.0)	(35.5)	(37.1)	(37.7)	(38.5)
Taxes on Corporate Income	5.3	6.0	5.7	4.6	4.0	3.9	4.1
Taxes on Expenditure	55.1	55.7	56.7	56.6	55.0	54.8	54.6
Capital Taxation	0.7	0.6	0.5	0.6	0.6	0.6	0.6
Other	0.2	0.2	0.2	0.2	0.3	0.3	0.2
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Table 4.1

Table 4.3
Composition of Tax Revenue, 1977-1983

	1977	1980	1983
	- (per cent of total) -		
Taxes on Personal Income(1)	27.6	32.0	29.5
Taxes on Corporate Income	4.1	4.5	3.8
Social Security Contributions(2)	13.5	14.5	16.9
Taxes on Property(3)	8.1	5.3	3.8
Taxes on Goods and Services	46.7	43.7	46.1
Total	100.0	100.0	100.0

(1) Includes Capital Gains Tax
(2) Includes Payroll Taxes
(3) Includes Rates, Stamp Duties etc.

Source: *Revenue Statistics of OECD Member Countries, 1965-1984*, OECD, Paris, 1985.

Tables 4.1 and 4.2 provide an incomplete picture of the evolution of the overall tax burden. Excluded from these tables are PRSI contributions and rates, which are widely perceived as taxes but which are not explicitly identified in the government's budgetary arithmetic. Table 4.3 shows the composition of this broader measure of tax revenue for the years 1977, 1980 and 1983. PRSI contributions provided almost 17 per cent of total tax receipts in 1983, a significant increase on the corresponding share for 1977. Of greater significance is the trend in the importance of taxes on property as a source of revenue. Such taxes provided less than 4 per cent of all tax receipts in 1983 compared with over 8 per cent in 1979 (and over 10 per cent in the early 1970s).

Although rates are not the only component of property taxes, the decline in the share of this tax category in the total provides an indication of the impact which the phased elimination of rates on domestic dwellings has had on the composition of the overall tax burden since 1977.

It is interesting to compare the composition of overall tax revenue in Ireland with the other member states of the European Community (see Table 4.4). EEC member states vary considerably in this regard and this affects the Community- wide average in respect of the shares of different tax categories in the total. Nonetheless Ireland's position presents some striking contrasts with the Community as a whole.

The share of taxes on goods and services in the total is higher in Ireland than in any other member country and is considerably in excess of the average share for the entire Community. In contrast, the share accounted for by employers' social insurance contributions is about half the Community average, with Denmark the only country with a lower share. Similar remarks

Table 4.4
Composition of Tax Revenue, International Comparisons, 1983

	Personal Income	Employees Social Security	(1) + (2)	Corporate Income	Employers Social Security	Property	Goods + Services	Other*	Total Tax Revenue as Proportion of GNP (%)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	
	— (per cent of total) —								
Belgium	35.0	10.6	45.6	6.0	20.1	1.8	26.4	0.0	45.4
Denmark	52.0	2.0	54.0	3.0	1.9	5.2	35.8	0.0	46.2
France	13.4	11.7	25.1	4.3	32.2	3.7	29.0	5.7	44.6
Germany	28.3	15.9	44.2	5.1	19.8	3.4	27.5	0.0	37.4
Greece	13.1	15.1	28.2	2.5	20.4	3.3	43.3	2.3	32.9
Ireland	29.5	5.5	35.0	3.8	9.4	3.8	46.1	1.9	39.2
Italy	27.9	7.2	35.1	9.3	28.7	2.8	23.4	0.7	40.6
Luxembourg	27.2	10.7	37.9	17.3	14.3	6.1	23.7	0.7	42.5
Netherlands	21.3	19.9	41.2	6.1	25.1	3.2	24.1	0.3	47.3
UK	27.7	8.1	35.8	10.8	9.6	12.7	29.8	1.3	37.8
Unweighted Average EC(10)	27.5	10.7	38.2	6.8	18.2	4.6	30.9	1.3	41.4

*Includes payroll taxes other than socal insurance.
Source: *Revenue Statistics of OECD Member Countries 1965-1984*, OECD, Paris, 1985.

apply to employees' social insurance. The share of taxes on corporate income is also significantly lower than in the Community as a whole and is less than in every other member state except Denmark and Greece.

In respect of the remaining sources of tax revenue the Irish situation is not markedly different from that of the Community. The importance of property taxation is somewhat lower than on average throughout the EC. In the case of taxes on personal income the range of experience is especially wide: its share in the total varies from 13 per cent in Greece to 52 per cent in Denmark. Ireland's share at 29.5 per cent is slightly above the Community average of 27.5 per cent.

3. CAPITAL TAXATION

In Tables 4.1 and 4.2 capital taxation is taken to include Capital Gains Tax (CGT), Capital Acquisitions Tax (CAT), Estate Duties (up to 1983), the Resource Tax (1980 and 1981) and the existing Residential Property Tax (RPT). Defined thus, capital taxation receipts have increased by about £16m since 1980. The most significant elements have been CGT and CAT, receipts from which amounted to £14.4m in 1980 and £31m in 1985. The share of capital taxation in total tax receipts has declined slightly since 1980.

Table 4.5
The Share of Capital Taxes in Total Tax Receipts, EC10, 1983

	Capital Gains Tax	Estate, Inheritances and Gift Taxes — (per cent of total) —	Total Capital Taxes
Belgium	—	0.66	0.66
Denmark	0.04	0.38	0.42
France	0.04	0.58	0.62
Germany	—	0.23	0.23
Greece	—	1.19	1.19
Ireland	0.15	0.28	0.43
Italy	0.91	0.18	1.09
Luxembourg	—	0.31	0.31
Netherlands	0.04	0.38	0.42
UK	0.74	0.50	1.24
EC10	0.19	0.47	0.66

Source: *Revenue Statistics of OECD Member Countries, 1965-1984*, OECD Paris, 1985.

Table 4.5 compares the importance of capital gains tax and capital acquisitions tax (taxes on estates, gifts and inheritances) as a source of tax revenue in Ireland with the other member states of the European Community. In no case do these taxes provide a substantial source of revenue. Their share in the total* ranges from 0.23 per cent in Germany to 1.24 per cent in the UK. The figure for Ireland is at the lower end of this range and is somewhat below the simple average for the Community as a whole.

*Total tax revenue in this case includes social insurance contributions and all taxes on property including rates.

In the period since 1980 there have been a number of important changes in CGT and CAT in Ireland. In 1982 the whole system of taxing capital gains was overhauled. The pre-existing tapering relief was abolished. The normal rate of CGT was increased from 30 to 40 per cent and higher rates of 50 and 60 per cent respectively were instituted for gains realised within 2-3 years and one year. There was also a four-fold increase in the exemption thresholds in respect of small gains: from £500 to £2,000 for single people and £1,000 to £4,000 for married couples. Capital gains realised from the disposal of development land were subjected to tax at 50 or 60 per cent depending on the time period within which the gains were realised. The base for CGT was widened somewhat in 1984 on foot of its extension to the receipts from the sale of a principal private residence to the extent that they are deemed to exceed the property's current use value. In the 1986 Finance Bill two new rates of 35 and 30 per cent were introduced in respect of long term gains, and favourable tax treatment for disposals of shares on the newly-founded Smaller Companies Market of the Stock Exchange was introduced.

Prior to 1982, only gifts and inheritances acquired by an individual from the same disponer were added together for purposes of capital acquisitions tax. The Budget of 1982 provided that all such acquisitions from whatever source would be added together to determine tax liability.

In 1984 further reforms were instituted in relation to CAT including the introduction of a common table of tax rates ranging from 20 to 55 per cent. Differential thresholds for CAT liability for different degrees of relationship were retained. These thresholds have not been increased for a number of years. A once-off charge of 3 per cent was imposed on discretionary trusts in certain circumstances. This charge was supplemented in 1986 by a 1 per cent annual charge on property in trust. Since 1984 transfers between spouses have been exempt from CAT.

Despite these changes the yield from CGT and CAT together has expanded very modestly in relation to expectations expressed at the time the measures were introduced. For example, it was predicted at the time the 1982 changes in CGT were announced that tax receipts would consequently be £11m higher in 1983. In the event receipts from CGT in 1983 were no more than £3.5m higher than in 1982. Similarly when the Residential Property Tax was introduced in 1983 the Minister for Finance indicated that he was making provision for a consequential revenue yield of £10m. In the event the yield from RPT in 1983 was just £1m and the yield in 1985 was little more than this.

The main explanation offered for the lower than expected capital tax yield is that the recession has reduced the volume of capital transactions and eroded the capital tax base. This explanation is valid in part but regard must also be had to the relevant features of the tax code and how they have contributed to and/or accelerated the erosion of the base. This is particularly pertinent in the case of RPT.

Liability for RPT is assessed with reference to the property-owner's income as well as the property value. Both liability thresholds are set at relatively high levels. This in itself narrowly delimits the base on which the tax is levied. Moreover the existence of an income threshold raises the question of equitable treatment as between PAYE and Schedule D taxpayers. Furthermore the mechanism whereby the property value threshold for RPT is automatically indexed gives rise to the erosion of the tax base in conditions where house prices generally are falling, as they have been in recent years.

In relation to CGT and CAT it should also be noted that, as in the case of personal income tax and corporation tax, the base is narrowed by the existence of a multiplicity of exemptions and reliefs. The range of assets on which gains are exempt includes the following: (i) small gains; (ii) principal private residences; (iii) government securities; (iv) gains realised from life assurance policies and deferred annuities; (v) gains to superannuation funds. As far as exemptions from CGT are concerned the Commission on Taxation had this to say: "The equity and efficiency effects of these exemptions are not essentially different from the implications of analogous exemptions in other parts of the system of personal taxation."*

The exemption thresholds for Capital Acquisitions Tax (Inheritance Tax) are as follows:

(i) £150,000 in the case of successions involving a spouse, child or the minor child of a deceased child;
(ii) £30,000 in the case of successions involving lineal ancestors or other direct descendants;
(iii) £20,000 in the case of successions between brothers, sisters, nephews and nieces;
(iv) £10,000 in the case of other relationships between the donor and the recipient.

Transfers between spouses, as noted above, are now exempt from CAT.

*First Report of the Commission on Taxation, 1982.

4. CORPORATE TAXATION

Taxes on corporate income are projected to amount to 4.1 per cent of total tax receipts in 1986. This compares with 5.3 per cent in 1980. The fall in the share of corporation tax is greater still if the 1986 position is compared with that of 1978 or 1979 when corporation tax receipts accounted for 6.1 and 6.5 per cent respectively of the total.

An assessment of the evolution of the corporation tax yield over recent years is complicated by a number of factors. To the extent that there is a long term decline in the share of corporation tax receipts in total tax revenue, 1981 may be regarded as the watershed since it was then that the 10 per cent rate for manufacturing industry came into effect. This in itself would have led to a significant reduction in the yield. Year-to-year changes in the yield however do not permit any robust inferences to be drawn about the underlying trend. Firstly, the level of profits fluctuates. Furthermore, every budget since 1980 has included provisions which effectively brought forward the payment dates for corporation tax, thereby conferring once-off revenue gains to the Exchequer.

The corporation tax base is diminished by the existence of reliefs, allowances and exemptions in much the same way as the personal income tax base. The most important of these have been the capital allowances and, prior to the 1986 Budget, the system of stock relief.

Allowance for depreciation in determining tax liability is a common feature of corporation tax codes. In Ireland such allowance is relatively generous. The present situation is one whereby capital allowances fall into one of the following two categories:

— 'free depreciation' (i.e. the right to claim any amount up to full cost) is available on a permanent basis for plant and machinery and for owner-occupied buildings;
— (a) 100 per cent initial allowance for new plant and machinery and (b) 50 per cent initial and 4 per cent annual allowances for industrial buildings are available up to 1986.

Much concern has been expressed about the trend in the cost of capital relative to that of labour and the resultant impact on the structure of industry in Ireland and on employment. It has been argued that the combined impact of certain instruments of industrial policy and of certain features of the tax system has been to substantially increase the ratio of labour costs to the cost of capital relative to what that ratio would be in the absence of intervention (and relative to what the ratio might be if different instruments were deployed).*

*F Ruane and A John: "Government Intervention and the Cost of Capital to Irish Manufacturing Indutry", *Economic and Social Review*, October 1984.

These concerns have been acknowledged, at least implicitly, in the enactment of provisions in the corporation tax code designed to counteract this capital using/labour saving bias. Most budgets since 1977 have either introduced a new tax incentive or extended the duration of an existing scheme whose purpose was to increase employment. In 1977 a special reduced rate of corporation tax of 25 per cent was instituted for firms showing specified increases in output and employment. This scheme was renewed in every budget up to 1981. In 1982 a scheme allowing a deduction against profits for corporation tax purposes of £10 per week per additional employee was introduced. This was renewed in the budgets of 1983 and 1984 but was discontinued in 1985 on the grounds that it had not proven to be effective.

There are a number of other provisions of tax law which have the effect of reducing the tax base in respect of corporations (including financial institutions). These include the treatment of Section 84 loans, preference share financing and leasing, collectively known as tax-based lending. It is estimated that the cost to the Exchequer in terms of tax revenue foregone, arising from the operation of tax-based lending, is currently £170m per annum.*

5. PERSONAL INCOME TAX

This section examines some of the principal features of the existing system of personal income taxation from the point of view of efficiency, equity and simplicity. It then proceeds to examine the way in which the system has evolved in recent years with particular reference to the diminution of the income tax base and the concomitant erosion of the real value of the marginal tax thresholds. The section concludes with a brief analysis of the distribution of benefits arising from the more important discretionary tax allowances available under the personal income tax code.

One aspect of the income tax system which is fundamental to perceptions of inequity is the differential treatment of employees, the self-employed and farmers. As regards farmers the new Farm Tax is one which departs in several important respects from the criteria of an income tax.

The principal differences between the tax treatment of employees and the self employed are as follows:

(i) taxes and levies are deducted from employee income at source but not in the case of income from self-employment;
(ii) liability for tax on self-employed income is assessed, and due taxes collected in arrears. In the case of employees, assessment and collection are carried out on a current year basis;

*Budget speech of 1986.

(iii) the expenses rule in respect of tax liability on self-employed income is significantly more liberal than for employee income;
(iv) the PAYE allowance is not available to the self-employed.

This differential tax treatment confers a number of advantages on self-employed persons relating principally to the discretion which they enjoy in determining their tax liability, making their remittances of due taxes, and complying with the tax collection and enforcement agencies.

(i) Marginal Tax Rates

The most striking feature of the present income tax system is the fact that high marginal tax rates (MTRs) are reached at relatively low levels of income, especially by single people. Table 4.6 sets out the evolution of MTRs across the income spectrum for single and married persons. At present a single person reaches an MTR (inclusive of PRSI contributions and income levies) of 55.5 per cent at an income level which is little more than two-thirds of average industrial earnings,* and progresses to an MTR of 65.5 per cent in the vicinity of the industrial average. His/her married counterpart, is liable to tax at a marginal rate of 42.5 per cent over the income range 52 to 126 per cent of the industrial average.

Table 4.6
Marginal Tax Rates(1) for PAYE Employees by Income Range and Marital Status (1986-87)

Income Range (% of AIE)(2)	Marginal Tax Rate %
— Single —	
0 — 26.9	5.5 (0.0)
26.9 — 31.1	40.5 (35.0)
31.1 — 69.2	42.5 (35.0)
69.2 — 94.4	55.5 (48.0)
94.4 —126.1	65.5 (58.0)
126.1 —132.4	64.5 (58.0)
132.4 +	59.0 (58.0)
— Marrieds —	
0 — 44.7	5.5 (0.0)
44.7 — 47.7	7.5 (0.0)
47.7 — 51.7	67.5 (60.0)
51.7 —126.1	42.5 (35.0)
126.1 —129.5	41.5 (35.0)
129.5 —132.4	54.5 (48.0)
132.4 —180.0	49.0 (48.0)
180.0+	59.0 (58.0)

(1) Marginal tax rates are inclusive of PRSI and the two levies. The figures in parentheses are marginal rates of income tax.
(2) Average male earnings in manufacturing industry, estimated at £11,100 p.a. in 1985-86.
Source: NESC Secretariat.

*Average industrial earnings are represented throughout the text by average male earnings in manufacturing industry. These are significantly higher than the average earnings of all workers in manufacturing industry and are unlikely to be representative of earnings levels in the services sector.

In addition to illustrating the severity of the tax treatment of single persons relative to their married counterparts, Table 4.6 also points to the existence of several anomalies in the structure of MTRs. Marginal tax rates do not increase uniformly with income. Thus for example, in the case of single persons, the MTR actually declines over ranges of income in excess of the industrial average. In the case of married persons such anomalies are even more prevalent.

These anomalies are caused by the following factors:

(i) the existence of the general exemption limits for income tax and the system of marginal relief which these limits necessitate;
(ii) the fact that the Youth Employment Levy and the Health contribution only become payable at income levels corresponding to the relevant Medical Card eligibility thresholds;
(iii) the existence of income ceilings of £14,000 and £14,700 p.a. demarcating liability for the Health and PRSI contributions respectively.

The interaction of these complex and *ad hoc* exemption thresholds and ceilings has implications for equity, efficiency and simplicity. It inhibits a clear understanding of the tax system on the part of taxpayers and creates difficulties for the agencies responsible for collecting revenue. In the case of low income married taxpayers with a large number of children, the structure of MTRs may exacerbate the problem of poverty traps whereby increases in gross income are converted into reductions in disposable income over certain income ranges.

A most important source of concern with the existing system of income and income-related tax rates is its likely impact on the labour market. In NESC Reports No. 75 and 79 the Council expressed the fear that high marginal tax rates have a dampening effect on enterprise and an adverse effect on competitiveness. Although empirical research on the employment impact of the present tax system has not, in general, been conclusive and does not permit any precise quantification, most of the indicators point in an unfavourable direction.

Aside from the likely impact on employment there are other reasons for considering the present tax system undesirable. One such reason has to do with considerations of equity. For example, as already indicated, single PAYE workers earning in the vicinity of the industrial average face a marginal tax rate of 65.5 per cent whereas persons whose income is derived from capital gains pay tax at a flat rate of 40 per cent or less.

Another aspect of the existing income tax structure which raises questions in relation to equity concerns the fact that the higher marginal tax rates are reached at low income levels because, *inter alia*, the tax base has been

increasingly eroded by the existence of certain discretionary reliefs the benefits attaching to which are regressively distributed.

(ii) Average Tax Rates

Liability to tax at high marginal rates gives rise to high average rates of tax. Table 4.7 compares the tax position of single and married employees on average industrial earnings in Ireland with the other member states of the European Community in 1983. On the basis of total deductions as a proportion of gross income, a single worker earning the industrial average in Ireland was significantly worse off than his/her counterpart in every other member state except Denmark, and considerably worse off than his/her European counterparts on average.

Table 4.7
The Tax Position of an Employee on Average Industrial Earnings, 1983

	Deductions as a Proportion of Gross Income	
	Single	Married
	(%)	(%)
Belgium	20.5	12.5
Denmark	29.6	23.8
France	8.4	0.4
Germany	17.1	10.5
Ireland	24.6	14.0
Italy	13.6	11.2
Luxembourg	17.4	2.7
Netherlands	12.0	9.6
UK	22.4	18.1
Unweighted Average (EC 9)	18.4	11.4

Source: *The Tax/Benefit Position of Production Workers 1979-1983*, OECD, Paris 1984.

The position of the married employee on average industrial earnings in Ireland was somewhat less unfavourable. Here the Irish person was worse off than his/her counterpart in all other member states except Denmark and the UK. In 1983 a married person earning the industrial average saw 14 per cent of his/her gross income deducted in direct taxes compared with 11.4 per cent for the Community as a whole. The corresponding proportions for single persons were 24.6 and 18.4 per cent respectively.

(iii) Gross Labour Costs and Disposable Employee Income

In the 1986-87 tax year the average earnings before tax of a male worker in manufacturing industry are estimated at £11,100. On this sum the employer

is liable for PRSI contributions at the rate of 12.2 per cent yielding a gross cost to the employer of £12,454. The employee is liable for PRSI (inclusive of levies) at the rate of 7.5 per cent, or £833 in absolute terms. The employee's income tax liability depends on marital status and number of dependents. A single person claiming no more than statutory tax allowances faces an income tax bill of £3345, yielding a disposable income of £6922. A married person claiming the statutory allowances pays tax of £2140 and has a disposable income of £8127.

The position, therefore, is that in the case of a single person whose gross income equals the industrial average, gross labour costs are 80 per cent higher than disposable employee income. In the case of a married person gross labour costs are 53 per cent higher than disposable income. Table 4.8 sets out the corresponding ratios for employees earning two thirds and one-and-a-half times average earnings for each tax year since 1977-78. Taking the period as a whole the ratio of gross labour costs to disposable employee income has increased at each earnings level selected, and for both single and married taxpayers. However, the ratio has increased faster for singles than for marrieds and faster for high earnings than low earnings.

Table 4.8
Ratio of Gross Labour Costs to Disposable Employee Income(1)

	Single			Married		
	2/3xAIE	AIE	1½xAIE	2/3xAIE	AIE	1½xAIE
1977-78	1.495	1.508	1.548	1.387	1.431	1.476
1978-79	1.494	1.508	1.565	1.327	1.377	1.442
1979-80	1.452	1.553	1.653	1.264	1.403	1.489
1980-81	1.444	1.550	1.656	1.266	1.391	1.456
1981-82	1.464	1.567	1.747	1.290	1.427	1.527
1982-83	1.486	1.658	1.871	1.304	1.451	1.524
1983-84	1.548	1.757	2.089	1.354	1.513	1.658
1984-85	1.581	1.815	2.124	1.392	1.546	1.665
1985-86	1.594	1.835	2.120	1.405	1.558	1.676
1986-87	1.567	1.800	2.056	1.384	1.532	1.653

(1) AIE: Average male earnings in manufacturing industry.
Source: NESC Secretariat.

In general the sharpest increases in the ratios occurred in the years 1981-82 to 1983-84, largely because of the failure to index the marginal rate bands in the respective budgets but also because of the increase in PRSI rates in 1982 and the introduction of two new imposts: the Youth Employment Levy (in 1982) and the temporary income levy (in 1983). The ratios have been reduced somewhat on foot of the 1986 Budget.

Table 4.9
Distribution of Taxpayers by Marginal Rate Band, 1986-87

Marginal Tax Band	Single (1)		Married		Total	
	'000	%	'000	%	'000	%
35%	239.0	50.2	229.6	59.2	468.6	54.2
48%	125.2	26.3	80.1	20.6	205.3	23.8
58%	112.0	23.5	78.5	20.2	190.5	22.0
of which marginal tax relief	(8.1)	(1.7)	(23.1)	(6.0)	(31.2)	(3.6)
Total	476.2	100.0	388.2	100.0	864.4	100.0

(1) Including widows and widowers.
Source: Revenue Commissioners.

Table 4.8 points to the existence of a substantial 'wedge' between the measures of wages which are of principal relevance from the respective viewpoints of employers and employees and also indicates that this 'wedge' has grown rapidly in recent years. Notwithstanding the absence of conclusive empirical research on this question, it must be accounted unlikely that the patterns described in the table have evolved without seriously impacting on the labour market.

(iv) Distribution of Taxpayers by Marginal Rate Band

The number of taxpayers paying tax at rates above the standard rate has increased rapidly in recent years. In 1973 8,000 taxpayers or 1% of the total were in this position. The corresponding figures for the tax years 1981- 82, 1982-83 and 1983-84 were as follows: 132,000 (14.8 per cent); 292,000 (32.3 per cent) and 363,000 (40.1 per cent) respectively. In 1986-87 it is estimated that 365,000 income tax payers (excluding those on marginal relief) will be liable at rates in excess of the standard rate. This figure represents about 42 per cent of the total.

Table 4.9 sets out the estimated distribution of taxpayers by marginal rate band in 1986-87. A significantly higher proportion of single than married taxpayers is liable at rates in excess of the standard rate: 50 per cent compared with 41 per cent. Excluding those covered by the marginal relief scheme the proportion of single taxpayers on the top rate is 22 per cent. The corresponding figure for married persons is just over 14 per cent.

(v) Evolution of Marginal Rate Bands

Tables 4.10 and 4.11 illustrate the evolution of marginal rate bands and exemption limits for single and married taxpayers respectively over the period 1977-78 to 1986-87. For each year the income level at which the relevant marginal tax rates became applicable is shown in terms of 1985-86 purchasing power. The results are striking and help to explain the dramatic increase in the proportion of taxpayers liable at rates above the standard rate. A comparison of the first and final columns of each table indicates the extent to which marginal rate thresholds have in general been eroded in real terms.

A few key examples serve to illustrate what has been happening. In respect of single taxpayers availing of statutory allowances only, the real income level at which tax becomes payable at the standard rate of 35 per cent will in 1986-87 be just over one half of what it was in 1977-78. In 1986-87 the real income levels at which tax becomes payable at the higher rate (48 per cent) and at the top rate of 58 per cent, will be 56 per cent and 52 per cent respectively of the corresponding 1977-78 levels. The case of married taxpayers manifests a somewhat less dramatic erosion in the real value of tax thresholds.

The data presented in Tables 4.10 and 4.11 show that the existing structure of marginal rate bands is due in large part to the failure of successive budgets

Table 4.10
Evolution of Marginal Rate Bands, 1977-78 to 1986-87 — Single

Marginal Tax Rate (%)	Income Level at which Marginal Tax Rate became Applicable (£s of 1985-86 purchasing power)										
	1977-78	1978-79	1979-80	1980-81	1981-82	1982-83	1983-84	1984-85	1985-86	1986-87
20	1710	1897	—	—	—	—	—	—	—	—
25	2995	3085	2313	2630	2482	2964	2664	—	—	—
35	5566	5460	4596	4366	3929	4218	3804	2848	2786	2899
45	13278	12586	10820	11311	10441	7982	7225	7090	—	—
48	—	—	—	—	—	—	—	—	7286	7462
50	17134	16239	13932	—	—	—	—	—	—	
55	—	—	—	14783	13336	10492	9505	9211	—	—
58	—	—	—	—	—	—	—	—	—	10181
60	19704	18614	16006	18255	16230	13001	11786	11332	10086	—
65	—	—	—	—	—	—	14066	13453	—	—
Exemption Limit	—	—	—	2950	2894	2760	2737	2651	2650	2573

Source: NESC Secretariat.

Table 4.11
Evolution of Marginal Rate Bands, 1977-78 to 1986-87 — Married

Marginal Tax Rate (%)	Income Level at which Marginal Tax Rate became Applicable (£s of 1985-86 purchasing power)									
	1977-78	1978-79	1979-80	1980-81	1981-82	1982-83	1983-84	1984-85	1985-86	1986-87
20	2828	4109	—	—	—	—	—	—	—	—
25	4113	5297	4627	4566	4096	4783	4317	—	—	—
35	6684	7672	6909	8038	6990	7292	6598	4757	4686	4841
45	14396	14798	13133	21927	20015	14821	13439	13241	—	—
48	—	—	—	—	—	—	—	—	13686	13967
50	18252	18361	16245	—	—	—	—	—	—	—
55	—	—	—	28872	25803	19839	18000	17483	—	—
58	—	—	—	—	—	—	—	—	—	19404
60	20823	20736	18320	35816	31592	24858	22561	21724	19286	—
65	—	—	—	—	—	—	27122	25966	—	—
Exemption Limit	—	—	—	5902	5789	5521	5473	5302	5300	5145

Source: NESC Secretariat.

to index tax bands. In the case of single people the consequent real erosion of rate band thresholds has occurred more or less continuously since 1977-78 but was accelerated by the budgets of 1981 through 1984. In the case of married taxpayers the erosion of rate band thresholds dates from the 1980-81 tax year. There has been some improvement in the situation in the budgets of 1985 and 1986.

In the period since their introduction exemption limits have declined only modestly in terms of their purchasing power equivalent: in 1986-87 the real value of the exemption limits will be 90 per cent of what it was in 1980-81. At the same time the real income level at which tax liability commences for persons of each marital status has increased substantially. The rapid increase in the number of taxpayers liable to tax at the higher marginal tax rates in recent years is not due therefore to the failure of personal tax allowances to keep pace with inflation.

(vi) Evolution of the Income Tax Base

A very wide array of allowances exemptions and reliefs exists in respect of personal income tax liability. Taken together they substantially reduce the income tax base. Available estimates for 1985-86 indicate that income totalling £4066m was exempted from tax on foot of these deductions. This amounted to the equivalent of almost 80 per cent of the income tax base. Included in the above figure of £4066m is some £2240m exempted on foot of the basic personal allowances. It is useful to allocate the balance of £1826m between the following categories:*

(i) Secondary Allowances and Exemptions, i.e. income exempted because of the recipient's dependency obligations, age, or physical incapacity, or because of the operation of the exemption limits;

(ii) Discretionary Reliefs, i.e. income exempted because of the way in which income is earned or disposed of and,

(iii) Other allowances, i.e. income exempted in order to explicitly compensate the recipients for the way in which other aspects of the taxation system operate.

The amount of income exempt under these three categories in 1985-86 was £650m, £495m and £681m respectively. The corresponding amounts of tax revenue foregone were £233m, £209m and £296m respectively — a total of £738m.

*The precise composition of each of these categories is set out in the explanatory notes appended to Table 4.13.

Table 4.12
Estimates of Income Under Various Headings, 1981-82 and 1985-86[1]

	1981/82 Diminution of Base (£m)	1985/86 Diminution of Base (£m)	1985/86 Tax Foregone (£m)
Married Person's Allowance	840	1,341	553
Single Person's Allowance	485	810	355
Widowed Person's Allowance	60	89	36
Single Parent Allowance	10.5	18	7
Widowed Parent	n.a.	11	4
Child Allowance	145	77	31
Nuptial Allowance	2.5	abolished	—
Age Allowance	8	5	2
Housekeeper Allowance	1.5	abolished	—
Dependent Relative Allowance	12	4.5	2
Blind Person's Allowance (1971)	0.2	0.4	0.2
Person Employed to care for Incapacitated Individual (1969)	2.5	1.3	0.5
Age Exemption (1977)	30	121	42
General Exemption (1980)	118	412	144
Interest relief	147	337	132
Medical Insurance (1955)	18	71	30
Life Assurance	27	66	28
Residence-related relief	4.5	abolished	—
Health Expenses (1967)	3	4	2
PAYE Allowance (1980)	520	489	214
PRSI Allowance (1982)	—	192	82
Premiums under permanent health benefit schemes (1979)	1	0.7	0.3
Preferential loans	20	11	5
Artists Relief	1.5	1.5	0.7
Covenanted subscriptions	5	4	2
Deposit interest (1956)	n.a.	20	9
Total Exempt Income	2,462.2	4,086.4	
Income Tax Base	3,941.3	5,321.6	
Exempt Income as proportion of Base (%)	62.4	76.8	

(1) Year numbers in parentheses indicate the dates on which certain reliefs were introduced.

Source: Revenue Commissioners

Table 4.12 sets out estimates of income exempted under each individual allowance, exemption and relief for the tax years 1981-82 and 1985-86 and provides estimates of the amount of tax revenue foregone in each case in 1985-86. Table 4.13 aggregates the estimates of exempt income in 1981-82 and 1985-86 under the four categories distinguished above. It can be seen from Table 4.13 that the category in respect of which the most rapid increase occurred was Discretionary Reliefs where exempt income more than doubled between 1981- 82 and 1985-86.

Table 4.13
Estimates of Income Exempted by Category of Exemption 1981-82 and 1985-86

	1981-82		1985-86	
	£m	%	£m	%
Basic Allowances(1)	1385	56.3	2240	55.1
Secondary Allowances and Exemptions(2)	330.2	13.4	650.2	16.0
Discretionary Reliefs(3)	227	9.2	495.2	12.2
Other(4)	520	21.1	681	16.7
Total(5)	2462.2	100.0	4066.4	100.0
of which:- introduced since 1977(6)	669	27.2	1214.7	29.9

(1) Married, Single and Widowed Person's Allowances.
(2) Allowances in respect of Single Parent, Widowed Parent, Child, Age, Housekeeper, Dependent Relative, Blind Persons, and Employed person taking care of Incapacitated Individual, Nuptial Allowance, Age Exemption Limit, General Exemption Limit.
(3) Reliefs in respect of Interest, Medical Insurance, Life Assurance, Permanent Health Insurance, Health Expenses, Residence-related Expenses and Artists Earnings, exemption in respect of Preferential Loan and Covenanted Subscriptions.
(4) PAYE and PRSI Allowances.
(5) Excluding deposit interest exemption.
(6) Age Exemption Limit, General Exemption Limits, PAYE Allowance, PRSI Allowance and relief for premiums under permanent health benefit schemes.

Source: NESC Secretariat.

Within this category, income exempt on foot of interest relief increased from £147m to £337m, notwithstanding the significant restrictions imposed on this relief in the budget of 1983, medical insurance premium relief from £18m to £71m and, life assurance premium relief from £27m to £66m. Almost £200m of tax revenue was foregone in 1985-86 on foot of the operation of these three reliefs alone.

Within the category of Secondary Allowances and Exemptions the single most significant item is the general exemption limit which reduced the tax base by £412m in 1985-86 (£118m in 1981-82) and resulted in tax foregone of £144m. The age exemption limit diminished the tax base by £121m in 1985-86 (£30m in 1981-82) and reduced tax revenue by £42m.

The PAYE and PRSI allowances, both introduced as *ad hoc* responses to taxpayers' disaffection with certain aspects of the taxation system, together resulted in a diminution of £680m in the 1985-86 tax base, compared with £520m in 1981-82, and a reduction of almost £300m in tax revenue in the latest tax year.

In the last ten years many new categories of exempt income have been created by Government taxation policy including the following:

(i) the introduction of the age exemption limits in 1977;
(ii) the introduction of relief for premiums paid under permanent health benefit schemes in 1979;

(iii) the re-introduction of the general exemption limits in 1980;
(iv) the introduction of the Schedule E (PAYE) tax allowance in 1981;
(v) the introduction of the PRSI allowance in 1982;
(vi) the introduction of tax relief in respect of residence related expenditure in 1979 (abolished in 1983);
(vii) the introduction of relief for rent on private tenancies to persons aged 65 years and over in 1982;
(viii) the doubling of the exemption threshold in respect of deposit interest for elderly taxpayers in 1985;
(ix) the introduction of the Business Expansion Scheme in 1984;
(x) the introduction of Section 23 relief in 1981.

The extent to which the tax base was diminished because of the existence of these exemptions taken together was £1215m in 1985-86, compared with £669m in 1981-82.* The corresponding amount of tax revenue foregone in 1985-86 is estimated at £482m.

Table 4.14
Evolution of Basic and Secondary Allowances and Exemption Limits, 1981-82 and 1986-87

	1981-82 Nominal (£)	1986-87 Nominal (£)	Real (1981-82 prices)(1) (£)	Change in Real terms 1981-82 to 1986-87 (%)
Married Person's Allowance	2230	4000	2706	+21.3
Single Person's Allowance	1115	2000	1353	+21.3
Widowed Person's Allowance	1185	2500	1691	+42.7
Widowed Parent Allowance	650	1500	1051	+56.2
Single Parent Allowance	650	2000	1353	+108.2
Child Allowance(2)	195	—	—	—
Age Allowance — Single	80	200	135	+68.8
— Married	180	400	271	+50.6
Dependent Relative Allowance	95	110	74	-22.0
Blind Person's Allowance	400	600	406	+1.5
Person Employed to take care for Incapacitated Individual	500	2500	1691	+238.2
Age Exemption Limit(3) -65+	4600	6300	4263	-7.3
-75+	5600	7350	4973	-11.2
General Exemption Limit(3)	4000	5300	3586	-10.3

(1) It is estimated that the cumulative increase in the Consumer Price Index over the period was 48 per cent.
(2) Abolished in the 1986 Budget.
(3) Married couples only.
Source: NESC Secretariat.

*These estimates are in respect of the first five items listed since these are the only items for which separately identifiable data are available for both 1981/82 and 1985/86.

Table 4.14 provides details on the evolution of basic and secondary allowances and exemption limits over the period since 1981-82. The first and second columns of data set out the nominal value of each allowance and exemption limit in 1981-82 and 1986-87 respectively. The third column provides estimates of their value in terms of 1980- 81 purchasing power which permits a computation of the changes in real terms.

The table reveals that the nominal value of all the basic personal allowances have increased at a faster rate than inflation since 1981-82: the real value of the married and single persons' allowances has accordingly increased by 21 per cent and the widowed person's allowance by 43 per cent. The real value of the secondary allowances in respect of single parents,widowed parents, and persons employed to take care of incapacitated individuals have increased by 56, 108, and 238 per cent respectively. The real value of the exemption limits has declined.

(vii) The Distribution of Discretionary Allowances

The question of equity is particularly pertinent in relation to the existence of discretionary allowances. On several occasions in the past NESC has expressed concern about the distribution of the benefits attaching to such allowances. This concern is provoked by the perception that it is the higher income groups who are best positioned to take advantage of the reliefs, and the fact that the reduction in tax liability which follows from a given deduction from taxable income increases with income.

Table 4.15 sets out the data in respect of the distribution of discretionary tax reliefs in 1982-83. It is clear from the table that in respect of both single and married taxpayers, the average amount by which taxable income was reduced on foot of the discretionary allowances (interest relief, life assurance and medical insurance premiums relief), increased markedly with income.* It is even more the case that the actual reductions in tax liability generated by the reliefs increased in the same way.

The data are four years old and, as pointed out above, the overall scale of utilisation of the reliefs in question has grown very considerably in the intervening period. It is not known whether the pattern of take-up and the distribution of associated benefits has changed significantly. However, it is unlikely that such changes, if they have taken place, would materially alter the conclusions drawn.

*Up to £30,000 in the case of single, and £40,000 in the case of married persons.

Table 4.15
The Distribution of Discretionary Tax Allowances, 1982-83(1)

Income Range (£)	Singles(2) Average Amount of Deductions (£)	Singles(2) Average Reduction in Tax Liability (£)	Marrieds(3) Average Amount of Deductions (£)	Marrieds(3) Average Reduction in Tax Liability (£)
2 — 3,000	18	5	132	—
3 — 4,000	37	13	135	—
4 — 5,000	59	21	208	52
5 — 6,000	75	26	295	74
6 — 7,000	109	49	356	125
7 — 8,000	140	63	415	145
8 — 9,000	200	110	486	170
9 — 10,000	295	162	567	199
10 — 12,500	369	221	709	248
12.5 — 15,000	452	271	807	363
15 — 17,500	503	302	917	505
17.5 — 20,000	523	314	1011	556
20 — 25,000	595	357	1261	757
25 — 30,000	720	432	1295	777
30 — 35,000	666	400	1338	803
35 — 40,000	609	365	1439	864
40 — 50,000	569	341	1414	848
50,000+	554	332	1478	887

(1) The averages are defined across all the taxpayers in each income range and not just those taxpayers claiming the reliefs.
(2) Single Males.
(3) Married, wife not earning.
Source: NESC Secretariat.

6. TAX EVASION, AVOIDANCE AND COLLECTION

The tax base is eroded by the operation of factors other than allowances, reliefs and exemptions. It is also diminished by the existence of tax evasion. Moreover, tax revenues are reduced by the failure to collect taxes once liability has been determined.

The scale of tax evasion cannot be estimated with any precision. However, there exists some direct evidence on the magnitude of the problems: the results of PAYE and VAT audits conducted by the Revenue Commissioners; new cases of persons liable for tax but not previously on record identified by the Revenue's Special Enquiry Units; back duty settlements for Income Tax and Corporation Tax; and, data on Customs and Excise offences.

Most of the data evince an increasing trend in recent years. However this direct evidence is available only in respect of cases where the Revenue Commissioners have been successful in detecting tax defaults and in bringing the offenders to book. It is not clear therefore what the existing data imply about the extent or scale of the problem. Nevertheless in their Fifth Report the Commission on Taxation arrived at the conclusion that tax evasion results in serious revenue loss.

It is useful to distinguish between two broad categories of black economy activity: individuals/businesses who are operating wholly within the unrecorded economy and individuals who supplement their taxed income by taking on casual or irregular work. Within the first category, it is probable that most operators at present in the black economy consist of small marginal enterprises. It is unlikely that the tax involved would be as high in proportion to income as the yield from those already in the tax net. Within the second category however it is likely that the supplementary income of the bulk of the tax evaders would otherwise be liable at the 48 and 58 per cent rates of tax. It is probable therefore that there would be a relatively large tax loss involved under this heading.

The tax collection system has deteriorated to such an extent that the Commission on Taxation were moved to remark that it had reached the point of near break-down. The Commission's conclusions on the matter are worth quoting at some length:

"We conclude that the enforcement of collection is in a very sorry state. The system is incapable of processing the large number of cases each year and the situation is deteriorating. The reasons for this are many. Non-compliance by taxpayers is having serious effects down the line to collection and enforcement so that too many cases for enforcement are based on estimates and are not actual amounts due. The Revenue Commissioners have attempted to deal with the problems of non-compliance in the submission of returns by using the enforcement agencies. The division of responsibility for collection between the

Table 4.17
Revenue Collected by County Registrars/Sheriffs as a Proportion of the Face Value of Certificates, 1980 to 1984

Year	Sheriff			Co. Registrar			Total	
	(1) Face Value of Certificates	(2) Revenue Collected	(2) as % of (1)	(1) Face Value of Certificates	(2) Revenue Collected	(2) as % of (1)	Face Value of Certificates	Revenue Collected
Year	£m	£m		£m	£m	£m	£m	£m
1980	76.6	12.5	16.3	81.8	8.5	10.4	158.4	21.0
1981	99.0	12.8	12.9	81.7	9.1	11.1	180.7	21.9
1982	155.1	16.3	10.5	114.7	8.7	7.6	269.8	25.0
1983	298.2	20.0	6.7	302.0	10.7	3.5	600.2	30.7
1984	312.7	21.4	6.8	217.7	10.7	4.9	530.4	32.1

Source: Fifth Report of the Revenue Commissioners.

Revenue Commissioners and the Department of Justice, with the resulting lack of accountability, has led to the enforcement system becoming more inefficient and ineffective".

Tables 4.16 and 4.17 provide some indication of the scale of the problem in relation to tax collection and enforcement. The data in the tables indicate quite clearly that the magnitude of the problem has increased quite dramatically in recent years and that the number of uncleared cases has increased progressively. The face value of certificates for unpaid tax issued to county registrars and sheriffs was £530m in 1984 compared with £158m in 1980. At the same time revenue collected as a proportion of the face value of certificates has declined precipitously from 13.3 per cent in 1980 to just 6 per cent in 1984.

Table 4.16
Cases on Hands of County Registrars/Sheriffs, 1981 and 1983

	Number of Cases		Face Value of Certificates	
	1981	1983	1981	1983
			£m	£m
Income Tax	22,080	36,835	25.7	82.6
Corporation Tax	5,446	8,406	14.4	37.0
PAYE/PRSI	9,013	34,894	14.9	98.3
VAT	16,150	34,420	30.3	81.2
Total	52,689	114,555	85.3	299.1

Source: Fifth Report of the Commission on Taxation.

The existence of tax evasion and collection problems raises fundamental questions of equity in two dimensions. In the first place the consequent revenue loss which must be made good has to be borne by taxpayers who do not default and who comply with the requirements of the tax collection and enforcement systems. In the second place the existing assessment and collection mechanisms are capable of systematic abuse and exploitation.

In general, persons covered by the PAYE system have little opportunity for tax evasion and have no discretion in complying with the collection and enforcement mechanisms. In contrast the self-employed, including farmers, have opportunities to evade tax and enjoy considerable discretionary power when it comes to compliance. The self-employed are also at a relative advantage when it comes to the determination of tax liability because of the greater discretion they enjoy on foot of the treatment of expenses for tax purposes. The attractiveness of evading tax for those who have opportunities to do so is enhanced considerably by the perceived probability of being detected. The attractiveness of frustrating the collection and enforcement procedures is further increased by the poor performance of the relevant state agencies in recent years.

PART II: OUTLOOK

5

PROSPECTS FOR ECONOMIC GROWTH 1986-1990

1. INTRODUCTION

In this chapter the prospects for growth in the Irish economy over the period to 1990 are assessed. This assessment is carried out against the background of the likely evolution of the international economic environment over the next five years, in particular the prospective growth in the output of industrial countries and in trade volumes amongst our main trading partners in the aftermath of the recent sharp decline in oil prices.

The assessment is based on the general assumption that the broad thrust of government policies currently in place will remain essentially unchanged in the period to 1990. This permits the question of desirable changes in policy to be brought more sharply into focus, as is done in the third part of this report. In addition, some indication of how the domestic economy is likely to respond to the expected upturn in international economic activity permits an assessment to be made of the extent to which the two most important problems currently confronting the economy, namely the level of unemployment and the major imbalance in the public finances, might be ameliorated under present policies. Accordingly the implications for employment and the public finances of the medium-term prospects for output growth are drawn out in the following chapter.

The content of the present chapter is organised as follows. Section 2 examines the medium-term outlook for the international economy drawing on the most recently published forecasts of the IMF. Section 3 contains a general discussion of the channels through which the recent sharp fall in oil prices will influence the course of domestic economic activity in the coming years. Section 4 reviews the short-term outlook for the Irish economy. Section 5 and 6 set out a more long-term overview of growth prospects for the exposed and sheltered sectors of the Irish economy respectively. In Section 7 the foregoing material is brought together into an assessment of medium-term prospects for overall economic growth.

2. PROSPECTS FOR THE INTERNATIONAL ECONOMY

There was a pronounced slowdown in the pace of world economic activity in 1985. According to the IMF* the industrial countries as a group experienced real GNP growth of about 2.8 per cent compared with 4.8 per cent in 1984 while the volume of world trade increased by less than 3 per cent compared with 9 per cent achieved in 1984. The deceleration of economic growth was particularly marked in the US where GNP expanded by 6.5 per cent in 1984 but by only 2.2 per cent in 1985.

At the same time other, favourable factors emerged during 1985. Inflation, as measured by the GNP deflator, declined further in the industrial countries from 4.3 per cent in 1984 to 3.9 per cent in 1985 (see Table 5.1). Nominal interest rates fell more sharply: the 6-month LIBOR rate declined from 11.3 per cent to 8.6 per cent between 1984 and 1985. Accordingly there was a significant reduction in real interest rates in most industrial countries, the UK and Japan being the principal exceptions.

The passage of the Gramm-Rudman-Hollings Act in December 1985 commits the US Administration to implementing a regime of fiscal retrenchment which is likely to see a significant reduction in the US budget deficit between now and 1991.** This should impact favourably on the international economic environment through, *inter alia*, a reduction of the pressure on real interest rates. It should also pave the way for more balanced world-wide economic growth through a reduction in the large deficit on the current account of the US balance of payments, as should the recent real depreciation of the US dollar against the other major currency blocs.

Together, these favourable developments suggest that the international economy may be poised on the threshold of renewed balanced and non-inflationary growth. From the point of view of the industrial economies this prospect is enhanced by the sharp fall in oil prices which has occurred since the end of 1985. Whatever about the speed with which the effects of the oil price fall make themselves felt it is clear that these effects will be positive. It is estimated that the combined import bill of the industrial countries will be reduced by the equivalent of ¾ per cent of GNP on foot of the reduction in oil prices between 1985 and 1986. It is projected that the impact effect of this will be to reduce consumer prices by 1-1½ per cent in 1986 and 1987 and it is expected that this in turn will provide a significant stimulus to consumption and investment.

*World Economic Outlook, IMF, April 1986

**Notwithstanding the rejection of a key provision of the Act by the US Supreme Court in July 1986.

The most recent medium-term projections for the world economy are those published by the IMF in their *World Economic Outlook* of April 1986 and summarised in Table 5.1. The principal assumptions* underpinning the projections are as follows:

(i) oil prices to average $16 per barrel in 1986, $15 in 1987 and, to remain unchanged in real terms thereafter to 1991;
(ii) real exchange rates to remain unchanged from their March 1986 level throughout the remainder of 1986 and 1987, with the US dollar projected to depreciate in real terms by a further 10 per cent over the 1988-1991 period;
(iii) fiscal policy to become restrictive in the US, with expenditure cuts of $12bn. per annum projected for the period 1987-1991, and to remain moderately restrictive in the other industrial countries;
(iv) monetary policy throughout all the major industrial countries to be such as to prevent any significant acceleration of inflation and,
(v) a modest reduction in nominal interest rates in 1986 and 1987, followed by a period of approximate stability thereafter.

Table 5.1 sets out the resulting IMF projections for the international economy for the years 1985 and 1986 and for the five-year period 1986-1990 as well as comparative figures for recent years. Real GNP growth in the industrial countries is forecast to accelerate gently from its 1985 rate of 2.8 per cent to 3 per cent in 1986 and 3.2 per cent in 1987. The annual average rate of growth projected for the 1986-1990 period, at 3 per cent, is a modest improvement on the 2.4 per cent attained during the 1981-1985 period. Growth rates expected for the US economy are higher than those projected for Europe but in the latter case the improvement over the 1981-1985 period is expected to be greater: an average of 2.7 per cent annually between 1986 and 1990 compared with the 1.3 per cent recorded between 1981 and 1985.

The volume of world trade is forecast to increase by 3.3 per cent in 1986 rising to 3.8 per cent in 1987 and averaging 4.4 per cent over the five years to 1990. This compares with an average of 2.5 per cent growth betwen 1981 and 1985.

The IMF interest rate assumptions do not imply any substantial fall in real rates from their prevailing levels. A modest decline in nominal rates is assumed for 1986 and 1987, broadly in line with the projected fall in inflation. The implicit outlook for real interest rates, therefore, is that they will be broadly unchanged in 1986 and 1987. This is also true of the rest of the period to

*It should be noted that some of the assumptions, especially those relating to the US dollar have been superceded by subsequent events.

Table 5.1
Medium-Term Prospects for the International Economy

	Average 1981-1985	1984	1985	1986	1987	Average 1986-1990
			— (Annual change in per cent) —			
Real GNP: Industrial Countries	2.4	4.8	2.8	3.0	3.2	3.0
— United States	2.3	6.5	2.2	2.9	3.6	3.0
— Europe	1.3	2.4	2.3	2.9	2.5	2.7
Inflation(1): Industrial Countries	5.8	4.3	3.9	3.4	3.0	3.5
World Trade: Volume	2.5	8.7	2.9	3.3	3.8	4.4
			— (Level: per cent) —			
Interest Rates: 6 month libor	12.0	11.3	8.6	7.8	7.3	7.8
			— (Annual change in per cent) —			
US: Nominal effective exchange rate	—	8.0	4.5	−11.2	8.0	−4.4

(1) GNP deflator.

Source: *World Economic Outlook*, IMF, April 1986.

1990. On average the projected real interest rate (the 6-month LIBOR deflated by the inflation rate) for the 1986-1990 period is 4.2 per cent, much the same as that in 1985 although significantly lower than in 1984 (6-7 per cent) and the rate that obtained over the 1981-1985 period on average (5.9 per cent).

As regards exchange rates the IMF expect that the US dollar will depreciate in nominal terms at an annual average rate of about 4.5 per cent between 1986 and 1990, comprising a large 11 per cent fall in value in 1986, a stabilisation of the exchange rate in 1987, and a modest depreciation over the three subsequent years to 1990 amounting to a cumulative 10 per cent.

In summary, from an Irish perspective, the main features of the IMF's medium-term outlook are as follows: (i) a resumption of GNP growth in the industrial countries as a whole with average annual growth in the period 1986-1990 being modestly higher than in 1981-1985; (ii) a somewhat more pronounced acceleration of GNP growth in Europe; (iii) an acceleration in the growth of the volume of world trade to an annual average rate in the 1986-1990 period almost twice that achieved between 1981 and 1985; (iv) a small reduction in real interest rates in 1986 from their 1985 level followed by a period of approximate stability thereafter to 1990 and, (v) a continued depreciation of the US dollar over the 1986-1990 period as a whole.

3. THE IMPACT OF THE OIL PRICE FALL ON THE DOMESTIC ECONOMY

Since Ireland is a net importer of oil — net imports of oil and oil-related products amounted to £840m in 1985 or, about 5½ per cent of GNP — the impact effect of the oil price fall on the Irish economy will be similar to its effect on the economies of most other industrialised countries.

Assuming, as is done by the IMF, that oil prices settle at $15 per barrel for the remainder of 1986 and that the value of the Irish pound averages $1.35, the domestic economy will enjoy a transfer of income, as measured by savings in the oil import bill, equivalent to about 2½ per cent of GNP. The impact effect of this will be to reduce the balance of payments current account deficit. Moreover, the oil price fall together with the concurrent depreciation of sterling and the weakening of the US dollar will exert significant downward pressure on domestic inflation.

These benefits of the oil price fall are undoubted but they are once-off in nature. It cannot be assumed that more enduring benefits will automatically accrue to the domestic economy. In particular it cannot be supposed that increases in output and employment levels will occur unconditionally even in the face of the upturn in world economic activity which is expected to

take place in the aftermath of the reduction in oil prices. Whether such enduring benefits do accrue in fact will depend on how the immediate gains associated with the terms of trade improvement, induced by recent movements in oil prices and exchange rates, are distributed within the economy, on the competitiveness of the exposed sectors, and on the evolution of the economy's productive capacity.

The transfer of income to the domestic economy on foot of the terms of trade improvement 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 reduction in the costs of goods and services which it purchases. The distribution of the terms of trade gain involves trade-offs and also determines the scale and composition of the resultant impetus to domestic demand as well as influencing the size and sustainability of the economy's supply-side response.

The gain accruing to the household sector is the greater and the gain to the corporate sector the smaller, the weaker is the tendency for private sector nominal wage growth to adjust downwards to the lower rate of inflation. If nominal wages remain inflexible in the face of decelerating inflation the result wll be an increase in real household disposable income which can be expected to generate an increase in the volume of consumer demand. However, such buoyancy in consumer demand may be achieved at the cost of some deterioration in the cost competitiveness of the exposed sectors of the economy, and a consequent reduction in output and employment particularly in firms which are dependent on export markets.

As regards cost-competitiveness it should be noted that the fall in oil prices *per se* will not make Irish producers any more competitive than their counterparts in our main trading partners since the opportunities for securing cost-reducing benefits from the oil price reduction are available to all. What matters for competitiveness is the extent to which such benefits are realised in terms of the speed of adjustment of both domestic oil prices and other costs of production, including labour costs, relative to those in our main trading partners.

In this connection it is worth noting that the data for the last 15 years would suggest that Irish imported oil prices adjust relatively slowly: in the immediate aftermath of OPEC I and OPEC II the price of oil imported by Ireland lagged behind the average OECD import price, while the period of falling oil prices since 1981 has seen Irish oil prices decrease rather more slowly than import prices for the OECD as a whole. The effects of long-term contracts negotiated by the Irish National Petroleum Company may explain these time lags.

The slow adjustment of costs of production relative to our main trading partners in the aftermath of the oil price fall would impinge detrimentally

on cost competitiveness and thus on output and employment in the short-term. Moreover such a conjunction of events would weaken the supply-side of the economy into the medium term because of the impact which a loss of competitiveness would have on profitability and investment and thereby on expanding the economy's productive capacity.

Reverting to the issue of the distribution of benefits from the terms of trade improvement, it may also be noted that the gain accruing to the household sector is the greater and the gain to the government sector the smaller, the weaker is the tendency for nominal wage growth in the public sector and nominal growth in social welfare payments to reflect lower inflation. If government spending on these items remains unchanged in the face of decelerating inflation, expenditure volumes are necessarily increased relative to budget targets, and the stance of fiscal policy is necessarily, albeit implicitly, shifted. Again, as in the case of the trade-off between the household and corporate sectors, the downward inflexibility of expenditure allocations under these headings in the face of lower inflation boosts the real disposable income of households and the volume of consumer demand, but this time at the cost of giving up an opportunity to effect improvements in the public finances.

What emerges from the foregoing discussion is that there is a clear distinction to be made between the short-term, principally demand-determined effect of the oil price fall on the economy, and the prospective long-term and primarily supply-side consequences. Moreover it is quite possible that a trade-off may occur whereby the beneficial impact of the terms of trade improvement is dissipated by being translated into an immediate but once-off increase in consumption rather than converted into more enduring increases in output and employment which would in the medium term generate a sustainable improvement in living standards.

4. THE SHORT-TERM PROSPECTS FOR THE IRISH ECONOMY

The published short-term forecasts for the Irish economy have become significantly less optimistic as 1986 draws to an end. The forecasts published in the early part of the year were dominated by the expected impact of the fall in oil prices and the upturn in the international economy and in world trade predicted for this year. These forecasts envisaged significant expansion of domestic output and employment levels, fuelled in large part by substantial growth in consumer expenditure and a modest recovery in capital formation. These prospects were predicated *inter alia* on the expectation of a sharp decline in real interest rates and a large increase in real disposable incomes because of falling inflation.

Since the earlier forecasts were prepared a number events, including the publication of key new economic data, have conspired to overtake them. In

the first place it is evident that the international economy has not responded as strongly to the oil prices fall as was earlier expected. On the domestic front the much vaunted consumer boom has not yet materialised on the scale envisaged. Real interest rates have remained high and investment activity has continued to be depressed. Moreover the poor summer weather conditions have seriously impaired the prospects of recovery in the agricultural economy.

The continuing weakness of Sterling impelled the authorities to devalue the Irish Pound by 8 per cent in August, an event which will have the impact effect of improving international competitiveness but at the expense of stimulating a modest acceleration of inflation.

The publication in July of the 1985 Labour Force Survey and the preliminary results of the 1986 Census yielded information which significantly altered perceptions of what has been taking place in the labour market in recent years. The new population and labour force data together amount to a radically changed basis for constructing forecasts of employment and unemployment.

It is now expected that the rate of inflation in 1986 will be over 3 per cent and not under 3 per cent as predicted before the summer. This is still significantly lower than the 5½ per cent recorded in 1985. The importance of import price trends as a factor underpinning the prospective deceleration of inflation may be guaged with reference to the fact that the latest published Central Bank *Bulletin* forecasts a decline of 6 per cent in import prices in 1986 and the latest published ESRI *Commentary* a decline of 4½ per cent.*

The fall in the rate of inflation in conjunction with emerging trends in nominal wages and salaries indicate that real disposable incomes will increase substantially in 1986 and with somewhat less certainty, in 1987 also. It was this factor principally which underpinned the projections of strong growth in the volunme of consumer spending which were made for 1986 by all forecasting institutions earlier in the year. It seems unlikely however that the earlier forecasts of 3-4 per cent real growth in consumer spending will materialise. The persistence of high real interest rates is an important factor in this regard. Volume growth in consumer spending of about 2 per cent might now be expected for 1986.

As outlined in Section 2 above the reduction in oil prices, together with other concurrent developments in the international economy, is expected to impart a fillip, albeit of modest proportions, to the world economy. The expected acceleration of GNP growth in the industrial countries and the associated increase in the rate of expansion of trade volumes, especially in Europe, will create somewhat more favourable international market conditions for Irish

* Central Bank *Quarterly Bulletin*, Summer 1986; ESRI *Quarterly Economic Commentary*, August 1986.

exports in 1986 and 1987 than existed in 1985. Whether this leads to a significant positive response on the part of exports and domestic output will, as pointed out Section 3, depend *inter alia* on the ability of the exposed sectors of the Irish economy to sustain and improve their competitive position.

Views on this question are significantly less sanguine now than was the case earlier in the year. Partly because the upturn in the world economy has not been as strong as previously envisaged but also because of the evident sluggishness of industrial output and exports in the first half of the year and the deteriorating position in agriculture, forecasts have been revised downwards. Earlier forecasts by the ESRI and the Central Bank envisaged volume growth of about 6 per cent in exports this year.* It now seems that a growth rate of 1-2 per cent is in prospect. This would compare with the 6.7 per cent volume growth in exports achieved in 1985. As regards industrial output volume growth of between 2 and 3 per cent would now appear likely. Agricultural output is now expected to decline in 1986.

Earlier expectations were of a modest increase in the volume of investment in 1986. The Central Bank in its Summer *Bulletin* revised its previous forecast of 2.75 per cent growth down to 2 per cent. The ESRI in its August *Commentary* however forecast a 2 per cent decline in investment, comprising a 3 per cent decline in the volume of capital formation in building and construction and a 1 per cent decline in machinery and equipment. It now appears certain that investment will register a significant volume fall this year. The more pessimistic prognosis for investment is heavily influenced by the unexpected persistence of extremely high real interest rates.

The discussion in the preceding paragraphs would suggest that volume growth in GDP this year will be low, falling within the range 1-2 per cent. GNP growth will be somewhat lower still.

The pace and distribution of output growth in 1986 will be insufficient to prevent unemployment from increasing further. Accordingly the average number unemployed during the year is forecast at 230,000 on a Labour Force basis, an increase of 3,000 on the corresponding figure for 1985, implying an unemployment rate of almost 18 per cent.

5. MEDIUM-TERM PROSPECTS FOR THE EXPOSED SECTORS

(i) Agriculture**

Output and Input Prices

Agricultural output prices are expected to increase by 1 per cent in 1986. This comprises a 2.5 per cent fall in cattle prices, a 1 per cent increase in sheep prices, a 3 per cent increase in milk prices and a 10 per cent increase in cereal prices following on an extremely low base in 1985.

* Central Bank *Annual Report*, 1986; ESRI *Quarterly Economic Commentary, April 1986.*
** This section is an edited version of material prepared for NESC by An Foras Taluntais.

The evolution of output prices to the end of the decade depends on the future price policy of the EEC Commission and on developments within the EMS exchange rate regime. It has already been noted in Chapter 2 that the common price stance has hardened since 1982-1983. There is every reason to expect this posture to continue to the end of the decade. Given the stubborn surpluses problem, Community enlargement, and the tensions in international trade the future price environment cannot be auspicious. Against this background there is little alternative but to assume a zero annual change in common prices between 1987 and 1990. In fact this prospect represents no more than what has emerged from the last three price agreements.

As indicated in Table 2.23, Green Pound devaluations have been of considerable significance in ameliorating the effects of reduced 'target' prices over the last five years. However it would be hazardous and imprudent to predicate forecasts of price increases for domestic producers on any assumption other than that of existing Green exchange rates remaining unchanged. Nevertheless, even in the face of no change in common prices and no future Green rate re-alignments, Irish producers will enjoy output price increases in 1987 arising from the devaluation of the Green Pound in September of this year. It is estimated that the resultant increase will be of the order of 4 per cent.

While the evolution of output prices holds out little prospect of relief the likely movement in input costs shows more promise for a number of reasons. Firstly, feedingstuffs, one of the major inputs into agricultural production, is one of the products whose price level is under severe pressure. Secondly, other inputs such as fertiliser are sourced outside agriculture and, in the case of phosphorous and potassium in particular, agriculture is almost the only market. Thirdly, many other agricultural inputs are energy-related and consequently only very moderate price increases are expected due to the weakening of oil prices and the US dollar. It is forecast that input costs overall will fall by about 6 per cent in 1986.

The key indicator of likely input cost developments in the period 1987 to 1990 is domestic inflation, which is expected to remain at about 3 per cent per annum. Agricultural input cost increases are likely to be somewhat lower — within the range 2-3 per cent — because of (a) the continued weakness which is expected to characterise fertiliser prices and (b) the expectation that the price of feedingstuffs will track cereals prices which in turn are likely to be weak because of the assumed common price policy stance.

A 1 per cent increase in output prices in 1986 combined with a 6 per cent fall in the cost of inputs implies a substantial relief in the cost price squeeze on the agricultural sector this year. The assumptions with regard to the evolution of output and input prices over the 1987-1990 period (the conjunction of an average 1 per cent per annum increase in output prices

with a 2.5 per cent annual average rise in input costs) implies the re-emergence of a cost-price squeeze but with an intensity somewhat less than that which characterised the 1980-1985 period.

Prospects for Output

The scenario for cattle output is dependent on the future trend in total cow numbers. The latter will depend on the relative growth rates in dairy and beef cows. It is assumed that dairy cow numbers will decline, in order to respect the quota, to at least four or five per cent below the levels recorded for June of 1985, which were about 14,000 down on 1984. For total cow numbers to remain unchanged, beef cow numbers would need to increase by about 16 to 20 per cent by 1990. It is expected that some of this beef cow growth will materialise on dairy farms which were not fully developed prior to the super-levy and where soil quality rules out tillage as an alternative. However, the brunt of the required beef herd expansion will fall on 'Disadvantaged Areas' and the increased headage grants this year should enhance the profitability of suckling. The best that might be expected is that cow numbers will show no change by 1990 over 1985. Recent data indicating a drop of 2.3 per cent in aggregate cow numbers in 1986 suggest that this expectation is optimistic.

According to CSO estimates, cattle output (including stock changes) increased by over one per cent in 1985. This represents an uninterrupted expansion vis-a-vis 1982. This feature is unprecedented historically and is difficult to explain. In normal circumstances we would expect cattle output to decline following such a growth in output unless the trend reflects a genuine improvement in animal productivity. A drop of about 1.5 per cent in cattle output is indicated for 1986. For the period 1987 to 1990, given the assumptions made with regard to cow numbers, it is expected that there will be no growth in cattle output relative to 1986. Indeed given the remarks above concerning the exceptional output levels in 1985, the recent reported fall in cow numbers, and the implementation of the EEC Milk Cessation Scheme in 1987 and 1989, a more likely outcome is for 1990 output to be well down on the levels attained in 1985.

Pig output is estimated to have declined by around four per cent in 1985 and is forecasted to fall by a further one per cent this year. Some recovery is expected from this low base by the end of the decade but the most realistic possibility is that recovery would be merely to 1984 production levels.

With the introduction of the common sheepmeat policy, ewe numbers have enjoyed an uninterrupted expansion of almost four per cent per annum between 1980 and 1984.* The figures for June of last year indicated an increase

*For a discussion of the propects facing the sheep industry see Fingleton, W.: Increased Production - Yes, Increased Margins — No: *The Practical Farmer*, April 1986.

of 10 per cent relative to 1984 with an increase of over 5 per cent recorded for June of this year. The forecast for sheep output in 1986 is a four per cent increase. Future prospects for sheep output production are relatively buoyant. Returns from the market place, in common with other livestock enterprises, will continue to be depressed. Profitability will be underpinned by increased productivity and by subsidies not related to sales (the 'ewe premium'). It is assumed that the level of subsidies will not deteriorate over the forecast period. Sheep production is also likely to advance owing to the anticipated enterprise-switching effects of the milk super levy and given that it is one of the few significant livestock activities in deficit in the Community it is likely to remain untouched by any quantitative restrictions for the foreseeable future. It is forecast therefore that ewe numbers will increase by around four per cent per annum from 1986.

Prospects for milk output are conditioned by the super levy and the EC Milk Cessation Scheme. It is assumed that Ireland will retain its guaranteed quantity up to 1990 and its share of the Community 'Reserve'. The implementation of the EC Milk Cessation Scheme as agreed in the April 1986 policy package is expected to cause production to decline by three per cent between 1986 and 1990. On the basis of trends to date a fall of at least six per cent in 1986 following on an increase of around 1.8 per cent in 1985 is forecast. As the drop this year is weather related a recovery can be expected next year, so by the decade end the volume of production is projected to be about three per cent below its 1985 level. It cannot be stressed sufficiently that the real impact of quantitative restraint in the dairy sector will only become manifest from now on. In the past we could have relied on a five per cent per annum increase in production, so for the foreseeable future the super-levy has effectively siphoned off about 3.5 per cent each year from what would otherwise be the increase in nominal farm incomes.

The outlook for cereals is perhaps the most hazardous to predict since it is the most sensitive to weather conditions and is also in the front line of the EC Commission assault on surpluses. Excluding the exceptional harvest of 1984, the aggregate production of cereals has been in decline since 1980. Last year, given the appalling weather conditions, production dropped below 1983 levels with a decline of 30 per cent recorded in the volume of output. Within the cereals aggregate there has been substantial growth in the area under wheat which increased from around 117,000 acres in June 1980 to 197,000 acres in June 1985. A somewhat disturbing feature, however, is that the increase of 46,000 acres in 1984 was not repeated in 1985, when a modest increase of only 4,000 acres was recorded. This could be a temporary lull as happened in 1983, but it is likely also that the recent harvest experience could place a temporary obstacle to further expansion of the winter wheat area. It is assumed that total cereal acreage will remain at its 1985 level by 1990. It is also assumed that yields will grow from an 1980-1985 average base by three per cent per year due to an anticipated continued expansion

in winter wheat. These assumptions suggest a recovery in total cereal production at a rate of around four per cent per annum relative to the low base of 1985. By 1990, however, we anticipate the production will still be below its 1984 peak.

Input Use

The medium-term outlook for the consumption of current inputs is always difficult to predict because differential input use will be influenced by the need to effect economies and the relative intensities of input use in different farm enterprises, as much as by the prospects for aggregate farm output. However, the fortunes of the dairy sector will have a significant bearing on the consumption of feedingstuffs and fertilisers over the next few years since it is estimated that dairy enterprises account for around half of total feed and fertiliser use. An increase in feedingstuffs consumption in 1986 of about 11 per cent is indicated following on the fodder shortage caused by last and this year's adverse weather conditions. Fertilisers on the other hand look likely to register a decline of around seven per cent. Given the sluggishness anticipated in cattle production and the possibility that quantitative restraint in the dairy sector will result in reduced current input use, as productivity advances become input conserving rather than output expanding, it is expected that the consumption of current inputs in 1990 will be about 3 per cent below the 1986 level in volume terms.

Prospects for Subsidies and Production Levies

Chart A in Chapter 2 demonstrated the growing importance of subsidies (comprised mainly of headage payments, calf premia, ewe premia etc) in cushioning potentially serious income effects emerging from market conditions in the recent past. Subsidies increased by IR£129 million between 1980 and 1985 and currently account for 16 per cent of farm incomes. The level recorded for 1985 was exceptional due to the bringing forward of headage payments from 1986 to alleviate serious fodder problems and the introduction of one-off schemes for the same purpose. Given the recent Government initiative to alleviate hardship arising from the severe weather conditions it is estimated that subsidies in 1986 will be £15m higher than in 1985.

The outlook for the balance of the period is problematic. If the thrust of the Commission's *Perspectives* paper* were to be implemented over the next few years we could see a significant growth in the importance of subsidies as they gradually replace the price mechanism as a means of supporting farm incomes. A consistent thrust is evident in the recent price proposals package of 1986/87 where it was suggested that with a downward price adjustment

*European Commission: *Perspectives on the Common Agricultural Policy*, 1985.

in the beef sector there would be new direct premia payments to designated producers. It should be noted however that the small size of the proposed premia would not compensate producers for the severe price reductions that could occur under the Commission's open-ended price policy proposed for beef. A further source of future transfer income which will materialise in the next few years is the monies which will accrue to those producers who surrender their quotas under the EC Milk Cessation Scheme. It is extremely difficult to adopt a firm view as to the likely future role of subsidies since their level will be largely politically determined. Thus, as a technical assumption, we postulate an increase of about IR£20 million in subsidies not related to sales.

The impact of production levies on farm incomes is of much less significance. An increase in the nominal value of levies of 7.5 per cent in 1986 with no change in the remaining years of the decade is assumed.

Capital Charges

In the National Accounts, capital charges are only estimated for 'machinery and equipment' and 'farm buildings' and these costs only include a depreciation element and do not incorporate interest or other factors relevant in the evaluation of total capital costs. Depreciation is equivalent to some fraction of the capital stock. The evolution of depreciation charges in the future will depend on the growth in the capital stock or, in other words, the anticipated level of investment. The key factor determining farm investment decisions are expectations regarding real farm incomes. An examination of historical trends reveals a positive relationship between changes in investment and the evolution of the real value of farm incomes. The substantial growth which occurred between 1975 and 1979 undoubtedly reflected the expectation that the advances in real incomes in train since 1976 would persist into the future. There is little likelihood of investment activity ever reverting to the 1979 levels and it is assumed that future trends will be dictated by expectations conditioned by the real income experience since 1980. It is forecast therefore that over the period 1986-1990 gross annual investment will just be sufficient to meet replacement needs and hence depreciation in constant prices will remain at its 1985 level. We assume the nominal value of depreciation will advance at an annual rate of two per cent in line with expectations for current input prices.

Summary Projections of Agricultural Output and Incomes

Table 5.2 crystalises the discussion of the preceding paragraphs into a set of summary projections of agricultural output and farm incomes for the 1986-1990 period. Farm output is forecast to decline by 3 per cent in 1986 and to increase at an annual average rate of 0.5 per cent thereafter to 1990. Given the projections regarding prices and input volumes, nominal farm incomes will be unchanged in 1986 from their 1985 level and are projected

to rise by a cumulative 7 per cent in the following four years to 1990. Real farm incomes are forecast to fall by 3 per cent in 1986 and by about another 4 per cent cumulatively in the period to 1990.

Table 5.2
Agricultural Output and Farm Incomes, 1985-1990 (1985 = 100)

	1985	1986	1990
Volume of Farm Output	100	97	99
Price of Farm Output	100	101	105
Volume of Farm Inputs	100	103	100
Price of Farm Inputs	100	94	104
Nominal Farm Incomes	100	100	107
Real Farm Incomes(1)	100	97	93

(1) Nominal farm incomes deflated by the CPI. It is assumed that the annual average increase in the CPI will be 3 per cent between 1986 and 1990.

(ii) Manufacturing Industry — The Modern Sectors

As detailed in Chapter 2 the modern sectors of manufacturing industry, comprising Chemicals, Office Equipment and Instrument Engineering, experienced very rapid growth between 1980 and 1985. Output from these three sectors taken together expanded at an annual average rate of 16 per cent, that is at a rate sufficient to account for virtually the entire increment in output recorded by manufacturing industry as a whole over the 1980-1985 period. Accordingly, it is estimated that these three branches of activity produced almost 40 per cent of overall manufacturing output in 1985, (compared with about 20 per cent in 1980), a proportion considerably greater than their share in manufacturing employment which was about 13 per cent.

Significantly, having expanded at a spectacular rate of almost 30 per cent in 1984 output growth decelerated sharply in the modern sectors in 1985 (see Table 2.7). The slowdown in the electronics sector has been put down to the difficulties faced by the industry world-wide in 1985, more particularly to the running down of stocks in that year consequent to the large build-up of stocks that appears to have occurred in 1984. This factor has not been adduced in explanation of the sluggish performance of the other two sectors in question: Chemicals and Instrument Engineering. The fact that all three sectors experienced a marked deceleration in output growth in 1985 suggests the existence of some common explanatory factor.*

*For the first six months of 1986 output of the electronics sector was 17.5 per cent higher than in the same period of 1985 and intrument engineering output was 5.6 per cent higher. The corresponding figure for chemicals shows an output reduction of 8.4 per cent.

All three sectors in Ireland are dominated by overseas firms. Foreign companies, principally US multinationals, account for 94 per cent of employment in Instrument Engineering, and 90 per cent and 67 per cent respectively in Office Equipment and Chemicals. Consequently it is to trends in foreign direct investment that one must look for an understanding of the evolution of output from these sectors over recent years.

It is evident that there was a substantial volume of overseas investment in Irish manufacturing in the late 1970s and early 1980s. Not all of this investment would have been directed towards the three most rapidly growing branches of industry but they would have accounted for a substantial proportion of the total, most of which came in turn from US firms. Table 5.3 sets out some relevant data.

The column headed 'New Foreign Investment Approved' measures foreign direct investment intentions and not the actuality. As such the corresponding data should be interpreted with some caution. The figures indicate that substantial increases occurred in each of the years 1979 through 1981 with steep declines taking place in 1982 and 1983. It is worth noting that the 1984 figure includes £180m in respect of an intended electronics project which has subsequently been indefinitely deferred. The data in respect of US firms' capital expenditure set out in the second column evince the same pattern of change over the period.

Table 5.3

Trends in Foreign Direct Investment, 1978-1984

	New Foreign Investment Approved	US Firms Capital Expenditure
	(£ million)	(£ million)
1978	150.1	102
1979	208.8	213
1980	279.0	207
1981	327.2	229
1982	196.3	146
1983	86.5	124
1984	284.1 (1)	123

(1) Boosted to the extent of £180m. by one intended project which was subsequently cancelled.

Source: Eoin O'Malley, 'Foreign Owned Industry in Ireland' in ESRI *Medium-term Outlook, 1986-1990*, February 1986.

The decline in US firms' investment spending in Ireland is largely explained by a similar reduction worldwide as Table 5.4 indicates. Total foreign investment by US manufacturing companies fell from $24bn in 1980 to $14bn in 1984. The principal explanation for this probably resides in the international economic depression over the same period. However, within the substantially

diminished total, the share accounted for by the newly industrialising countries of South East Asia significantly increased.

The data in Table 5.4 do not distinguish between new 'green-field' investment and capital formation in pre-existing production units reflecting re-equipment of plants. It is almost certain that the increasing share of South East Asian countries which emerges from the undifferentiated data would be even greater if 'green-field' investment were separately identified.

Table 5.4

Capital Expenditure by MOFAs(1) of US Companies

	1980	1981	1982	1983	1984
			($ billion)		
Total	23.944	19.164	17.469	13.724	14.048
Europe	13.116	10.273	9.643	7.824	7.619
Asia and Pacific(2)	0.486	0.542	0.533	0.513	0.635
Ireland	0.175	0.229	0.146	0.124	0.170

(1) Majority-owned foreign affiliates
(2) Comprising the following countries: Hong Kong, India, Indonesia, Malaysia, Philippines, Singapore, SouthKorea, Taiwan and Thailand.

Source: *Survey of Current Business*, US Department of Commerce, various issues.

In the light of the foregoing discussion it is possible to provide an outline of the prospects for the 'modern' manufacturing sector over the next five years, given that the international conditions expected are somewhat more favourable than those experienced in the 1980-1985 period.

In the short-term (1986 and 1987) the upturn in the world economy and in particular the expected recovery of European markets should have beneficial effects on export and output growth. However a number of cautionary notes are appropriate on this score. Grounds for caution have already been provided by the evolution of output and exports from the relevant sectors to date in 1986.

Firstly, as noted above the first six months of the year have seen a decline in the output of chemicals relative to the same period in 1985 of 8.4 per cent. Corresponding data for office machines and instrument engineering indicate increases in output of 17.5 and 5.6 per cent respectively, higher than the growth rates in 1985 as a whole, but about one third of those attained in 1984 and about half the annual average growth rate achieved between 1980 and 1985.

Secondly, demand can only drive output in the short run up to the point of full capacity utilisation. It is not clear to what extent the capacity of the sectors in question is currently being utilised. What is clear, however, is that

the rate of increase in capacity, as measured by foreign direct investment flows, has decelerated sharply since 1981. On this basis it is unlikely that the next two years will see a resumption of output growth on the scale witnessed between 1980 and 1984.

A third and related point has to do with the purely arithmetic effect on the recorded output data over the first half of the decade whereby the output of the modern sector exhibited strong growth in percentage terms because increments to output were large relative to the pre-existing level of output in that sector. As the level of output continues to rise growth rates in percentage terms necessarily fall, even if the absolute size of the increments to output remains the same. Recorded growth rates will *a fortiori* fall if the absolute size of the increments diminishes in successive years.

Another related point which must be considered is the possible existence of a 'life-cycle' effect within successive generations of foreign companies established in Ireland, of which the most recent generation comprises companies located principally in the Chemicals, Electronics and Instrument Engineering sectors. Empirical evidence on this issue has been assessed by O'Malley* and points to a situation whereby successive generations of overseas firms expand output rapidly in the years immediately following their establishment in Ireland, stabilise output and employment around a peak level in the next period, and succumb to a period of decline thereafter during which output falls and jobs are shed.

If the generation of overseas companies responsible for the impressive output and export growth recorded in Chemicals, Office Equipment and Instrument Engineering between 1980 and 1984, has entered the second stage of the life-cycle described above — an assessment with which the performance of these sectors in 1985 and early 1986 is consistent — optimism about the magnitude of these sectors' response to the expected upturn in the world economy may be misplaced. Moreover such an assessment highlights the question of whether the improving international trading climate will generate an acceleration of foreign direct investment into Ireland and thereby sow the seeds of substantial output and employment growth in the medium term.

Turning to this question some pointers to a possible answer have already been provided. The increasing share of South East Asia in total world-wide foreign investment by US companies has been noted. Of greater significance than the fact that published data reveal this trend is the near certainty that they underestimate the rate of increase in the share of South East Asian countries in investment in new projects as distinct from re-equipment

*Eoin O'Malley: 'Foreign Owned Industry in Ireland: Performance and Prospects', in *Medium-Term Outlook, 1986-1990*, ESRI, February 1986.

expenditures. It is not possible to isolate with any precision the factors responsible for this but it would seem reasonable to suggest that the buoyancy of the Far East economy relative to Europe in recent years has exerted a powerful influence in this regard. It would seem therefore that rapid and sustained economic growth in Europe is a pre-requisite for reversing the recent trends in the geographical pattern of US foreign direct investment flows.

Moreover Ireland's share of US foreign direct investment in Europe has recently been coming under pressure because of the increasing competition between European countries and, within countries, between regions and urban areas, for industrial projects. The intensification of such competition has been due in large measure to rising levels of unemployment and the deployment of industrial policy instruments by governments to secure their employment objectives. Given the medium-term outlook for unemployment in Europe it seems likely that the intensity of this competition will be maintained. Moreover Ireland's share is likely to come under continued pressure on foot of the recent accession of Spain and Portugal to EEC membership.

Another factor which is relevant to considering foreign direct investment prospects in the medium-term is the current situation of the electronics industry which has provided a large proportion of the inflow into Ireland over the last decade or so. Informed analysis of the world-wide electronics industry suggests that renewed expansion on a scale comparable to that which characterised the period up to 1984 is critically dependent upon a new technological breakthrough which will bring with it a fresh wave of innovations and applications of electronics technology to new areas of activity. While this technological breakthrough is awaited existing technologies will progress towards maturity and the industry world-wide may enter a period of relative stagnation.

Taking all the above-mentioned factors into consideration it would appear extremely unlikely that the modern manufacturing sectors will expand output over the next five years at a rate equivalent to that which obtained between 1980 and 1985. This would seem to be especially true of the Office Equipment sector. An optimistic scenario might be one in which the rate of growth in output from the Electronics industry would decelerate to 17.5 per cent per annum between 1986 and 1990, compared with 35 per cent between 1980 and 1985, with the Chemicals and Instrument Engineering industries each growing at rates somewhat below those achieved in the last five years i.e. about 7.5 per cent annually. This would yield an annual average growth rate of about 12 per cent for these three sectors taken together, compared with 16 per cent annually between 1980 and 1985.* It might be more realistic

*The projected increase in output has been calculated by using estimated 1985 net output weights, the figure for 1980-1985 by using actual 1980 weights. The two sets of weights are significantly different due principally to the very rapid growth in output from the Office Equipment sector between 1980 and 1985.

to expect the growth rates of all three sectors to be somewhat lower: say, 12.5 per cent per annum in Office Equipment and 5 per cent per annum in both Chemicals and Instrument Engineering. This would imply output growth of just over 8 per cent per annum for the three sectors taken together between 1986 and 1990.

(iii) Manufacturing Industry - The More Established Sectors

The sectors of manufacturing other than those discussed in the preceding paragraphs constitute a very heterogeneous grouping comprising branches of activity which vary substantially in respect of the proportion of employment accounted for by foreign firms, the proportion of output which is exported, and the importance of labour costs as a determinant of competitiveness. As a group they can be distinguished from the modern industries discussed above principally with reference to their output and employment performance over the last five years. Output from the more established sectors taken together expanded at an annual average rate of only 0.2 per cent between 1980 and 1985 while employment in 1985 was more than 20 per cent below its 1980 level.

In three of these sectors exports account for less than 30 per cent of output: Non-metallic Minerals, Timber and Furniture, and Paper (see Table 2.8). Demand for the output of these sectors is principally determined therefore, by the size of the domestic market, and in the former two cases, strongly influenced by conditions in the Building and Construction industry. However the domestic market is not insulated from foreign competition: a substantial proportion of domestic demand is satisfied by imports. Moreover as Table 2.8 indicated the evidence of recent years points to increased penetration by imports since 1980. The three industries in question currently account for about 12 per cent of manufacturing output and some 18 per cent of manufacturing employment. It is probably reasonable to expect that the decline in output experienced by these sectors in the 1980 - 1985 period as whole will be reversed over the coming years with the scale of output growth depending in the main on the degree of buoyancy in the domestic economy.

The Textiles, Clothing, Footwear and Leather industries are considerably more exposed: exports account for 63, 52 and 58 per cent of output respectively in these sectors. In each case imports account for two-thirds or more of the domestic market and again, the evidence from recent years points to a significant increase in import penetration. As regards the geographic distribution of exports, in each case over half by value is directed to the UK. Moreover in recent years there has been a sharp decline in Ireland's share of UK imports under each of these commodity headings (see Table 2.13).

The large reductions in output and employment experienced by these sectors during the 1980 - 1985 period, although partly explained by the weakness

of the domestic market, would therefore appear to be more adequately explained by a deterioration of competitiveness, as indicated by increasing import penetration and a falling share of the dominant export market. Given the importance of labour costs in the value-added structure of the sectors in question it is not unreasonable to look to the trends in relative hourly earnings as the proximate source of competitive pressure although the ultimate source of poor competitiveness may be sought in the failure or inability of firms in these labour-intensive industries to secure adequate levels of investment. For the sectors in question the most relevant exchange rate is that of the Irish pound against sterling.

Prospects for the Textiles, Clothing, and Footwear industries in the short to medium term cannot be accounted bright given current exchange rates. If the Irish pound continues to trade against sterling in the 90-95 pence range, a range which implies a nominal appreciation of 9-14 per cent vis-a-vis 1985, or about 10.5-15 per cent vis-a-vis the average position for the 1981-1985 period as a whole, an intensification of competitive pressure can be expected in the short run, given especially the recent and emerging trends in rates of pay.

On this basis it seems inevitable that output and employment will continue to decline in these sectors. In this regard it should be noted that although the industries in question produce only 6 per cent of manufacturing output, they account for about 14 per cent of manufacturing employment because of their relative labour intensity. It might be added that, in contrast to many of the other more established manufacturing sectors which in 1985 reversed their previously recorded output declines, output in Textiles, Clothing and Footwear experienced sharp reductions in output in 1985. It might be expected that the five year period to 1990 will see a decline in the output of these sectors at a rate perhaps somewhat lower than that which obtained between 1980 and 1985. It would be optimistic, given the present outlook for exchange rates and average earnings, to expect the output decline to be halted.

The Food, Drink and Tobacco, and Other Engineering* industries were the only long-established manufacturing sectors to experience output growth over the 1980-1985 period. In the case of Drink and Tobacco, this was almost entirely attributable to the performance of output in 1984 and 1985, which may in turn have been due to the relaxation of the tax treatment of alcohol and tobacco products in recent budgets. For both the Food, and Drink and Tobacco industries domestic sales are the most important demand outlet with exports accounting for about one-third of output. Future prospects for output growth are accordingly heavily dependent on the evolution of domestic consumer demand.

*Engineering other than Office Equipment and Instrument Engineering.

However, in the case of food processing, particularly in the dairy products and meat processing sub-sectors, it might be reasonable to expect some slowdown in the rate of output growth recorded in recent years, because of the effects of reforms in the CAP on the agricultural sector. That is, unless a concerted and successful attempt is made to develop higher value-added products as a means of obviating the otherwise output-dampening effects which will follow on the restrictions in raw material supplies associated with CAP reform.

For the purposes of quantifying the medium term prospects for manufacturing output as a whole therefore two scenarios have been constructed reflecting respectively an optimistic and a pessimistic outlook. The difference between the projections for the manufacturing industry groupings as between these two scenarios have been anticipated in the discussion above but may be summarised as follows:

(i) the 'optimistic' scenario envisages output growth of about 12 per cent per annum in the years 1986-1990 for the modern sectors (compared with 16 per cent per annum between 1980 and 1985), and just over 2 per cent annually in the more established sectors taken together, which compares with 0.2 per cent per annum over the last five years. This would yield an average annual growth rate of about 6.5 per cent between 1986 and 1990 for total manufacturing industry, somewhat higher than the growth rate attained between 1980 and 1985.

(ii) the 'pessimistic' scenario envisages output growth in the modern sectors taken together decelerating to about half that recorded between 1980 and 1985 i.e. to about 8 per cent, due in particular to a sharp deceleration in Electronics. This scenario envisages output growth in the more established sectors between 1986 and 1990 occurring at a moderately faster rate than that achieved over the last five years, the principal elements in which are a continued though somewhat gentler decline in textiles, clothing and footwear, and a modest deceleration in output growth from the food industry because of the impact of CAP reforms. These projections add up to a projected annual average growth rate of about 4 per cent between 1986 and 1990 for the manufacturing sector as a whole.

6. MEDIUM-TERM PROSPECTS FOR THE SHELTERED SECTORS

(i) Building and Construction

The two most important components of output in Building and Construction are private residential investment and investment carried out under the Public Capital Programme. It is estimated that the former category accounted for about 36 per cent of total Building and Construction output in 1985, while Local Authority residential construction together with categories of non-residential construction other than those attributable to Agriculture, Industry,

Semi-State Bodies, and Commercial Development accounted for a further 47 per cent. This second aggregate corresponds roughly to that element of building and construction activity which comes within the ambit of the PCP.

The 1986 Budget provisions imply a volume reduction of over 3 per cent in the PCP this year. It is assumed that there will be no volume growth in PCP building and construction activity over the 1987-1990 period as a whole.*

The prospect of zero volume growth on average in PCP building and construction activity between 1987 and 1990, if realised, would significantly attenuate the probability of substantial growth in overall building and construction activity. What growth would take place in the output of the industry would have to come exclusively from private residential investment, new capital formation by the Semi-State Bodies and private non-residential investment in agriculture, industry and commercial development.

Looking back over the last five years the volume of new private residential investment peaked in 1981. A volume decline of about 5 per cent is expected under this heading in 1986 implying that an annual average rate of growth of almost 11 per cent would be required between 1987 and 1990 for the 1981 peak to be regained by the end of the decade. Notwithstanding the likelihood of some reduction in real interest rates over this period and some modest improvement in disposable per capita incomes relative to the 1980-1985 period it seems most unlikely that such a rate of expansion could be achieved. It might be optimistically assumed that the average rate of growth in new private residential investment between 1987 and 1990 would be about 5 per cent. When allowance is made for an acceleration of expenditure on private sector repairs and maintenance in the wake of the new measures introduced in October 1985, this would translate into an annual average volume increase in overall private residential investment of about 7 per cent.

However, regard must also be had to likely rates of household formation. In this connection trends in the population aged between 20 and 29 are a useful indicator. It is estimated that the numbers in this age group increased by 1 per cent annually between 1981 and 1986, but population projections for the 1986-1991 period point to a decline of 0.8 per cent per annum in the corresponding age category.** This might be expected to impart a downward influence to overall private residential investment making a rate

**The population projections in question are those published by the CSO in 1985. These have been superceded by

*The population projections in question are those published by the CSO in 1985. These have been superceded by the publication of the 1986 Census which revealed the existence of net outward migration of 75,000 between 1981 and 1986 a figure substantially higher than that assumed in the earlier population projections. Having regard to this and to the likelihood of continuing emigration the decline in the 20-29 age-group over the next five years will probably be significantly greater than indicated in the text.

of expansion of 5-5½ per cent per annum between 1987 and 1980 a not unreasonable projection.

In the case of agricultural investment it is projected that the volume growth will be just sufficient to cover depreciation needs over the 1986-1990 period, implying a rate of 2 per cent per annum.

As to the remaining categories of private non-residential construction: the Semi-State Bodies, Industry, and Commercial Development, volume growth of over 20 per cent annually would be required to regain 1981 volume levels. Bearing in mind that the levels of investment recorded under these headings in the early 1980s were underpinned *inter alia* by a large influx of foreign direct investment in manufacturing and by the fact that major projects by the ESB and An Bord Gais were then on hands, and given the medium-term prospects for foreign direct investment discussed earlier, it must be accounted extremely unlikely that 1981 volume levels of private non-residential investment will be attained by 1990. An annual average growth rate of 10 per cent between 1986 and 1990 probably demarcates the likely upward bound for such investment, with 5 per cent perhaps representing a more reasonable expectation.

Drawing together the various elements of output therefore and noting in particular the assumption that construction activity under the PCP will exhibit zero volume growth over the next five years,* it seems likely that total building and construction output will expand at an annual average rate within the range 2 to 3¾ per cent in the 1986-1990 period. This would compare with the annual average output decline of 5.5 per cent experienced between 1980 and 1985.

(ii) The Services Sector

Within the overall services sector the first distinction that needs to be made is between public and private services. As far as the former category is concerned it may be reasonable to expect no volume growth in output over the 1986-1990 period as a whole. As far as the latter is concerned it should be noted that very little is known about the precise determinants of output growth. It is intended that this issue will be addressed in a forthcoming NESC report on the services sector.

Although the mechanisms which influence output growth in private sector services cannot be identified with any great precision it is clear that the growth of producer services is associated with the evolution of output in agriculture and industry, and the growth of services to consumers with the evolution and

*This is a working assumption and not a forecast. It is clear that in each of the years 1983 through 1986 there have been substantial volume cuts in the PCP.

pattern of consumer demand. Given the medium-term outlook for real personal disposable income, and in particular the likelihood that consumer demand will be somewhat stronger in the 1986-1990 period than over the last five years, it might be expected that the output of consumer services will increase somewhat faster in the coming five years than in the years 1980-1985. Output of producer services may grow somewhat faster than over the 1980-1985 period, depending on which of the two medium-term scenarios for industrial output is considered the more likely.

Under the more optimistic assumptions the annual average growth rate in private sector services output could be 3 per cent between 1986 and 1990 yielding a rate of growth for the services sector as a whole of about 2 per cent. Under the more pessimistic scenario the corresponding growth rates might be 1½ and 1 per cent respectively. It should be stressed that a considerably greater degree of uncertainty inheres in these projections than in those for the agricultural and industrial sectors.

7. OVERALL ECONOMIC GROWTH

The assessment in Sections 5 and 6 above of the prospects for output growth in the main sectors of the economy permits the broader picture of overall growth prospects to be constructed. These projections are summarised in Table 5.5

Table 5.5
Summary of Projected Growth Rates, by Sector: 1986-1990(1)

	'Optimistic'	'Pessimistic'
	(per cent per annum)	
Agriculture	-0.2	-0.2
Industry	5.8	3.7
Services	2.0	1.0
GDP at Factor Cost	3.2	1.9

(1) These projections should be accorded no greater degree of precision or certainty than the discussion in the text suggests.

Under the 'optimistic' scenario an annual average growth rate of GDP of just over 3 per cent might be envisaged for the 1986-1990 period. This would be significantly faster than the annual average growth rate of 1.8 per cent achieved between 1980 and 1985 but very much lower than the 4.6 per cent per annum attained in the 1975-1980 period.

Under the 'pessimistic' scenario a growth rate of under 2 per cent annually might be in prospect for the 1986-1990 period. This is roughly comparable to that achieved over the last five years.

6

IMPLICATIONS OF THE MEDIUM-TERM OUTLOOK

1. INTRODUCTION

In the previous chapter a number of plausible scenarios for the evolution of output in the Irish economy over the medium term were constructed on the assumption that the broad thrust of existing policies would remain unchanged. It is important to consider the extent to which the evolution of output as postulated under these 'optimistic' and 'pessimistic' scenarios, might be expected to contribute to the resolution of the two most pressing problems currently confronting the economy, namely the high level of unemployment and the major imbalances which exist in the public finances.

The content of this chapter is organized as follows. Section 2 assesses the prospects for employment growth in the period to 1990 given the output projections developed in Chapter 5. Section 3 considers likely future growth in the labour force and the implications for unemployment.

Section 4 assesses the likely implications of the output and employment projections for the public finances on the assumption that the present stance of fiscal policy remains unchanged to 1990. In this section the analysis concentrates principally on the likely evolution of the National Debt-GNP ratio. Section 5 contains a summary and concluding remarks.

2. MEDIUM-TERM PROSPECTS FOR EMPLOYMENT

The employment levels which might be associated with the medium-term output scenarios developed in the previous chapter are summarised in Table 6.1. The difficulties involved in constructing employment projections are considerable, even given projections of output growth. The principal problem revolves around the issue of prospective trends in labour productivity, the determinants of which are imperfectly understood. Accordingly the projections contained in Table 6.1 should not be ascribed any greater degree of certainty or precision than the discussion in the following paragraphs suggests.

(i) Agriculture

It has been conventional to suppose that employment trends in agriculture are exogenous to income developments in that sector and to assume accordingly

that the rate of employment decline will follow the long-term trend rate of 3 per cent per annum. The results of recent Labour Force Surveys prompt a questioning of the validity of this approach: the numbers engaged in agriculture fell by 20,000 between April 1983 and April 1985, or at a rate of 5.5 per cent annually, which represents a significant acceleration relative to trend.

Whether this rate of decline can realistically be expected to persist over the medium-term depends upon which factors are considered responsible for what has occurred in 1984 and 1985. Three main sets of factors can be isolated: demographic, classificatory and economic. The purely demographic factor is associated with the age distribution of farmers and the incidence of retirements and deaths amongst those engaged in agriculture. The classificatory factor has to do with a possible increased incidence of part-time farming and the resultant reclassification of those previously recorded as farmers in the LFS to non-farm occupations. The economic factor has to do with the income losses sustained in agriculture over the last two years which, coupled with the uncertainty concerning future prospects, may have induced an exodus from farming through earlier retirements and emigration, coupled with fewer people entering agriculture.

Table 6.1
Employment Projections to 1990 (Thousands)(1)

	1985(2)	1986(2)	1990(2) 'Optimistic'	1990(2) 'Pessimistic'
Agriculture	**169**	**160**	**142**	**142**
Industry	**305**	**298**	**314**	**289**
— Manufacturing	204	200	203	186
— Building	76	73	86	80
— Other	25	25	25	23
Services	**600**	**602**	**634**	**606**
— Public	243	240	240	240
— Private	357	362	394	366
Total Employment	**1074**	**1060**	**1090**	**1037**

(1) The projections should not be ascribed any greater degree of certainty or precision than the discussion in the text implies.
(2) Mid-April. The 1986 figures are NESC Secretariat estimates.

These factors are interrelated and their relative weights difficult to quantify. However, to the extent that the sharp recorded fall in agricultural employment since 1983 is attributable to (a) reclassifications which may be once-off in effect and/or (b) age-related demographic factors which will weaken in time, it is unlikely that the recent rate of decline in the farm labour force can be sustained. In relation to demographic factors it should be noted that recent years have seen an unprecedented decline in the number of farmers aged 65

years and over. Accordingly the cohort from which the bulk of future retirements can be expected is one which is considerably smaller now than in 1979: there were 31,000 farmers aged 65 and over in 1979 compared with 20,000 in 1985.

Our projections of agricultural employment see a 5.5 per cent decline in 1986 and an average decline of 3 per cent annually between 1987 and 1990. This would imply a projected farm labour force of 142 thousand in 1990, compared with 169 thousand in 1985, a fall of 27 thousand over the five-year period.

(ii) Industry

The assessment of prospects for the Building and Construction industry in Chapter 5 envisaged annual average output growth of 3.75 per cent and 2.2 per cent in the period 1985-1990 under the 'optimistic' and 'pessimistic' scenarios respectively. It is assumed that the corresponding rates of employment growth will be somewhat lower. Under the 'optimistic' scenario therefore employment in 1990 is projected at 86 thousand, 10 thousand higher than in 1985. Under the 'pessimistic' scenario the employment projection for 1990 is 80 thousand.

It is considered that the expansion of output from manufacturing industry together with its distribution between the main branches of activity, projected under the optimistic scenario, will be insufficient to increase employment in manufacturing above its 1985 level by 1990. The key factor here is productivity growth. Over the 1980- 1985 period output per employee grew at an annual average rate of 15 per cent in the 'modern' sector* while the corresponding rate of increase in the more established sectors was about 5 per cent.

If these trends in productivity growth were to be maintained over the 1985-1990 period it would require commensurate growth rates in output — growth rates considerably higher than projected under the 'optimistic' scenario — to maintain 1985 levels of employment in manufacturing.

However, there is reason to believe that the high growth of output per employee recorded by the 'modern' sectors between 1980 and 1985 was due in part to factors which are unlikely to recur, including the very high levels of new foreign direct investment which took place in the late '70s and early '80s. Moreover recorded productivity growth in the more established sectors between 1980 and 1985 was in part attributable to the influence of competitive

*Chemicals, Office Machines and Instrument Engineering taken together.

pressures (partly induced by a recession in demand) on employment levels. If, as is implied by the 'optimistic' projections of output growth, competitive pressures on the more established sectors are relaxed over the medium-term, it might be reasonable to expect a deceleration in recorded productivity growth in these sectors.

Because of an assumed deceleration of productivity growth* therefore manufacturing employment under the 'optimistic' scenario is projected to be 203 thousand in 1990 that is, unchanged from its level in 1985.

The growth rates in manufacturing output postulated under the 'pessimistic' scenario would be consistent with a continued sharp decline in employment with both the modern and the more established sectors shedding labour. Under this scenario manufacturing employment may fall to 186 thousand by 1990, almost 20 thousand below its level of 1985.

(iii) Services

It is assumed that employment in public sector services will remain unchanged at its estimated 1986 level of 240 thousand in the period to 1990. This is by way of a working assumption and is not a forecast.

As to private services, employment under the 'optimistic' scenario is projected to be 37 thousand higher in 1990 than in 1985. The implied annual average rate of increase projected here is somewhat less, at 2 per cent, than the corresponding rate of growth in output (3 per cent per annum) in order to reflect the likelihood of increasing output per employee as the more extensive application of technology brings enhanced labour productivity to the services sector.

Under the more pessimistic scenario (output growth of 1.5 per cent annually) the rate of change in employment is assumed to be no more than 0.5 per cent per annum. The resultant projection of private services sector employment in 1990 is 366 thousand, about 10 thousand higher than its estimated level in 1985.

(iv) Total Employment

Drawing together the employment projections by sector yields a total employment figure of 1090 thousand by 1990 under the 'optimistic' scenario, representing an increase of 16 thousand on the 1985 level and an average annual increase of about 3,500. Under the 'pessimistic' scenario it is projected that employment would fall to 1037 thousand by 1990, that is 37 thousand below its 1985 level, representing an annual average decline of over 7,000 per annum.

*Under both scenarios, productivity growth in the 'modern' sector is assumed to decelerate from 15 per cent per annum in 1980-1985 to 10 per cent per annum in 1985-1990, and in the more established sectors from 5 to 2.5 per cent.

Table 6.2
Trends in GDP and Total Employment

	GDP	Total Employment	GDP per Employee
	— (average annual change, per cent) —		
1975-1980	4.6	1.5	3.1
1980-1985	1.8	−1.5	3.3
1985-1990(O)	3.2	0.3	2.9
1985-1990(P)	1.9	−0.7	2.6

(O): 'Optimistic' scenario
(P): 'Pessimistic' scenario

It is worthwhile considering what the employment projections described in the previous paragraphs, together with the medium-term output projections from which they are derived, imply for prospective economy-wide productivity trends in the 1985-1990 period, and how these productivity trends in turn compare with the experience of recent periods.

Table 6.2 indicates that GDP per person employed increased at an annual average rate of 3.1 per cent between 1975 and 1980, and by 3.3 per cent in the 1980-1985 period. Under the 'optimistic' scenario for the period 1985-1990 the implied annual average rate of increase in GDP per employee is 2.9 per cent. The corresponding projection of total employment growth therefore is consistent with an evolution of GDP per employee broadly comparable with that of the two most recent five-year periods.

Under the 'pessimistic' scenario the implied annual average rate of growth in GDP per employee between 1985 and 1990 is 2.6 per cent, significantly below that recorded in either of the two most recent periods of similar duration. That economy-wide labour productivity growth is lower under the 'pessimistic' than the 'optimistic' scenario has to do with the fact that it has been assumed that the respective 1990 levels of employment in agriculture and public sector services would be unchanged as between the two cases.

3. MEDIUM-TERM TRENDS IN THE LABOUR FORCE AND UNEMPLOYMENT

(i) Recent Trends in Unemployment

Live register unemployment stood at 240 thousand in December 1985, equivalent to over 18 per cent of the estimated labour force. The monthly

Live Register figures for 1985 revealed a deceleration in the rate of increase towards the end of the year. The trend over the first nine months of 1986 has seen some reversal in what previously appeared to be an inexorable rise. There were 232,400 persons on the Live Register in September 1986, on an unadjusted basis, a fall of 7,500 from end-1985. On a seasonally adjusted basis however, the figures for September show a modest increase of some 1,300 from their December 1985 level.

Whatever about the rate of change in the numbers on the Live Register the magnitude of the unemployment problem remains enormous. Notwithstanding the modest reduction in the numbers unemployed which has been recorded in 1986 to date, it appears likely that the average unemployment rate for the year will be in the region of 18 per cent.

Moreover the deceleration in the rate of increase in 1985 and the modest decline recorded in early 1986 must be viewed in conjunction with the marked turnaround in net migration which has occurred in recent years. In each of the years 1972-1981, with the exception of 1980, net inward imigration took place with average annual immigration of 9,500. The 1986 Census of Population reveals that net outward migration totalling 75,000 occurred between 1981 and 1986, that is, an annual average net outflow of 15,000. Moreover it is estimated that net outward migration of 20,000 and 31,000 took place in the years to April 1985 and April 1986 respectively.

The evolution of unemployment in the period to 1990 depends as much on future trends in the labour force as on prospective changes in the numbers at work. The latter element has been considered in detail above. The following paragraphs consider the question of prospective trends in the labour force.

(ii) Prospective Trends in the Labour Force

The likely future evolution of the labour force is an issue surrounded by considerable uncertainty. At the present time in Ireland the degree of uncertainty on this issue is accentuated by the results of the most recent Labour Force survey (LFS) and of the 1986 Census of Population. The 1985 LFS revealed that the labour force declined in the year to April 1985 for the first time since the Survey was instituted. The preliminary results of the recent Census indicate that net outward migration totalling 75,000 took place in the 1981-1986 period and indicate that a modest decline in population occurred between 1985 and 1986. Moreover it is estimated that net outward migration of 31,000 took place in the year to April 1986 alone.

Likely future trends in the labour force depend *inter alia* on whether, and at what rate, net outward migration persists over the coming years, and on whether the overall decline in labour force participation rates evident in recent

years continues. The answers to these questions depend in turn on the evolution of economic magnitudes and more particularly on the trend in employment. The evolution of the labour force is not independent of the evolution of employment.

Such is the uncertainty which currently attends these questions that the likely future *direction of change* in the labour force is a matter of some doubt in contrast to previous periods when it was the magnitude of the increase that was uncertain.

Constructing satisfactory labour force projections is a complex task requiring sound judgement not only about the likely future evolution of demographic factors but also a model of how the labour force responds to economic variables both at home and abroad. In the short time that has evolved since the publication of the preliminary results of the 1986 Census it has not been possible to construct a model of labour force growth sufficient to this task. What follows therefore represents nothing more than an attempt to derive a plausible projection for 1990 based on a relatively crude methodology.

Population

Population growth comprises two elements: the natural increase, and net migration. It is assumed that net migration to the end of the decade will average 25,000 per annum, considerably higher than the average annual outflow which characterised the 1981-1986 period as a whole but somewhat lower than the 31,000 net outflow which is officially estimated to have occurred between 1985 and 1986. It is assumed that the age distribution of this net outflow will be broadly comparable to the pattern which characterised the high migration assumption outlined in *Population and Labour Force Projections 1986-1991* published in 1985 by the CSO. It is also assumed that trends in fertility will follow the high fertility case used in the same publication.

On the basis of these main assumptions it is projected that the population in 1990 will be 3534.6 thousand a slight reduction on the Census figure for 1986*. Within this total a significant shift in the age structure of the population is anticipated. A substantial reduction in the numbers aged under 15 and a largely counterbalancing increase in those aged 15 and over are projected. The proportion aged 15 and over is projected to rise from an estimated 70.8 per cent in 1986 to 72.5 per cent in 1990, yielding an absolute increase over the period from 2503 thousand to 2652 thousand in the numbers of working age.

*The population projections were prepared by Mr John Blackwell. Appendix 2 details the assumptions upon which these projections are based.

The overall population projection combined with the assumptions relating to net outward migration imply a natural increase of 25,600 per annum over the remainder of the decade. This is very much lower than the corresponding figure of 33,000 for the 1981-86 period but represents a continuation of a trend evident over recent inter-censal periods.

Participation Rates

Table 6.3 sets out the evolution of participation rates by sex and marital status over the 1975-1985 period. From the point of view of using these data as a guide to likely future trends, two sub-periods may be distinguished: that spanning the years 1975 to 1983 and the two years from 1983 to 1985.

From 1975 to 1983 there was a decline in the male and the single and widowed female participation rates of, on average, 0.4 and 0.2 percentage points per annum respectively. At the same time there was a substantial increase in the participation rate of married women of 0.7 percentage points annually on average. The rate of decline in male participation rates accelerated between 1983 and 1985 while in the case of single and widowed females the rate of decline accelerated even more markedly. The steady increase in the participation rate of married females evident in the eight years to 1983 was reversed in 1984 before increasing modestly again in 1985. The married females' participation rate in 1985 was only slightly above the 1983 rate.

Table 6.3

Participation Rates by Sex and Marital Status, 1975-1985

	1975	1977	1979	1981	1983	1984	1985
			– (per cent) –				
Males	78.4	76.8	76.6	76.5	75.3	75.1	74.1
Single and Widowed Females	46.9	44.2	45.1	45.1	45.1	44.7	42.7
Married Females	14.5	14.4	15.2	17.4	20.0	19.5	20.4
Total	53.8	52.4	52.4	53.3	53.3	52.9	52.1

Source: *Labour Force Surveys*, successive issues.

The overall participation rate (the proportion of the population aged 15 years and over in the labour force) has followed a trend reflecting the evolution of the marital status and sex-specific participation rates outlined above. In 1983 this was 53.3 per cent, down only slightly on the corresponding figure of 53.8 per cent in 1975. However, relatively sharp falls in the overall rate were recorded for 1984 and 1985.

Available data for 1986 are insufficient to estimate labour force participation rates by sex or marital status. However, using an estimate of 1290 thousand for the labour force and 2503 thousand for the population aged 15 years and over yields an overall labour force participation rate 51.5 per cent for 1986 suggesting that the sharp declines registered in the previous two years persisted.

In very broad terms two factors will impel the overall participation rate over the remaining years of the decade, and in opposite directions. The persistence of high emigration concentrated amongst those in the younger working age groups is likely to have the impact effect of reducing the corresponding age-specific participation rates*. On the other hand, to the extent that labour market conditions are eased somewhat by the continuation of net outward migration on the scale assumed, the so-called discouraged worker effect might be expected to weaken as a higher proportion of those who remain in Ireland may start to seek employment.

In the absence of a complete model of labour force determination, it is extremely difficult to anticipate what future trends in participation rates the balance of these, and other, factors will produce. Our labour force projection of 1317 thousand for 1990, 27 thousand higher than has been estimated for 1986, implies that the overall participation rate in 1990 will be approximately the same, at 51.5 per cent, as the rate estimated for 1986**.

(iii) The Outlook for Unemployment

The 'optimistic' medium term scenario envisages 1090 thousand persons at work in 1990. This combined with the illustrative labour force projection of 1317 thousand derived above implies an unemployment level of 227 thousand in 1980 representing just over 17 per cent of the labour force and a very modest reduction on the estimated level of 1986.

The 'pessimistic' scenario for 1990 envisages substantially fewer people at work: 1037 thousand. This would be consistent with an increase in unemployment of 50 thousand from its 1986 level of 230 thousand, *if the labour force were to evolve as indicated above.* The corresponding unemployment rate would be over 21 per cent. It should be stressed however that this is a rather facile conclusion. As indicated earlier the evolution of the labour force is not independent of the evolution of employment. Trends in participation rates are likely to be positively correlated with employment trends and for this reason it must be accounted unlikely that the labour force in 1990 would be as large under the 'pessimistic' as under the 'optimistic' employment scenario.

*On the grounds that the participation rate of emigrants in a particular age group is higher than that of the total population in that age-group and a fortiori higher than the participation rate of those in that age group who remain in Ireland.

**A combination of age and sex-specific participation rates which are consistent with these results are set out in Appendix 2 together with the other assumptions used to derive the population and labour force projections.

4. MEDIUM-TERM PROSPECTS FOR THE PUBLIC FINANCES

We now turn to a consideration of the likely implications for the public finances of prospective economic developments in the medium term. Of particular interest in this regard is an assessment of the extent to which the fiscal imbalances which currently exist might be ameliorated by likely future growth in output and employment on the one hand, and by the prospective future evolution of interest and exchange rates on the other.

A useful perspective on this question is provided by considering the conditions which must obtain in order that the ratio of National Debt to GNP be stabilised — the stabilisation of the National Debt-GNP ratio was adopted as a target for 1987 in *Building on Reality* — and then by going on to consider whether these conditions are likely to be met, given the medium-term scenarios for output and employment growth developed above. This approach also permits the crucial role played by interest rates in shaping the budgetary arithmetic to be identified.

Before analysing the likely future evolution of the public finances it is worth briefly describing the budgetary targets adopted for 1986 and the extent to which they appear likely to be breached.

(i) The 1986 Outturn

Table 6.4 sets out details of the current and capital budgets for 1986 in terms of the Budget estimates and what now appears likely to be the outturn for the year following the publication of the end-September Exchequer returns.

The Exchequer Borrowing Requirement (EBR) is now set to reach £2180m, £180m in excess of the target set in the January budget. This would represent about 13.3 per cent of GNP. For the 1987 EBR target, as set out in the Government's economic plan *Building on Reality,* to be attained would require a reduction in the EBR equivalent to 3.5 percentage points of GNP in 1987.

The expected EBR overrun is entirely concentrated on the current account. The current budget deficit is expected to reach £1430m in 1986 or 8.7 per cent of GNP. This would represent the highest current budget deficit ever recorded and would be 3.7 percentage points of GNP higher than the 1987 target set out in *Building on Reality.* Exchequer borrowing for capital purposes as a proportion of GNP had been reduced by 1985, to the level envisaged for 1987 in *Building on Reality.* Assuming that the Budget target of £750m is attained in 1986, this element of the EBR will have been brought below its 1987 target.

Table 6.5 sets out the elements of the current budget in somewhat greater detail for both 1985 and 1986. It can be seen that the prospective 1986 outturn will see a reversal of the trend evident in recent years whereby the surplus

Table 6.4

Current and Capital Budgets 1986

	Budget Estimate		Forecast Outturn(1)	
	(£m)	(% of GNP)(2)	(£m)	(% of GNP)(2)
Current Revenue				
— Tax	6117	36.0	6077	36.8
— Non-Tax	675	4.0	615	3.7
	6792	40.0	6692	40.5
Current Expenditure				
— Central Fund	2290	13.5	2270	13.8
— Supply Services	5752	33.8	5852	35.5
	8042	47.3	8122	49.3
Current Budget Deficit	**1250**	**7.4**	**1430**	**8.7**
Capital Borrowing	**751**	**4.4**	**750**	**4.5**
Exchequer Borrowing Requirement	**2001**	**11.8**	**2180**	**13.2**

(1) As indicated in the Government press release which accompanied the Exchequer returns of end-September.
(2) Budget estimates based on projected value of GNP of £17bn. Forecast outturns based on GNP projection of £16.5bn.

Source: 1986 Budget Booklet, Exchequer Returns (end-September).

on non-interest items increased. This surplus is now set to fall from £540m in 1985 to £410m in 1986. If the Budget targets were attained the non-interest surplus on current account would increase to £600m.

As regards increases in expenditure allocations there is considerable variation across the principal aggregates. The projected rate of growth in interest payments, at less than 1 per cent, is such as to restrain the growth of overall current spending somewhat. The nominal increase of 6.6 per cent in non-pay non-transfer payments supply service spending now expected, compares with a 2.7 per cent increase targetted in the Budget. This represents an over-run of £75m relative to the Budget allocation due, *inter alia,* to the allocation to agriculture of £49m more than was allowed for in the Budget.

Spending on pay and pensions is projected to grow by almost 8 per cent in 1986. When account is taken of a likely decline in public sector employment in 1986 what is implied here is an increase in average income per capita of over 8 per cent or, an increase of over 5 per cent in real terms. Of the nominal increase in the pay and pensions allocation, 1½ percentage points may be attributed to a carryover in rates of pay from 1985, about 2 points to the impact of the current Public Sector Pay Agreement in 1986, and about one percentage point to the effect of incremental scales.

Gross spending on Social Welfare transfer payments is set to rise by almost 9 per cent in 1986. Of this increase 3.2 percentage points may be attributed to carryover from 1985 and a further 1.9 points to the impact of the increases in rates of payment which took effect from mid-July of this year. The balance is attributable to projected increases in the number of recipients under the various programmes, especially UA and UB.

Turning to the revenue side of the current account, a large shortfall on Budget targets amounting to £100m is now projected for 1986. Of this, £40m is attributable to the tax component comprising in the main a lower than expected outturn in respect of VAT and customs receipts. The shortfall in non-tax revenue is likely to be £60m implying an outturn of £615m in 1986 compared with £750m in 1985.

Table 6.5

Current Budget Detail, 1985-1986

	1985	1986	Change 1985-1986
Expenditure	**(£m)**	**(£m)**	**(%)**
1. Pay and Pensions	2479	2667	7.6
2. Net Social Welfare Transfers	1314	1471	11.9
- Gross Social Welfare Transfers	(2188)	(2378)	(8.7)
- PRSI Receipts	(874)	(907)	(3.8)
3. Other Supply Services, net	1608	1714	6.6
- other supply, gross	(2086)	(2208)	(5.8)
- Appropriations-in-Aid	(478)	(494)	(3.3)
4. Total Supply Services (1+2+3)	5401	5852	8.4
5. Other Non-Interest	387	426	10.1
6. Total Non-Interest (4 + 5)	**5788**	**6278**	**8.5**
7. Interest Payments	1827	1844	0.9
8. Total Current Revenue (6 + 7)	**7615**	**8122**	**6.7**
9. Tax	5581	6077	8.9
10. Non-Tax	750	615	-18.0
11. Total Revenue (9 + 10)	**6331**	**6692**	**5.7**
Non Interest Current Balance (6-11) (1)	**-543**	**-414**	**—**
Current Budget Deficit (8-11)	**1284**	**1430**	**—**

(1) Minus sign denotes surplus

Source: *Budget Booklet* 1986, NESC Secretariat Estimates.

(ii) The National Debt

The evolution of the National (Exchequer) Debt in recent years was documented in Chapter 3 where it was shown that in nominal terms the National Debt increased two-fold between 1981 and 1985, from £10.2bn to £20.4bn or from 94 to 134 per cent of GNP. Associated with this growth in the National Debt there has been a rapid increase in the cost of servicing

it. Exchequer debt servicing costs absorbed 8.2 per cent of GNP in 1981 and 12.9 per cent of GNP in 1985. The National Debt/GNP ratio is an important indicator of fiscal imbalance for reasons which are more fully explained in Chapter 8. It also provides a convenient and useful framework for assessing the medium-term prospects for the public finances.

A growing National Debt implies growing debt servicing costs. Accordingly, in circumstances where the National Debt is increasing relative to GNP, interest payments will absorb an increasing proportion of GNP if the interest rate remains unchanged. The corollary is that Exchequer borrowing will become unsustainable. This suggests a simple rule of thumb, namely that a sustainable borrowing position is consistent only with a situation where the ratio of National Debt to GNP is stabilised or reduced.*

Whether or not the National Debt/GNP ratio evolves in a sustainable direction depends critically on three factors: (i) the future course of interest rates and exchange rates; (ii) the evolution of nominal GNP and (iii) the stance of fiscal policy as measured by the non-interest budget balance, that is the EBR net of interest payments.

If it is assumed that the non-interest EBR as a proportion of GNP were to remain unchanged then the question of a stable National Debt/GNP ratio reduces to a consideration of the relationship between the nominal interest rate and the rate of growth in nominal GNP. Under such circumstances, if the nominal interest rate exceeds the rate of growth in nomimal GNP, the debt ratio will tend to rise and to accelerate without theoretical limit, and interest payments will absorb an ever-increasing proportion of GNP.

At the time of writing (September 1) the average interest rate on new Exchequer debt was approximately 8.5 per cent.** If this rate were to obtain throughout the period to 1990 it would require an equivalent rate of increase in nominal GNP over the period to stabilise the debt-GNP ratio, assuming no change in the non-interest budget balance as a proportion of GNP in the intervening period. With an annual average inflation rate of about 3 per cent in prospect for the years 1986-1990 this would translate into the requirement that real GNP increase at an annual average rate of about 5.5 per cent — a rate which is well beyond the optimistic end of the range which emerged from the discussion of the medium-term outlook for output and employment presented in Chapter 5.

*This condition defines only what is sustainable. This is very much a minimal target for management of the public finances. A given magnitude for the National Debt may be sustainable but neither desirable nor optimal.

**This was computed as the weighted average of foreign interest rates as measured by 6-month Eurocurrency rates and the domestic rate as measured by the redemption yield on medium-dated Government stock. The weights used reflect the composition of Exchequer debt outstanding at end-December 1985.

These figures derive from the assumption that interest rates and the exchange rate of the Irish pound will remain broadly unchanged from their September 1986 levels for the period to 1990. Expectations exist that international interest rates will fall somewhat from their current levels and that some exchange rate movements will occur over the medium term, in particular a further weakening of the US dollar. It has already been noted however that the IMF projections to 1991 do not foresee any significant further reduction in international real interest rates from their 1986 levels over this period. It might seem reasonable to expect some reduction in domestic rates but this is a matter of considerable uncertainty.

In any event it would require a large measure of interest rate optimism to change the conclusion drawn above about the sustainability of the debt-GNP ratio. In particular, it would require an average real interest rate reduction of about two and a half percentage points (with unchanged inflation projections) relative to the September 1986 position, in order that the rate of real GNP growth necessary to achieve a stabilisation of the debt-GNP ratio would fall within the range outlined in the medium-term scenarios for output and employment constructed in the previous chapter.* Again, this is on the basis of an unchanged non-interest EBR relative to GNP.

(iii) The Exchequer Borrowing Requirement

The conclusions in the preceeding paragraphs about the likelihood of conditions existing over the 1986-1990 period which would be sufficient to stabilise the debt-GNP ratio derive from a rather simplistic mechanical exercise in which it was assumed for purely illustrative purposes that the non-interest EBR would remain unchanged as a proportion of GNP over the medium-term. In the following paragraphs this assumption is relaxed in order to pose the question: whether the non-interest EBR is likely to expand or contract between 1986 and 1990, on the basis of the medium-term scenario for output and employment developed above and, on the basis of existing government policies in relation to expenditure and taxation.

Some cautionary notes about this exercise should be struck at the outset. In the first place, given that the expenditure and revenue projections arrived at are not derived from a comprehensive set of national accounts-type income and expenditure forecasts for the economy as a whole, in which the full set of macro-economic interactions are estimated and taken into account, the exercise must be viewed as somewhat incomplete and the projections of budgetary aggregates must be interpreted as being of the "orders of magnitude" variety. In particular the projections should not be ascribed the status of forecasts.

*An average nominal interest rate of 6 per cent would, given an inflation projection of 3 per cent per annum for 1986-1990 require an annual average growth rate in real GNP of about 3 per cent in order to stabilise the Exchequer Debt/GNP ratio. This discussion is further elaborated in Chapter 8.

Secondly, there is some difficulty in satisfactorily translating the assumption that existing government policies will continue, into projections of tax and expenditure growth under certain headings. In this regard there is particular difficulty attaching to the pay and pensions, and non-pay non-transfer payments components of current spending. In the interests of clarification therefore it is useful to specify the assumptions which have been used in regard to the various elements of the non-interest EBR. They are as follows:

(i) that expenditure on pay and pensions will increase from £2667m in 1986 at a rate of 4.75 per cent per annum in the four years thereafter to 1990, reflecting an annual inflation rate of 3 per cent, an allowance of a 1 per cent per annum increase to incorporate the impact of incremental scales and an allowance of 0.7 per cent per annum increase to cover the impact of other factors (Implicit in the projection therefore are the assumptions that numbers employed in the public sector will remain unchanged at their 1987 level through to the end of the decade, and that special pay agreements will add nothing to the Exchequer pay bill in the 1988- 1990 period)*;

(ii) that per capita rates of social welfare transfer payments will rise in line with the CPI, that is by 3 per cent per annum between 1986 and 1990;

(iii) that expenditure on the non-pay non-transfers element of supply services will expand at an annual average rate of 4.5 per cent between 1986 and 1990 incorporating all allowance of 1.5 per cent annually for volume growth;

(iv) that expenditure on the non-interest component of the Central Fund (mostly Ireland's contribution to the EEC budget) will increase at an annual average rate of 4 per cent between 1986 and 1990;

(v) that there will be no volume change in the PCP over the period of 1990, that Exchequer capital spending will accordingly expand in nominal terms by 3 per cent per annum with a pro rata increase in Exchequer capital resources and that, as a result, Exchequer borrowing for capital purposes will be some £850m in 1990;

(vi) total tax revenue will grow in line with nominal GNP implying an elasticity of tax revenue to GNP of unity.

As regards non-tax revenue a number of factors indicate that there will be very little buoyancy over the rest of the decade. These factors include the reduction in the Bord Gais surplus on foot of lower oil prices, and the uncertainty about whether the operating surplus of An Bord Telecom will continue to be remitted to the Exchequer after 1988. Accordingly non-tax revenue is projected to be no more than £650m in 1990 compared with an expected outturn of £615m in 1986.

*The assumption about the future impact of special agreements may in itself bias the 1990 projections downward somewhat.

Table 6.6*

Projected Evolution of the Public Finances to 1990

	1986(1)	1990	
		Optimistic	Pessimistic
	(£m)	(£m)	(£m)
Current Revenue			
Tax	6077	7760	7390
Non-Tax	615	650	640
Total	**6692**	**8410**	**8030**
Non-Interest Current Expenditure			
Pay and Pensions	2667	3210	3210
Net Transfer Payments	1471	1680	1940
Other Supply Services, Net	1714	2060	2060
Non-Interest Central Fund	426	510	510
Total	**6278**	**7460**	**7720**
Non-Interest Current Balance	+414	+950	+310
Exchequer Capital Borrowing	751	850	850
Non-Interest EBR	-337	+100	−540
(% of GNP)	-2.0	+0.5	−2.7

(1) Likely outturn

Based on these assumptions, illustrative projections of the components of the non-interest EBR for 1990 are set out in Table 6.6. Two sets of projections are given for 1990 corresponding respectively to the optimistic and pessimistic output and employment scenarios constructed earlier. The principal channels through which the different output and employment projections produce a different prospect for the non-interest EBR are: tax revenue, and net expenditure on transfer payments. Tax revenue is £370m lower under the 'pessimistic' scenario because of the lower rate of employment growth and the lower rate of increase in the volume of personal consumption which would consequently ensue. Net expenditure on transfer payments is £260m higher under the 'pessimistic' scenario because of the higher level of unemployment and the lower level of PRSI contributions associated with lower employment.

Under the 'optimistic' scenario the net effect on the non-interest component of the EBR would be to transform an expected deficit of £337m in 1986 into a very modest surplus of £100m in 1990. Under the 'pessimistic' scenario it is projected that the non-interest EBR would be in deficit to the extent of £540m in 1990. This would be equivalent to almost 3 per cent of 1990 GNP compared with the corresponding proportion of 2 per cent in 1986.

*The projections in this table should be ascribed no greater certainty or precision than the discussion in the text implies.

5. CONCLUSIONS

The medium-term outlook for output growth as analysed in Chapter 5 indicates that the continuation of existing policies offers little prospect of ameliorating the two most serious problems currently facing the Irish economy.

The more optimistic scenario is consistent with an almost negligible reduction in unemployment even in the face of net outward migration at the rate of 20,000 per annum on average between 1986 and 1990. A very modest improvement in the public finances by 1990 might be in prospect under this scenario but as Chapter 8 indicates this improvement would be insufficient, given the likely evolution of interest rates, to secure what can only be regarded as the minimal objective of fiscal policy, namely stabilisation of the National Debt-GNP ratio.

Under the more pessimistic scenario the prospects are worse. The numbers out of work are projected to increase above the already disturbing level of 1986 and the public finances projected to deteriorate further.

What emerges clearly from the assessment contained in this and the previous chapter is that there is no automatic correction mechanism at work in the public finances. Indeed, the pessimistic scenario indicates that quite the opposite forces may be at work. The assessment also clearly indicates that under existing policies the principal mechanism which is likely to, at best contain the growth of unemployment, is that of emigration.

PART III: POLICIES

7

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 unremittingly 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

*OECD *Economic Surveys: Denmark*, February 1986.

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 also, 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-servicing 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 acknowleded 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 jettisonned 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 arsing 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, 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 defensible long-term 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 unemployed or underemployed human resources. It is here that their 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 GNP 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 recognise 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.

8

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 end- December 1985 the National Debt already amounted to 134 per cent of GNP. Moreover, present trends indicate that a deficit on 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.

*This assertion must be qualified somewhat. A cut in interest rates may bring with it a reduction in servicing costs while the underlying stock of debt increases. The effect of an interest rate cut on servicing costs however is once-off. Once the interest payments have fallen to reflect the reduction in interest rates, servicing costs will resume their growth if the stock of debt increases.

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 over-riding objective of fiscal policy. Indeed, for reasons which are spelled out below this can only be regarded as the minimum requirement of a sound

*See, for instance: Chouraqui et. al. "Public Debt in a Medium-Term Context and its Implications for Fiscal Policy", OECD Department of Economics and Statistics, Working Paper No. 30, May 1986.

financial strategy on the part of government. The conditions necessary for stabilisation of the debt-GNP ratio have been adverted to in Chapter 6. Where the nominal interest rate exceeds the rate of growth in nominal GNP the debt ratio will tend to increase at an accelerating rate if the non-interest budget balance on current and capital account taken together remains unchanged. It follows that, if the debt ratio is to be prevented from increasing in circumstances where the growth rate of nominal GNP is exceeded by the nominal interest rate, there must be a surplus on the non-interest budget account. The magnitude of the required surplus depends upon the size of the debt-GNP ratio, and on the margin by which the nominal interest rate exceeds the growth rate of nominal GNP.

Table 8.1 sets out estimates of what the required non- interest surplus as a proportion of GNP would be, corresponding to different combinations of prospective interest rates and GNP growth rates for the 1986-1990 period. It has been assumed for the purpose of this exercise that the annual average inflation rate for the period will be 3 per cent. The nominal GNP growth rates have been chosen to reflect the range suggested as plausible by the earlier discussion of the medium-term prospects for output growth.* Thus the annual average growth rate of nominal GNP of 6.25 per cent reflects the 'optimistic' scenario for output growth while the 5 per cent rate corresponds to the 'pessimistic' scenario. The range of nominal interest rates chosen is demarcated at one end by the assumption that the weighted average of existing international and domestic rates will remain unchanged** over the period to 1990, yielding a rate of 8.5 per cent and, at the other end, by the projection of a fall of two percentage points in this representative rate on average over the period, yielding a rate of 6.5 per cent.

Table 8.1.
Required Surplus on Non-Interest Account as a Proportion of GNP to Stabilise National Debt-GNP Ratio

		Nominal Interest Rate		
		8.5%	7.5%	6.5%
Nominal GNP Growth	6.25%	3.0	1.7	0.3
	5.5%	4.0	2.7	1.3
	5.0%	4.7	3.4	2.0

Note: (i) The entries indicate what surplus on non-interest account (current plus capital), expressed as a percentage of GNP, would be required to stabilise the national debt-GNP ratio at its end-1985 level of 134 per cent, under the various combinations of nominal interest rates and rates of growth in nominal GNP. The non-interest surplus required is calculated by multiplying the existing national debt-GNP ratio by the difference between the interest rate and the nominal GNP growth rate.

(ii) The figures in the table are computed on the assumption that a reduction in interest rates would impact on interest payments in respect of the entire stock of Exchequer debt outstanding. In practice this would not happen immediately but with a time-lag as some 70 per cent of existing Exchequer debt is denominated in terms of fixed interest rates. However fixed interest debt is rolled over and this practice permits an increasing proportion of the debt to benefit from 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.

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 the 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 to 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 stablise 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.

*Cuts in net expenditure can be secured by cutting gross expenditure, increasing charges for services, or increasing revenue from such sources as PRSI or Health contributions, or by a combination of such measures.

(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, committed 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 incease 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.

**The Way Forward,* 1982, p.23.

**See NESC Reports Nos. 70, 75 and 79.

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 focusses 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 rigorous 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 per annum) which was more than counterbalanced by volume growth in spending on transfer payments (6.6 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 jettisonned in the process of restoring order to the public finances.

*See Table 3.3

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 contribuions 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 betwen 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 heterogenous 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 over 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

*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 increases.

**The estimates provided in this paragraph are based on the assumptions of an average interest rate of 7.5 per cent and nominal GNP growth of 5.5 per cent in 1987 and 1988.

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

*This volume cut is relative to the 1986 outturn. The required reduction in relation to the 1987 opening position is likely to be substantially higher.

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 portfolios 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 by unsustainable. Moreover, just as there may be a 'portfolio' effect on domestic interest rates arising from an accumulating stock of domestic government debt, there may be an analogous effect on the exchange rate associated with an accumulating stock of exchequer 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.

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 profitablity 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$ 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

*The public finances would also benefit from the effect of increased levels of economic activity on tax revenues but this would be a "second-round" effect and not an impact effect of the oil price fall

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 increases 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 ESRI *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 outstripped 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 redressing 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 liabilites 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.

*This depends on the currency in which the transactions are invoiced. It can be assumed in the case of Ireland that all imports and the bulk of exports are invoiced in foreign currencies.

**John Flynn: "A Simulation Model of the Effects of Exchange Rate Changes on Inflation and the Trade Balance", *Central Bank Quarterly Bulletin*, Summer 1986.

A survey conducted earlier this year by the CII provided some evidence 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 activites 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-a-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-a-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 profitablity 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:

	1979	1980	1981
		(1973 = 100)	
Textiles	127.2	107.1	103.5
Clothing	91.7	88.4	85.3
Footwear	69.8	63.9	65.2
Timber and Furniture	102.2	90.0	88.9

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- inducing 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 cost increases exceed 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

*Dalia Marin: "Structural Change through Exchange Rate Policy", *Weltwirtschaftliches Archiv*, Vol. 121, No. 3, 1985.

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 adjusted 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 re-allocation 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

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-a-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-a-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 8.2
Irish Trade Patterns

	Exports		Imports		Average	
% Shares	EMS	UK	EMS	UK	EMS	UK
1971	9.7	66.0	16.7	49.5	13.2	57.8
1975	18.4	56.4	21.7	46.6	20.1	51.5
1978	30.2	47.3	20.8	49.5	25.5	48.4
1979	31.1	46.4	21.6	50.0	26.4	48.2
1980	31.7	42.7	20.1	50.8	25.9	46.8
1981	29.8	39.6	21.2	49.7	25.5	44.7
1982	31.6	39.0	22.2	48.2	26.9	43.6
1983	31.7	36.9	21.8	45.4	26.8	41.2
1984	33.7	34.4	21.7	42.9	27.7	38.7
1985	34.1	33.0	21.8	42.7	28.0	37.9

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 by 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 depreciation/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 guaged 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 to 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 cost 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, 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)

Year	Gross Personal Income	Real Gross Personal Income	Disposable Personal Income	Real Disposable Personal Income
1981	+22.8	+2.0	+22.7	+1.9
1982	+13.9	-2.8	+11.8	-4.6
1983	+ 8.6	-1.7	+ 6.7	-3.5
1984	+ 9.1	+0.5	+ 7.1	-1.4
1985	+ 6.1	+0.6	+ 5.9	+0.5
1980-85	+75.7	-1.5	+65.9	-7.0

Source: *National Income and Expenditure*, 1985, *Quarterly Economic Commentary* ESRI, August 1986.

(b) exchange rate movements over the same period, however, accomodated 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 18 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' industries (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 1.8 per cent between 1980 and 1985 with the older industries experiencing a rise of 6.4 per cent per annum;*
(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 merits comment. This combination of events can 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 14.3 (10.1) per cent, creating a differential or wedge of 27.3 (23.1) percentage points over the period.

*Considerable caution should be exercised in interpreting movements in unit labour costs (see Chapter 2 for discussion).

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 employee'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)

Year	Total Increase	Increase due to		
		Payroll Taxes	Income Taxes	Indirect Taxes(1)
1981	+ 4.9	+0.2	+ 1.1	+3.6
1982	+ 7.8	+1.5	+ 3.5	+2.8
1983	+ 8.2	—	+ 5.4	+2.8
1984	+ 4.6	+0.6	+ 3.4	+0.6
1985	+ 1.8	+0.4	+ 1.3	+0.1
1980-85	+27.3	+2.7	+14.7	+9.9

(1)The 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 calculations here 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 manufactured output prices increased at broadly comparable rates over the period.

(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 4¼ and 3¾ per cent respectively, while unit labour costs are projected to increase by 2¼ per cent in 1986 and by 1½ per cent in 1987 for the seven major industrial countries. There can be litle 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 in 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. COMPETITON 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 reorganisation of the institutions dealing with competition policy. This reorganisation 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 contraints 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 significiant 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 peformance (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, commerical state-sponsored bodies, however, must be viewed in a broader context than competitiion 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.

9

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

*NESC, Report No. 61, Irish Social Policy: Priorities for Future Development, Stationery Office, Dublin 1981.

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 commentaries** 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 focussed 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

*OECD, Role of the Public Sector, 1985.
**Peter Saunders, Public Expenditure and Economic Performance in OECD Countries, Conference Paper 1984; David Cameron, Public Expenditure and Economic Performance in International Perspective, Conference Paper, 1984.

Table 9.1
Expenditure by Functional Area as a Percentage of GDP, Selected Countries, 1978 and 1980/3

Functional / Country	Australia	United States	Belgium	Denmark	West Germany	France	Italy	Ireland	Netherlands	United Kingdom	Japan
Education	5.6	5.7	7.7	7.5	4.9	5.8	5.1	5.5	7.4	5.3	5.0
	5.7	—	8.3	8.2	5.2	5.7	6.0	6.3	6.9	5.1	5.0
Health	4.3	2.6	5.5	5.6	6.3	5.9	5.9	5.9		4.5	4.5
	4.7		5.7	5.8	6.8	6.1	6.0	7.2		4.4	4.6
Social Security and Welfare	7.6	9.9	24.0	19.6	19.6	18.3	16.1	9.1	20.5	13.0	6.7
	8.2		29.0	22.4	19.8	19.0	17.4	13.2	22.8	12.9	7.3
Housing and Community Amenites	0.4	0.4	0.7	1.6	1.2	2.7	1.2	3.7		3.6	2.4
	0.4		0.8	1.6	1.4	2.7	1.7	4.1		3.5	2.4
Other Community and Social Services	0.7	0.4	0.4	1.6	0.7	0.7	0.3	0.7		0.5	0.4
	0.9		0.5	1.6	0.8	0.8	0.4	0.9		0.5	0.4
Total Social Services	18.7	19.0	39.2	35.7	32.8	33.4	28.6	24.9		26.9	19.0
	20.0		44.3	39.8	34.0	34.4	31.4	31.7		26.5	19.7
General Public Services	2.6	2.7		4.2	3.6	3.0	2.9	3.2		2.2	3.3
	2.9			4.9	3.9	2.7	3.1	4.0		1.8	3.3
Defence	2.1	4.7	2.9	2.3	2.9	3.3	1.9	1.7	3.1	4.4	0.9
	2.6		3.1	2.6	2.9	3.6	2.1	1.7	3.4	4.5	0.9
Public Order and Safety	1.1				1.7	0.9	1.7	—		1.4	
	1.3				1.8	0.9	1.7	—		1.5	
Economic Services	3.4	3.2		4.1	5.4	3.4	8.0	10.4		3.8	6.0
	3.9			5.7	4.9	3.5	8.1	10.2		3.6	6.1
Other Functions	2.5	1.0	5.3	2.8	1.6	1.5	3.2	—		4.4	0.0
	3.4		8.1	6.6	2.2	1.5	7.5	—		4.6	0.4
Total of Above	30.5	30.4	58.0	49.0	48.0	45.5	46.3	40.2	53.7	43.1	29.1
	34.0		66.7	59.6	49.6	46.7	53.9	47.6	60.9	42.5	30.1

Source: Australia, Denmark, West Germany, France, Italy, United Kingdom: OECD (1984): National Accounts, Vol. II, 1970-1982
United States, Japan: OECD (1982) National Accounts, Vol. II 1963-1980
Belgium, Netherlands: Eurostat (1984) Central Government Account and Statistics, 1980-1982
Ireland: CSO (1984), National Income and Expenditure Accounts, 1975-1981

The upper and lower parts of each row refer to 1978 and 1980/1

Note: The later years for the countries are as follows
Ireland, 1983, Australia, Belgium, West Germany, 1981
Denmark, Italy, Netherlands, 1982, United Kingdom, 1979, Japan, 1980

59.6% for France, West Germany and Denmark respectively: the non EEC countries listed show much lower figures. However, Ireland is among the countries which has had a relatively high growth of public expenditure since 1978. Total social expenditure in Ireland, 31.7% of GDP in 1983, is at the lower end of the spectrum for EEC countries. However the growth of social expenditure in Ireland is comparatively rapid, from 24.9% to 31.7% of GDP during the 1978-83 period. In other countries the growth of social expenditure has been less significant. The data on specific social programmes raise more interesting points. Health services expenditures in Ireland are the highest in the comparison at 7.2% of GDP, and the rate of growth of these expenditures has been greater than elsewhere. These figures contrast with those for social security and welfare where Ireland has the second lowest figure among the EEC countries, 13.2% of GDP in 1983. (Classifications of expenditure vary somewhat between countries: notably, many European countries include some health expenditures under social security and therefore the stated contrast between Ireland and other countries regarding the relative sizes of health and social security commitments should be considered in the light of the different expenditure classifications). Housing expenditures also account for a higher proportion of GDP in Ireland than in other countries.

(ii) Unemployment Compensation

The discussion in the following paragraphs of the possible economic affects of social programmes is confined to social security. This reflects both the relative importance of social security expenditure and the centrality of social security to the debate on the economic consequences of social programmes. Central to the critique of social programmes has been the contention that unemployment compensation has led to 'induced' unemployment.

The links between unemployment payments and unemployment levels might be as follows: (a) the cost of being without a job is reduced for those unemployed in receipt of a payment, and this might induce voluntary job quitting or more prolonged periods of unemployment; (b) a result of unemployment payments is to increase the 'reservation wage' of job seekers so that the probability of acceptance of job offers is reduced; (c) an 'eligibility effect' may occur in that the prospect of future unemployment benefit may induce higher labour force participation rates especially among secondary workers and those interested in part time employment.*

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

*The above points are the more important aspects of this argument. In addition it might be suggested that (i) unemployment payments raise the return to work in industries susceptible to seasonal fluctuations — if these industries grow relative to others the average unemployment rate is raised and (ii) unemployment compensation acts as an automatic stabiliser, which may reduce unemployment in the short term: through the maintenance of aggregate demand.

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 benefit 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."††††

*OECD, The Role of the Public Sector, pages 151-152.

†**These figures refer to single persons; the corresponding figures for a man, spouse and four children are 1.8% and 3.1%.
†Donal P. O'Mahony, A Study of Replacement Ratios Among a Sample of Unemployed Workers, *Economic and Social Review*, vol. 14, no. 2 1983, pages 77-91.

††J. Blackwell, Unemployment Compensation Work Incentives *Commission on Social Welfare, Backround Paper No. 2*, 1986 pages 14-15.

†††G Hughes, B.M. Walsh: Unemployment Duration, Aggregate Demand and Unemployment Insurance: A study of Irish Live Register Survival Probabilities, 1967-1978, *Economic and Social Review*, Vol 14, 2, 1983, pages 93-118.

††††Blackwell, *op. cit.* pages 25-26.

Table 9.2
Distribution of Recipients of Unemployment Compensation, by Dependency Circumstances, and Rate of Payment Together with Replacement Ratios, at Mid-1984

	Single	Married without children	Married with Children 1	2	3	4	5	6 and over	Total
Distribution									
Unemployment Benefit %	60.0	9.0	7.6	8.6	6.4	4.5	2.2	1.7	100
Unemployment Assistance %	56.4	7.4	7.0	8.8	7.2	5.6	3.5	4.1	100
Replacement ratios for those on average industrial earnings:									
Unemployment Benefit %	46	57	64	71	76	82	87	92	—
Unemployment Assistance %	27	39	45	51	56	60	65	69	—

Notes: Rates of benefit at July 1984 are used. *Average* rate of pay-related benefit of £16.11 for 1984 is used. Maximum urban rate of Unemployment Assistance (short-term) is used. Income calculations: as for Table 9.3.

Source: J. Blackwell, Unemployment Compensation and Work Incentives, Commission on Social Welfare, Background Paper No. 2, 1986, page 22, Table 6.

An important consideration concerning social security payments and possible work disincentives in Ireland is the sensitivity of actual replacement ratios to the family and dependancy 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 overstates 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 therefore 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

*OECD, The Role of the Public Sector, Paris, 1985.

**G Hughes Social Insurance and Absence from Work in Ireland, ESRI Report, 108, 1982.

(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 benefit, 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 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 Governments' social commitment. These programmes have been the largest element of social security spending for some time: in 1985 they accounted for 29% of the social welfare budget, almost £690 millions when ancillary benefits in kind are included. A recent concern among economists about retirement pensions is their potentially depressing effect on private savings and capital formation. It has been argued that pay-as-you-go 'unfunded' state pensions may lower saving: 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 provisions 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.†

*G Hughes, op. cit. pages 31-33.

**OECD, The Role of the Public Sector 1985, Page 146.

†ILO, Into the Twenty First Century, The Development of Social Security, Geneva, 1984, page 95 ("We regard the argument that pay as you go financing reduces total savings as unproven)".

Table 9.3
Number of Pensioners, Real Value of Pensions and Savings Ratios

	Pensioners per 1000 population Aged 65+	Index for Real Value of Pensions*	Personal Savings Ratio	Ratio of Gross National Savings to Gross National Disposable Income	Ratio of Gross National Savings to Gross National Product at Market Prices
1971	496.1	100.0	10.4	19.5	19.9
1972	485.5	101.6	14.5	22.3	22.7
1973	497.2	110.7	17.0	23.2	23.9
1974	567.7	116.0	16.2	18.6	19.3
1975	602.7	128.3	21.6	20.9	21.8
1976	602.0	124.4	17.3	19.6	20.2
1977	631.5	122.2	16.5	21.7	22.9
1978	629.5	113.6	16.9	21.6	23.0
1979	626.9	116.4	15.2	19.1	20.4
1980	623.1	126.1	13.3	15.8	17.0
1981	620.2	132.6	12.4	13.1	13.7
1982	624.0	146.8	14.9	15.1	15.7
1983	622.1	148.3	15.6	17.1	17.8
1984	624.4	149.5		18.5	19.4
1985		151.3			

*contributory Old Age Pension (Maximum Personal Rates)

Sources: Department of Social Welfare
Census of Population, Vol II 1981
Labour Force Surveys, 1975, 1977, 1979, 1983, 1984
Irish Statistical Bulletin
National Income and Expenditure Accounts

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 most 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.

*Qualifications must attach, however, to the aggregate measures of savings in National Income data which are given in Table 9.3.

(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 expendiuture.

*In *Building on Reality* it was stated that "A balance is required between what is necessary to meet acceptable economic constraints and what relates specifically to the creation of a more just and equal society" (page 87).

**The NESC in Report No. 61, *Irish Social Policy: Priorities for Future Development*, 1981.

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;

Table 9.4
Growth in Social Welfare Payments 1986-1990

Social Welfare Payment	1986 £m	Inflation Per Annum %	Volume Change Per Annum % 'O'	Volume Change Per Annum % 'P'	1990(1) £m 'O'	1990(1) £m 'P'
Unemployment Benefit	297	3	-0.3	+5.0	330	440
Unemployment Assistance	388	3	-0.3	+5.0	431	574
Old Age	721	3	+0.4		824	824
Deserted Wives, Single Parents etc	78	3	10.4		130	130
Widows	248	3	+0.3		282	282
Disability	282	3	+0.5		331	331
Invalidity	82	3	+0.5		94	94
Childrens Allowances	211	3	-1.7		222	222
Other	85	3	+0.5		98	98
All	2398	3	+0.4'	+2.6	2742	2995

Source: Secretariat calculations
(1)'O' is optimistic and 'P', pessimistic scenario for unemployment. See Chapter 6, sections (ii) and (iii).

— childrens 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 th 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 1982, Chapter 21

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 emposes on employers, the varifying 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 earmaked 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 employments 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

Expenditure — Insurance Payments	£m	1,204.9
Expenditure — Assistance Payments	£m	982.9
Total Expenditure (1)		2,274.0
Total Revenue		2,274.0
of which, employers	£m	615.5
employees	£m	283.6
state	£m	1,370.3
other	£m	4.6
Revenue as % of expenditure		%
Total Revenue/total expenditure		100.2
State Contribution/Total expenditure		60.2
Employers plus employee contributions/ total expenditure		39.5
employee contribution/total expenditure		12.5
employers contributions/insurance expenditure		51.1
employees' contributions/insurance expenditure		23.5

Source: Statistical Information on Social Welfare Services; 1985.

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

*Report of the Commission on Social Welfare, Chapters 10 and 12.

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 5%" 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 eventual increase in insurance benefits expenditure which will derive from wider entitlement to social insurance (ii) the diminution in social assistance expenditure which will offset the increase in social insurance expenditure and (iii) the revenue increase resulting from the inclusion of short 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 regard 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 expenditures. 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

*The revenue reduction would be £410m. See Donal de Buitlear, Some Implications of Tax Reform, *Paper to the Social and Statistical Inquiry Social of Ireland*, Dublin, November 1983.

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 conjuction 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

*J. G. Hughes, Payroll Tax Incentives, The Direct Tax Burden and the Rate of Return on State Pension Contributions, ESRI, Paper 120, 1985.

*Report of the Commission on Social Welfare, Stationery Office, Dublin 1986, Chapter 9.

- 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 costed 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 Childrens 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 note 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,

and prior to this, in 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 regard to the Commission on Social Welfare's analysis, and in regard 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;

*_Building on Reality_: The Government pointed out that "The standard of living of those who rely on social welfare has risen significantly both in real terms and relative to that of the employed population, though in absolute terms social welfare payments for those who have a long term dependence on the system still only represent an income close to subsistence" (page 102).

**P Saunders, Evidence on Income Distribution by Governments, OECD Working Paper No. 11. Paris, 1985, pages 26-27.

†D Hannan, D Rottman, P O'Connell The Redistributive Effects of Social Expenditure and Taxation in the Republic of Ireland: An Evaluation of Welfare State Policies, Conference Paper. 1984.

— 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 utilistion 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 implictions of the structure and financing of health services. For three reasons public expenditures on health in contemporary Welfare States may have

*Office of Health Economics, Health Expenditure in the UK, London 1986

Table 9.6
Total Health Care Expenditure Expressed as Percentage of Gross Domestic Product (GDP)

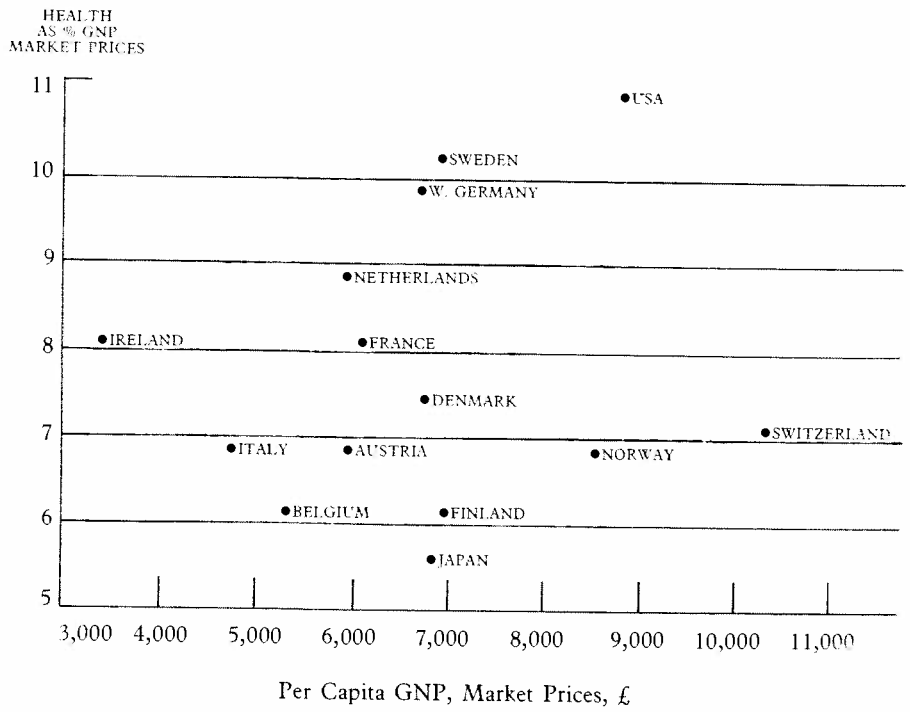
	1960	1965	1970	1975	1977	1978	1979	1980	1981	1982	1983
Austria	4.4	4.7	5.3	6.4	6.6	6.9	6.9	7.0	7.2	7.3	6.9
Belgium	3.4	3.9	4.1	5.5	6.1	6.3	6.3	6.3	6.2	6.2	6.5
Denmark	3.6	4.8	6.1	6.5	6.7	6.6	6.6	6.8	6.8	6.8	6.6
Finland	4.2	4.9	5.6	5.8	6.6	6.6	6.3	6.3	6.4	6.6	6.6
France	4.3	5.3	6.1	7.6	7.8	8.2	8.3	8.5	8.9	9.3	9.3
Germany W	4.8	5.1	5.6	8.1	7.8	7.8	7.8	8.1	8.3	8.2	—
Ireland	4.0	4.4	5.6	7.7	7.6	7.4	7.8	8.7	8.4	8.2	8.2
Italy	3.9	4.6	5.5	6.7	6.3	6.6	6.8	6.8	7.0	7.2	7.4
Japan	3.0	4.4	4.4	5.5	5.7	5.9	6.1	6.3	6.4	6.6	6.7
Netherlands	3.9	4.4	6.0	7.7	7.8	7.9	8.1	8.3	8.5	8.7	8.8
Norway	3.3	3.9	5.0	6.7	7.1	7.2	6.9	6.8	6.7	6.8	6.9
Sweden	4.7	5.6	7.2	8.0	9.2	9.3	9.1	9.5	9.6	9.7	9.6
Switzerland	3.3	3.8	5.2	7.1	7.2	—	7.0	7.2	—	7.8	—
UK	3.9	4.1	4.5	5.5	5.3	5.3	5.3	5.8	6.1	5.9	6.2
USA	5.3	6.1	8.0	8.6	8.9	8.9	9.0	9.5	9.7	10.6	10.8
Average	4.0	4.6	6.0	6.9	7.1	6.6	7.2	7.5	7.6	7.2	7.7

Notes: —indicates figure(s) not available
*Average excluding country(ies) with no returns

Source: 'Measuring Health Care 1960-1983', OECD Paris 1985

FIGURE 9.1

Relationship between Health as per cent of GNP and per capita GNP. 1983.



Source: Office of Health Economics, Helath Expenditure in the UK, London, 1986, page 9.

Table 9.7
Sources of Income for the Health Services 1986

Source	£m	%
Exchequer	1,092.0	85.7
Health Contribution	78.5	6.2
Charges for Maintenance(1)†	36.2	2.8
Other Health Agency Income	43.5	3.4
EEC and Other Receipts	21.5	1.7
Hospital Trust Fund	2.3	0.2
Total	1,274.0	100.0

(1) This item refers to charges for semi private and private accommodation in public hospitals.

Source: Health Services 1983-1986, Department of Health, 1986, page 20.

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 using 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

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

**Abel Smith and A Maynard, The Organisation, Cost and Financing of Health Care in the European Community.

†A Dale Tussing, Irish Medical Care Resources: An Economic Analysis, ERSI Report, 126, 1985.

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 out-patient 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 reliefs on VHI 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 relavitely 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 major new hospital facilities in some regions.†

Table 9.8
Age Distribution of Polulation Ireland, U.K. and Denmark and Hospital Bed Provision

Age Group	*Ireland*	*U.K.*	*Denmark*
	%	%	%
0-14	30.3	20.4	14.4
15-64	59.0	60.5	65.8
65+	10.7	15.1	14.8
All ages	100	100	100
Hospital Beds per 1,000 Population	9.5	8.2	8.2

Source: Eurostat Volumes; Minister of Health, Reply, Dail Eireann, February 1986

*A Dale Tussing, op cit, page 138.
**NESC Report No. 73, Health Services: The Implications of Demographic Change, 1984.

†Services for handicapped persons may be an exception to this general argument about the levels of provision. These services comprise 9.9% of current expenditure on health and 11.2% of capital expenditure. Demographic projections in NESC Report No. 73 suggest that there will be an increase in the number of mentally handicapped persons from 1981 to 1986 of between 5.1% and 5.9%, and between 9.9% and 11.9% from 1981 to 1991. There is therefore little scope for reductions in the services provided for this clientele. While the wider strategy of de-institutionalisation applies also in this area, the UK evidence indicates that community, non institutional provision may be no less expensive for some sub groups within this client population.

Psychiatric services which are largely institutional at present, account for 12% of health expenditure. In the current fiscal situation the Council endorses the general direction for the development of psychiatric services in Planning for the Future.* The alternative to this policy is to retain and maintain the existing expensive capital stock of psychiatric hospitals. This issue of psychiatric services raises the general point that the fiscal constraints heighten the need for the rapid development of more appropriate non institutional services.

A further specific issue arrising from the general analysis of health service utilisation, but with an added redistributive dimension, is the question of tax subsidised private health care. 'Private' health care, in the Irish health care regime, is often significantly subsidised by the public health system — this cross-subsidisation arises from the use which consultant hospitals doctors in public hospitals may make of publicly provided amenities for their private patients who do not bear the economic cost of their utilisation. Tax allowances need to be considered in the light of this subsidisation. The existence of tax allowances for private hospital insurance creates, as with all tax allowances, a regressive dimension to the tax system and an inequitable dimension to health care accessibility. In the light of the fiscal constraints, the efficiency implications of induced demand for health care, and the equity aspects of both health care and taxation, the Council therefore recommend curtailment of this tax allowance. (This recommendation of course is consistent with the general approach to tax allowances agreed by the Council in Chapter 10).

Finally, in relation to health services, its employment content should be noted. The relevent data in Chapter 3 revealed that:

> Almost two thirds of current health expenditure consists of 'pay' items; aggregate real pay has declined by 7% from 1980 to 1985; and, health services manpower numbers have fallen somewhat since 1981, (the number of GMS doctors has been rising however).

It will be clear that wider policies regarding manpower levels in the public service and public sector pay levels will have a crucial effect on health services expenditure.

(iii) Education Policy

The commentary on eduction expenditure in 1980-85 in Chapter 3 showed that, in parallel with health expenditure, there have been real reductions in the latter part of the 1980-85 period.

*The Psychiatric Services: Planning for the Future, Department of Health 1984.

Table 9.9.
Educational Level by Father's Class for Male Post-primary School Leavers 1980-1981

	Percentage by Row						
	Third Level	Leaving Certificate	Intermediate Certificate	Group Certification	No Qualifications	N	%
Upper Non-Manual	53.7	34.6	8.6	2.5	0.6	162	9.3
Lower Non-manual	28.6	40.7	20.3	5.8	4.7	637	36.8
Skilled Manual	14.0	29.8	29.3	14.2	12.7	450	26.0
Semi-skilled and Unskilled Manual	7.6	20.7	28.3	26.0	17.4	484	27.9
N	369	549	412	231	172	1,733	
%	21.3	31.7	23.8	13.3	9.9		

Source: Whelan and Whelan, ESRI Report 116, Table 7.7.

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 level 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 accept 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 puplis from lower social class groups attain Leaving Certificate standard their participation rates at Third Level are lower than that of their middle class counter parts, 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%).

*NESC Report No. 71, Education: The Implications of Demographic Change, 1984.

**A. D. Tussing, Irish Educational Expenditures: Past, Present and Future, ERSI. Report No. 92, 1978.

†A. C. Barlow, The Financing of Third Level Education, ERSI Report 106, 1982.

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 patterns 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:

- sylabbus review with a view to eliminating role stereotyping;
- changes in subject provision and subject allocation practises;
- 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

Table 9.10
Percentage of Male and Female School Leavers (1980) from Each Class Background Who had Completed the Leaving Certificate in 1980, who Went on for Further (All 3rd Level) Education in 1981.

Social Background of Pupils	Per cent of those with the Leaving Cert from Each Class Background Who went on to Third-Level Education or Training	
	M	F
1. Upper middle-class	68.1% (69)	48.6% (72)
2. Lower middle class and farmers	44.3% (341)	43.0% (381)
3. Upper working class	36.5% (88)	23.4% (77)
4. Lower working class	31.75% (63)	18.9% (74)

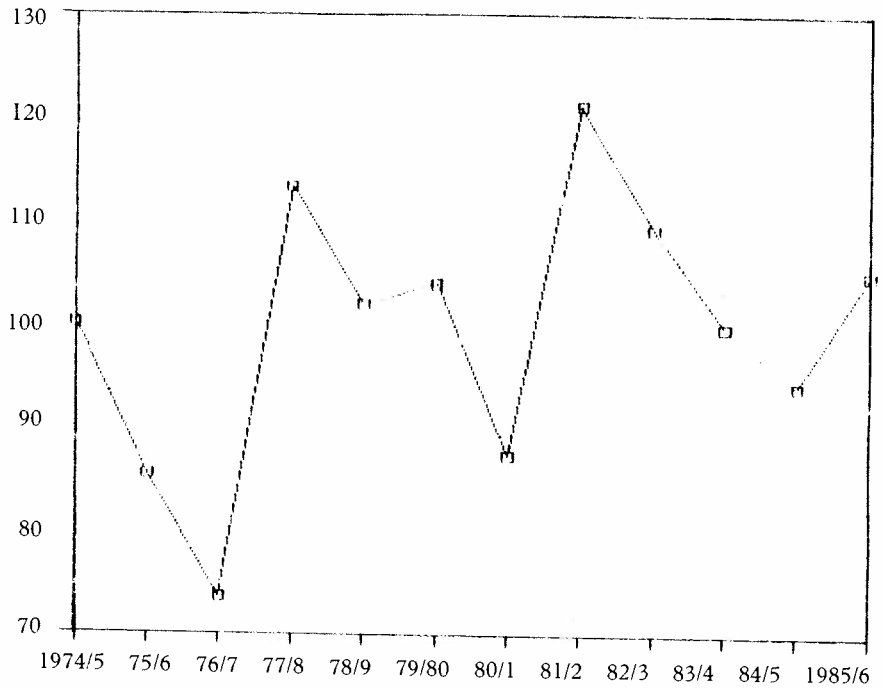
Source: Hannan: Breen et al, ESRI paper 113, Table 3.10, page 64 based on NMS School Leavers' Survey. Figures in brackets refer to sample numbers.

*Damian Hannan, Richard Breen et al, Schooling and Sex Roles, ESRI Paper No. 113, 1983.

**Hannan, Breen, et al, op. cit, Chapter 11.

†C T Whelan and B J Whelan, Social Mobility in the Republic of Ireland, A Comparative Perspective, ERSI Report 116, 1984.

Figure 9.2
Index of Real Value of Higher Education Grants 1974/5-1965/6



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 differentation in participation is still very marked. This differentation 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 eligibity limites 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 ublished information available on this topic is very limited.† 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 9.11
University Fees(1) 1980/81 — 1985/86

Academic Year	Nominal Prices	CPI	Constant (1980/81) Prices	
			£	Index
1980/1	316	100.0	316.0	100.0
1981/2	421	119.9	351.1	111.1
1982/3	526	133.1	395.2	125.1
1983/4	658	145.7	451.6	142.9
1984/5	792	154.3	513.3	162.4
1985/86	873	160.5	543.9	172.1

(1) Arts, Commerce, Law at UCD.
Source: University College Dublin.

*Building on Reality, Stationery Office, Dublin 1984, page 93.

** A C Barlow, The Financing of Third Level Education, ESRI Report 106, 1982.

†Comprehensive Public Expenditure volumes for 1984 and 1985 indicate that net expenditure in diverging from gross expenditure as a result of proportionately increasing reveues from fees, other than income, 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 adequacy 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 pertain during the 1986-1990 period, then expenditure on housing may moderate.

Table 9.12
Waiting Lists for Local Authority Housing

	At 31/12/83	At 31/12/85
Total	28,937	22,434
County Boroughs	9,074	6,749

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

Secondly, on the revenue aspect there may be scope for increasing the rental revenue from the local authority sector. Average weekly rent which was £3.97 in 1980 and £6.65 in 1984 grew less rapidly than real social welfare payments. In 1984 average real rents were below the figure for 1980, as Table 9.13 indicates.

Redistributive criteria would also appear to suggest a restructured system of local authority rents. In previous reports* NESC have pointed out that the differential rents system is not progressive in relation to household income and the Commission on Social Welfare have also made this point.** The

*NESC Report, No. 75, Economic and Social Policy 1983: Aims and Recommendations.

**Report of Commission on Social Welfare, Stationery Office, Dublin, 1986, Chapter 14.

Council therefore reiterates its view that the system of local authority rents should be restructured so that the rental system overall is more economic and more effectively redistributive.

Table 9.13
Local Authority Rents

Year	Average Weekly Earnings	Average Weekly Rent	CPI	Real Average Weekly Rent	Real Value Unemployment Benefit
1980	100.0	100.0	100.0	100.0	100.0
1981	116.7	113.1	120.4	93.9	98.6
1982	131.7	139.3	140.8	98.9	105.3
1983	147.1	143.8	155.8	92.3	104.9
1984	165.1	167.5	169.3	98.9	105.9
1985	179.6	N.A	178.5	N.A.	105.9

Source: Quarterly Bulletin of Housing Statistics Department of 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 availablity 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.

*J Blackwell, Housing Conditions, An Overview, unpublished, 1985.

Table 9.14
Summary of living conditions: All Travellers and Travellers Living in Different Types of Accommodation

Per cent of families	All Travellers %	Standard Housing %	Chalet %	Serviced Site %	Roadside %
With no piped water supply	48.1	2.2	2.7	22.3	96.1
With no use of hot water tap	61.6	13.4	26.7	99.4	99.8
With no fixed bath or shower	62.5	15.1	30.6	99.4	99.7
With no toilet facility	50.3	2.8	4.3	37.6	97.5
With no connection to public electricity supply	54.4	1.5	4.8	92.8	99.2

Source: Rottman, Tussing and Wiley, ESRI Report 131, Table 4.1, page 52, 1986.

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 signficant 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 38% in standard houses. These accommodtion 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 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.

*Rottman, Tussing, Wiley, op. cit. page 73.

10

REFORMING THE TAX SYSTEM*

1. 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 stabilistion 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.

*Incorporated in this chapter are the Council's views on the Reports of the Commission on Taxation.

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 organised 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 one 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 or 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 any set of 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 re-inforcing 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 assignation: (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 generallly 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 attaching 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 indexation of all income tax bands and credits; (ii) the indexation 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 accomodate 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 most 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?

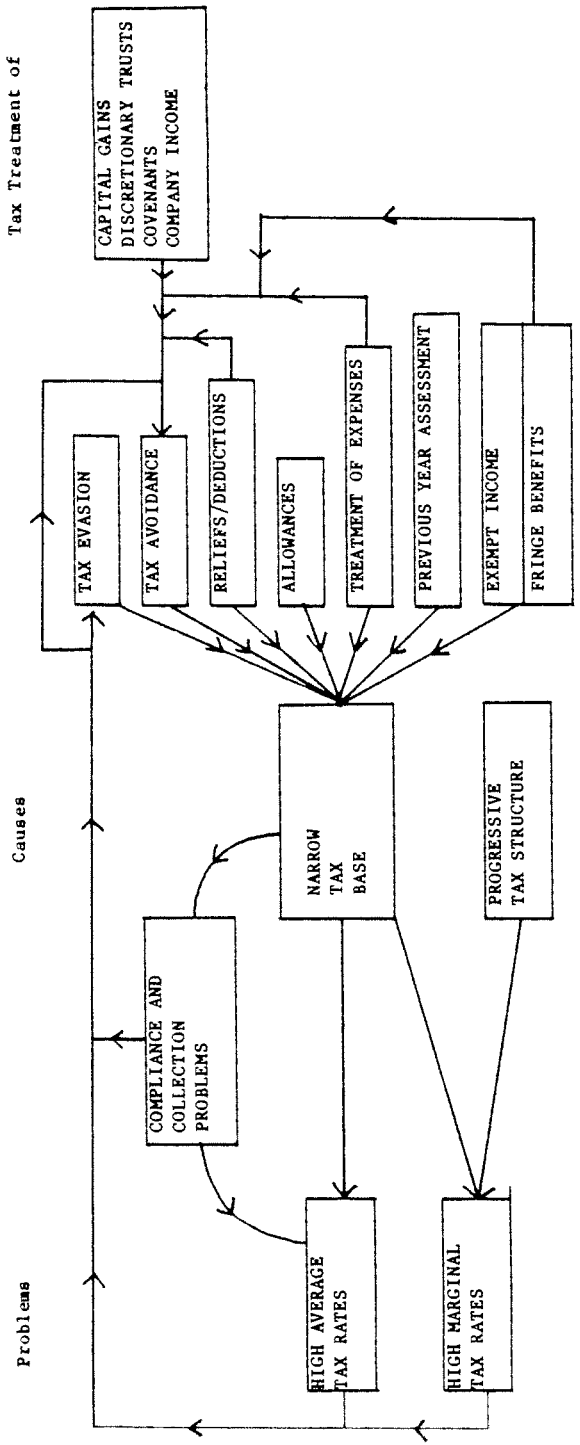
(ii) to what extent would the implementation of a subset, or the totality of the Commission's first-phase recommendations, in the next five years necessitate, on grounds of coherence and consistency, the implementation of all the remaining proposals of the Commission in the longer-term?

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

FIGURE A

The Irish Income Tax System - Problems and Diagnostics



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.

Table 10.1
Personal Income Tax: Commission's Proposals for First Phase of Reform

1. Extension of Base
   (a) Taxation of Income which is currently exempt
   — All social welfare benefits
   — Retirement benefits
   — Compensation payments for loss of office
   — Redundancy payments
   — Compensation payments for injury
   — Foreign pensions
   — Earnings of Artists
   — Gambling winnings*
   — Profits of sweepstakes
   — Fringe benefits*
   — General exemption limits

   (b) Abolition of reliefs deductions with no compensatory payments
   — Medical Insurance relief*
   — Permanent health insurance premiums*
   — Mortgage interest relief(1)*
   — Life assurance premium relief*

   (c) Abolition of allowances with provision for compensatory payments
   — Child tax allowances(2)
   — Widowed persons with no dependents
   — One-parent family allowance
   — Age allowance
   — Dependent relative allowance*
   — Blind person's allowance
   — Allowance in respect of employed person looking after incapacitated individual
   — Health expenses relief

   (d) Other recommendations which would extend the base
   — Abolition of Schedule E (PAYE) allowance
   — Current year basis of assessment for Schedule D
   — Determination of business expenses*

2. Structure of Income Tax System
   — Make the family the unit of taxation
   — Conversion of remaining tax allowances into tax credits
   — Lowering of income tax rates
   — Widening of income tax bands
   — Indexation of bands and allowances/credits

(1) Provision for compensating first-time more buyers.
(2) Abolished in 1986 Budget.

*Recommendations which, if implemented, would in themselves reduce the scope for tax avoidance.

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 conduit 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 acquistions 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 envisage 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 respect of personal income tax, corporation tax and capital taxation are fundamentally related, ultimately by the objective of securing a single rate of tax spanning these three 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 evaluate 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 a social security tax 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 VAT only are provided here.

The Commission consider a number of options for progressing towards the ultimate objective of levying VAT 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 VAT, 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 restrictions imposed an interest relief in the Budget of 1983.
**All secondary allowances except the Dependent Relative Allowance have been increased in real terms since 1981-82. See Table 4.14.

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 10.1 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 on foot of the base-widening proposals (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 grounded in the same basic principles should apply 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 Commissions' 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 into 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 as a basic building block 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 was 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 farm profits on the basis of income. The Council also pointed out however that it considered the question of a resource tax on farm land to be a separate issue, related to development policy.

**NESC Report No. 76 *The Role of the Financial System in Financing the Traded Sectors*, October 1984, p. 10.

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 as 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.

**Manpower Policy in Ireland,* NESC Report No. 82, December 1985.

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 in 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.

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 to 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.

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 bouyant 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 over-riding 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 1984.

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 (NESC 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 value 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 here 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 US. 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 functions carried out here i.e. that these functions are capable of being carried out elsewhere, and not an assertion about how they actually behave 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 36 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
Irish Raw Materials as a Proportion of Total Raw Materials, 1983

	All Firms (%)	Overseas Firms (%)
Clay, Glass & Cement	38	15
Chemicals	33	20
Electronics	17	17
Mechanical Engineering	28	24
Food	87	81
Drink & Tobacco	63	73
Textiles	22	21
Clothing & Footwear	39	24
Paper & Printing	33	27
Timber & Furniture	49	27
Miscellaneous	22	20
Total Manufacturing	61	36

Source: *The Irish Economy Expenditures of the Irish Manufacturing Sector, IDA, Autumn 1985.*

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

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 £420m 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

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 overused 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

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 to 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.

(1) F Ruane and A John: 'Government Intervention and the Cost of Capital to Irish Manufacturing Industry', Economic and Social Review, October 1984.

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 of resignation 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 focussed are 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

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 re-allocation will be vital since it is in those 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 competitve 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 wide 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

* Telesis Review of Industrial Policy, NESC Report No 64: see pages 211-215.
** Op. cit.pp. 235-236.

only very general guidelines as to the consequent resource re-allocation 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-or knowledge-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 agrument 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 establised, 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 re-allocation 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 re-allocating 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 gilts 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

* *The Role of the Financial System in Financing the Traded Sectors*, NESC Report No. 76, October 1984.

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 monies. It is essential that this expenditure be rigorously evaluated in terms of future rates of return to the Exchequer. If the monies 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 re-allocation 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 if 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 unanticipated 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 in 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

Economic and Social Policy Assessment, NESC Report No. 79, January 1985.

* *Policies for Industrial Development: Conclusions and Recommendations*, NESC Report No. 66, October 1982.

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 sychronisation between food industry supplies and market needs;
(b) redressing 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-orienting production towards higher value-added products is an essential ingredient for sustained expansion of output

*See for instance: *A Review of Industrial Policy*, NESC Report No. 64, October 1982; *Report and Recommendations on the Beef Industry*, Sectoral Development Committee, Report No. 7, April 1985.

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)

	Ireland (Ecus)	EEC(1)	IRE./EEC (%)
Vegetable and Animal Oils	8,608	21,009	41.0
Meat Processing	8,087	10,376	77.9
Dairy Products	8,261	10,501	78.7
Fruit and Vegetables	14,314	9,779	146.4
Fish Processing	10,887	10,824	100.6
Grain Milling	16,848	18,780	89.7
Bread and Flour	7,265	10,871	66.8
Sugar, Chocolate etc.	14,694	14,901	98.6
Animal and Poultry Foods	15,616	17,379	89.9
Other (2)	78,135	20,287	385.1
All Food	12,405	13,271	93.5
All Food (excl. Other)	10,128	12,522	80.9

(1) EEC 9
(2) The very large figure for Ireland may be due to the accounting practices of overseas firms operating in this sub-sector.
Source: *Structure and Activity of Industry 1980/1981*, Eurostat, 1984.

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.

The food processing industry is no different from other sectors of manufacturing in that the creation of a cost competitive environment is an essential ingredient in its successful development. However necessary such an environment might be it is hardly likely to be a sufficient condition for the achievement of sustained expansion in food processing. Some of the other requisite ingredients of success are the same as for indigenous industry more generally: greater attention to market needs, the development of new export markets and the development of new products especially those with a higher value-added content.

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 designd 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 CAP. Among the many problems facing the future of the CAP, there is hardly any more significant or conspicious 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 derives 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 of 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 11.3
Pattern of FEOGA Expenditure (mill ECU)

	1981	1982	1983	1984	1985(4)	1986(5)
EAGGF Guarantee	10,980.2(1)	12,405.6	15,811.6(2)	18,346.5(3)	19,979.1	21,053.3
EAGGF Guidance	576.4	650.0	728.0	676.2	659.7	755.2
Total gross expenditure	11,556.6	13,055.6	16,539.6	19,022.7	20,638.8	21,808.5
Ordinary levies	1,264.8	1,522.0	1,347.1	1,259.9	1,081.5	1,584.9
Sugar levies	482.5	705.8	948.0	1,176.4	1,025.0	1,113.8
Total Net Expenditure	9,809.2	10,827.8	14,244.5	16,586.4	18,532.3	19,109.8

Notes: 1981-1985 = EUR 10
1986 = EUR 12

(1) Allowing for a reduction in expenditure of 161 million ECU because of claims disallowed when the 1974 and 1975 accounts were cleared.
(2) Allowing for a reduction in expenditure of 108.1 million ECU because of claims disallowed when the 1976 and 1977 accounts were cleared.
(3) Allowing for a reduction in expenditure of 25.5 million ECU because of claims disallowed when the 1978 and 1979 accounts were cleared.
(4) Budget.
(5) Draft Council budget of 18.9.1985, including fisheries (41.3 million ECU).

Source: Commission of the European Communities (1985).

Table 11.4

FEOGA Expenditure in EC Budget, %

	1981	1982	1983	1984	1985(1)	1986(2)
FEOGA	64.6	63.1	66.7	69.9	72.6	68.6
Guarantee Section	61.4	59.9	63.7	67.4	70.3	66.2

1981-1985 = EUR 10
1986 = EUR 12
(1) On the basis of the budget
(2) On the basis of the Council's draft budget of 18.9.1985.

Source: Commission of the European Communities (1985).

cent. It is easy to understand why the proportion of total expendiuture devoted to guarantee prices and markets has remained so high when the Community finances all expenditure in this section but funds only a variable fraction of structural expenditure. In the immediate future there seems little possibility of any significant shift towards structural expenditure despite possible adjustment pressures arising from the restrictive price policies now being pursued.

(ii) Distribution of FEOGA Support

Ireland has been a substantial net beneficiary from the Community budget since accession and the composition of the receipts by Ireland in recent years is shown in Table 11.5.

Table 11.5

Subsidies and Grants Received by Ireland
(including monies for work on behalf of the Commission)

	1983 Amounts Received	1984 Amounts Received — (IR£m) —	1985 Amounts Received
FEOGA — Guarantee Section	441.70	644.60	836.56
— Guidance Section	63.70	44.80	55.83
European Social Fund	92.70	84.30	141.00
European Regional Development Fund	58.20	65.20	79.00
EMS Interest Subsidies	43.60	—	—
Research and Investment Projects	1.08	0.10	—
Projects in the Energy Sector	0.47	0.03	—
Miscellanous	0.54	0.18	—
Total	701.99	843.21	1127.90

Note: Receipts also arise as a result of the Community Regulations on social security for migrant workers. In 1984 Ireland's receipts from the UK under this heading were IR20 million.

Source: EC Commission, Developments in the European Communities, 25th Report, Government Publications.

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 11.6

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

	1980	1981	1982 (ECUs)	1983	1984
Germany	3072.5	2578.1	2496.9	3746.4	4038.2
France	2440.78	2680.4	2472.4	3079.74	3076.9
Italy	685.4	778.3	970.9	1066.1	1444.5
Netherlands	10,751.2	8177.8	9884.9	11,906.4	13,615.7
Belgium	5231.5	4555.1	4806.8	5517.2	6124.8
Luxembourg	2482.8	1234.3	1840.2	949.0	1517.6
United Kingdom	3948.8	4778.6	5398.6	7383.15	8939.2
Ireland	2721.7	2236.52	2623.0	3162.5	4271.4
Denmark	5206.3	4314.7	4647.1	5677.9	7280.3
EC 9	2075.5	2017.2	2153.9	2706.5	3137.86

Note: The number of people with holdings in 1979/80 was used as the denominator in the table.
Source: Various issues of the Financial Report on the European Agricultural Guidance and Guarantee fund; "The Agricultural Situation in the Community, 1985 Report" for the number of holders.

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

	1980	1981	1982	1983	1984
			(ECU's)		
Germany	215.6	180.9	175.2	262.8	283.3
France	93.99	103.2	95.2	118.4	118.5
Italy	109.6	124.9	155.8	171.0	231.8
Netherlands	774.76	589.32	712.3	858.0	981.2
Belgium	411.3	358.12	377.9	433.8	481.5
Luxembourg	98.9	49.2	33.5	37.8	60.5
United Kingdom	53.03	64.17	72.5	99.0	120.0
Ireland	106.8	87.73	102.9	124.1	167.6
Denmark	222.9	184.72	198.9	243.1	311.7
EC 9	129.45	125.81	134.29	168.8	195.71

Source: "Financial Report on the European Agricultural Guidance and Guarantee fund" various issues; "The Agricultural Situation in the Community, 1985 Report", EC Commission, Brussels.

(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 only very slowly. 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 essentially 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 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 enable the price supported Community product to 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 feedingstuffs, 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 arangements against various products outlined above, were originally negoitiated 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 of multilateral trade negotiations to be carried on 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 prominance. 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 incomes 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 25 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 maldistribution 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:

Netherlands	434	F R Germany	129
United Kingdom	285	France	98
Denmark	232	Luxembourg	48
Belgium	195	Italy	46
Republic of Ireland	136	EC-9	100

Table 11.8

Large and Very Large Farm Businesses (1983/84) as a Percentage of Total Farms (1980) for EC-10 Member States and their Level of Farm net Value added per Annual Work Unit

	Very Large		Large		Both
	%	NVA/AWU (000 ECU)	%	NVA/AWU (000 ECU)	%
Netherlands	22.52	31.3	53.18	21.5	75.70
United Kingdom	17.09	22.4	32.64	14.4	49.73
Belgium	8.66	31.6	41.74	20.2	50.40
Denmark	8.43	29.1	36.90	19.6	44.73
Germany	5.67	15.4	35.92	11.3	41.59
France	4.61	19.7	32.53	13.7	37.13
Luxembourg	3.47	14.8	54.07	12.6	57.54
Italy	1.59	24.1	6.14	16.0	7.73
Ireland	0.38	30.0	4.52	19.8	4.90
Greece	0.05	5.8	1.09	8.3	1.14
EC-10	2.13	23.3	9.46	14.9	11.59

Source: The Agricultural Situation in the Community, 1985 Report, Brussels.

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 Size Unit for very large farm businesses is over 40 and for large farm businesses is 16 to 40 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 20% in real agricultural prices. The table also shows that by far the greatest real reduction (31.6%) 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%.

Table 11.9
Percentage Reduction in Real Prices Received by Farmers in EC Member States (1)

	1971-1981	1981-1985	1977-1985
W. Germany	10.8	10.6	20.2
France	14.5	9.2	21.5
Italy	11.9	8.2	19.1
Netherlands	10.5	5.0	14.9
Belgium	9.9	5.1	14.5
Luxembourg	10.1	0.7	10.8
UK	12.6	9.5	20.9
Denmark	8.5	8.6	16.3
Ireland	16.6	17.9	31.6
EC-9	12.3	9.0	19.8

(1) Prices received by farmers deflated by a combination of input prices and prices generally.

Source. Professor S.J. Sheehy, *CAP Reform and Compensation*, AIB Review, July 1986.

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 proporton 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 headage 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 agricultual 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 suprluses 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.

* Irish Agriculture: Toward 2000, paper presented by Professor S J Sheehy on the occasion of the 30th Anniversary of the foundation of the IFA.

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 quantitiative 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 effect 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 jeopordise 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 Bord "... no amount of jugggling 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, encomapassing 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

	Suckling				
	Mainly single	Mainly double to multiple	Mainly artifical rearing to stores	Calf to beef	Finishing all year round
Per Livestock unit					
Output	251	280	414	475	317
Direct costs	76	104	174	206	134
Gross margins	175	176	240	269	183
Forage acres	1.76	1.58	1.73	1.44	1.69
Per acre					
Gross margins	100	112	138	186	108

Source: National Farm Survey files, AFT.

Table 11.11
Long-Term Interest Rates (%) for Farm Investments, 1979-85

Country	1979	1980	1981	1982	1983	1984	1985
The Netherlands	9.6	11.3	11.8	n.a.	8.9	n.a.	n.a.
West Germany	7.8	10.0	13.0	12.0	n.a.	9.5	n.a.
France	10.4	11.6	13.5	13.5	13.0	n.a.	n.a.
Belgium	10.5	13.3	14.1	14.5	13.0	12.8	12.2
United Kingdom	16.5	19.0	15.6	14.3	11.7	11.6	14.5
Denmark	17.1	20.4	20.6	21.4	15.1	14.5	13.1
Ireland	16.0	17.8	17.4	19.0	16.6	15.3	16.1
Italy	14.6	15.6	18.3	21.0	20.2	18.3	16.8

Note: n.a. = not available.
Source: The Agricultural Situation in the Community, 1985: EC Commission.

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 initative 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 load)."

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 £200m working capital and refinancing 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 and 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 tenture 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 promoting 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 EC 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 limit 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).

It is also the case that such ceilings will not always be in place. In fact it was argued earlier that quantitative restrictions are not a desirable long-run solution to the problems of market imbalance since they give rise to a fossilisation of agricultural structures. When these ceilings are eventually removed there will be a premium on an efficient agricultural sector.

In essence, therefore, arguments against the introduction of measures which would promote more effective land use on grounds of a changed production and market environment within the EEC must be set against the necessity of ensuing a thriving, efficient primary sector. It should also be emphasised that there is scope for the development of farm businesses in a non-conventional direction. Forestry has a particular role to play in the use of land withdrawn from agriculture and also as a source of supplementary income.

PART IV: CONCLUSIONS

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CONCLUSIONS

1. INTRODUCTION

(i) Overview of Economic Situation

The economic and social problems now confronting the country are extremely grave. This is particularly the case with regard to the labour market situation and the public finances.

Total employment in the economy declined at a rate of 11,000 per annum over the period 1980-85. Unemployment now stands at 18 per cent of the labour force, while in the year to April 1986 net emigration is estimated at 31,000 compared to a natural increase of 28,000.

Failure to make significant progress towards reducing the chronic imbalances in the public finances has resulted in a rapid growth in the size of the national debt. Total exchequer debt outstanding doubled over the period 1981-85 from £10.2bn or 94% of GNP to £20.4bn or 134% of GNP, a historically unparalelled figure and by far the highest in the OECD area. The servicing of this debt now amounts to one quarter of total current public expenditure.

While the current situation is grave, the Council is even more concerned at the fact that, without a change in present policies, the medium term prospects offer no relief. On the basis of likely developments in the international economy and the continuation of existing policies a set of medium-term scenarios for output growth for the economy are set out in Chapter 5. Under the optimistic scenario an annual average growth rate of GDP of 3 per cent is envisaged for the 1986-90 period. The pessimistic end of the range is a growth rate of under 2 per cent per annum.

Under the pessimistic scenario total employment in the economy is projected to fall by 23,000 over the period. The optimistic scenario envisages employment growing by 30,000 from its 1986 level. Neither scenario is likely to see a significant reduction in unemployment unless accompanied by higher rates of emigration or a greater fall in participation rates than was assumed in Chapter 6. Moreover, neither scenario gives rise to automatic correction

of the public finances imbalances. In fact under the pessimistic scenario the fiscal imbalances could deteriorate appreciably. This is the background against which the relevant policy choices must be formulated and decisions taken.

Since the Council initiated this report in early 1986 the overall economic and social situation has deteriorated even further. The 1986 Census of Population revealed net outward migration of 75,000 between 1981 and 1986. This, when viewed in conjunction with the growth in unemployment over this period provides the clearest evidence of deteriorating economic performance. The overrun on the public finances from the original budget position, which became evident as the year progressed, is also a matter of serious concern. This overrun is particularly disconcerting against the background of chronic imbalances in the public finances and given some of the favourable influences on the budgetary figures, such as the more benign inflation environment. Such overruns are due to excessive rigidity, particularly with regard to public expenditure and an associated inadequate control by Governments over the public finances.

Another major development since the Council initiated this report has been the sharp movement of interest rates and exchange rates. The Council is extremely concerned at the recent sharp upward movement of interest rates and at the overall volatility of the money and foreign exchange markets. The factors giving rise to these movements, in particular the drain of liquidity from the domestic monetary system, can only be tackled by adopting, as a minimum, the strategy put forward in this report.

The medium term prospects for the economy contained in Chapter 5 are based on a general assumption that the broad thrust of Government policies will remain essentially unchanged in the period to 1990. Both of the scenarios painted to 1990 are clearly unsatisfactory on any objective criteria. The continuation of existing policies is therefore not a viable option. The argument against a continuation of present policies is sometimes based on the consideration that discretion over economic and social policy would ultimately be removed from our control. However, a much more rapid and potent threat to the continuation of present policies arises from a possible erosion of domestic confidence in the economy.

(ii) The Central Problem

The two major issues identified in this report are the unemployment situation and the imbalances in the public finances. However, these problems cannot be viewed in isolation from one another or from the functioning of the economy more generally. They are in fact closely interrelated and their deterioration can be partly traced to a common origin. This common origin is the rate of growth of the economy. As argued in Chapter 7 it is the level of national output which determines both the level of sustainable employment

and the level of public expenditure which can be sustained by acceptable levels of taxation and prudent levels of borrowing.

Between 1981 and 1985 the level of GNP registered negligible growth in marked contrast to the 1976-80 period when real GNP grew by almost 4 per cent per annum. Similar trends emerge in respect of GDP with the respective growth rates for 1981-85 and 1976-80 being 2 per cent and 4.5 per cent. With the growth of productivity being broadly similar in the range 3-3½ per cent per annum over the two sub-periods the contrasting employment performance is accounted for by the difference in growth rates. This slowdown in growth in the 1980-85 period also exacerbated the structural difficulties inherent in the public finances.

One of the features of the current economic situation which gives particular cause for concern because of its implications for long-term growth is the fall off in the rate of investment. Gross fixed capital formation declined in volume terms by an average of 2 per cent per annum between 1980 and 1985 compared with an annual average increase of 8.5 per cent between 1975 and 1980. The decline in fixed capital formation in agriculture and manufacturing industry was considerably more rapid.

2. KEY ELEMENTS OF A SOLUTION

The Council believes that any strategy for economic recovery must contain three essential elements. The policy section of this report is built around these three elements. *Firstly,* since the low level of national output and the slowdown in the growth of national output in recent years is a central problem then the acceleration of output growth and consequently employment growth has to be a central feature of the solution.

However, and *secondly,* growth per se will not solve the imbalances in the public finances. Table 8.1 shows that growth rates even at the optimistic end of the range specificed are insufficient to result in automatic correction of the imbalances. It is essential to adopt a realistic approach to the constellation of variables impinging on the budgetary aggregates in the formulation of fiscal policy over the medium term.

Thirdly, the achievement of a more rapid and sustainable rate of growth and the correction of the chronic imbalances in the public finances will require a considerable degree of sacrifice from society. If such sacrifices are to be accepted without compensation being sought it is essential that they are shared equitably across all sections of society. A central element of any strategy must therefore be the removal of inequities from many aspects of our society ranging from the financial inequities inherent in the taxation and public expenditure systems to issues of access and opportunities in a more general context. As

argued in Chapter 7 the redistributive objectives of Government cannot be ignored even at a time when the economic environment suggests tough decisions. However, it must be emphasised that these objectives would be more readily attainable in a rapidly growing economy where balance had been restored to the public finances.

Against the background of these three essential elements the Council has, in this report, put forward an overall strategy for economic and social development. It contains four major pillars: (i) an integrated macro-economic policy addressed to correcting the imbalances in the public finances while at the same time promoting the development of the traded sectors through the provision of an appropriate environment; (ii) fundamental reform of the tax structure designed to enhance the efficiency and equity of the present system; (iii) the promotion of the traded sectors through the provision of an appropriate environment together with a set of improved sectoral policies in which state intervention is directed towards more effectively and efficiently addressing the structural deficiencies in the productive base of the economy, and (iv) the progressive removal of the major inequities in society.

The Council considers that failure to implement this four pronged strategy will consign the economy to a stagnation of employment coupled with higher unemployment and/or the persistence of high levels of emigration, continued deterioration of the public finances and, growing public disaffection with the economic and political system.

Derived from this four pronged strategy is a carefully balanced package of economic and social policy initiatives which are briefly outlined and summarised in this conclusions chapter and elaborated upon fully in the policy chapters of the report. The recommendations put forward are the absolute minimum necessary to restore balance to the economy and generate the conditions necessary for a restoration of confidence in the economy. One essential theme which runs through all the policy chapters is the complementarity between various policies and the need for consistency between the policy instruments. In fact failure to implement the various policies as an integrated whole will only exacerbate our present difficulties and keep us in the vicious circle which we currently occupy.

3. THE POLICY FRAMEWORK

This section outlines the policy instruments and the direction which they must take in order to underpin the four pronged strategy set out above. Macroeconomic policy, comprising fiscal, monetary and exchange rate policy, and policies with regard to the evolution of incomes, is designed to *simultaneously* address the central problem of low growth and its associated symptoms of imbalances in the public finances and growing unemployment.

Reform of the taxation system is concerned with improving resource allocation within the economy, thus leading to an acceleration of output and employment growth. Policies for the individual sectors are concerned with the provision of an appropriate environment and the removal of structural impediments to growth. Finally, removal of inequalities from society, particularly those inherent in the taxation and public expenditure systems, is essential if the tough decisions associated with the other strands of the strategy are to be accepted.

(i) Macro-economic Policy

Fiscal policy

The Council believes that stabilisation of the debt-GNP ratio must now be a minimum objective of fiscal policy. Stabilisation is a first and necessary step towards the ultimate objective of reducing the ratio. While there may be short-term dislocation effects arising from stabilising the debt-GNP ratio this must be set against the even greater dislocation which would arise in the medium-term if action is not taken to stem the growth of the debt. Any adverse consequences must also be set against some of the more positive effects of stabilising the debt ratio and reducing the borrowing requirement. These positive effects derive primarily from an easing of interest rate pressures.

The fiscal policy implications of stabilising the debt-GNP ratio can best be considered by examining the necessary evolution of the non-interest balance on the Exchequer account, i.e. the sum of exchequer capital borrowing and the current budget deficit net of interest payments. In order to stabilise the national debt-GNP ratio at its end-1985 level a surplus of 2.7 per cent of GNP on the non-interest account would be necessary. Given that this account is likely to record a deficit of about 2 per cent in 1986 a shift towards surplus of between 4½ and 5 per cent of GNP is required.

In the Council's view it is neither feasible or desirable to effect the required degree of adjustment in the public finances through the medium of higher taxation. While the short term effects of rectifying the chronic imbalance in the public finances may be adverse, particularly if not accompanied by other policy changes, the extent of these adverse effects is likely to be greater if increases in taxation are used to effect the adjustment. Public spending reductions are therefore the most appropriate means of restoring order to the public finances if the encouragement of strong and sustainable growth is to be part of the medium-term strategy. In the Council's view the scale of the public spending reductions necessary is such that any savings arising from increased productivity, greater programme efficiency and better management will make only a partial contribution in the context of the overall adjustment that is likely to be required.

The question of whether expenditure cuts should be concentrated on current or capital spending should be decided on the basis of protecting the long-term growth potential of the economy. There is a clear case for concentrating public spending cuts on current expenditure though, as indicated in Chapter 8, not all current expenditure programmes are devoid of long-term beneficial effects on the productive base of the economy. Equally not all capital projects enhance the long term growth rate of the economy. Notwithstanding this latter point the Council is concerned at the fact that the burden of adjustment that has been effected over the first half of the 1980s has been concentrated on a reduction in exchequer borrowing for capital purposes.

The objective of fiscal policy has been couched in terms of stabilising the debt/GNP ratio, which is consistent with a continuation of a current budget deficit. However, it is emphasised in Chapter 8 that stabilisation of the debt GNP ratio is a minimum requirement of fiscal policy and that when the ratio is stabilised there will continue to be an imbalance in the public finances. Stabilised at 134 per cent of GNP the National Debt would still be extremely high by international standards and unprecedented historically. Its magnitude, coupled with the proportion of Exchequer resources required to service it, would leave the public finances excessively vulnerable to interest and exchange rate movements. Stabilising the debt-GNP ratio therefore should be seen as the first step towards reducing it.

The means of stabilising the National Debt-GNP ratio embrace not only measures, such as Government spending cuts, which are designed to reduce Exchequer borrowing, but also measures which have the effect of increasing the rate of growth in GNP.

As outlined in Chapter 7, economic growth in a small open economy is powered by the internationally trading sectors. The Council's views on the most appropriate way to effect adjustment in the public finances have therefore been strongly influenced by the need to foster the growth prospects of the internationally traded sectors. While the determined pursuit of credible fiscal policy objectives can make a significant contribution in this regard through, inter alia, a reduction of interest rate pressures, this must be accompanied by compatible incomes and exchange rate policies.

One of the factors giving rise to the sub-optimal performance of the Irish economy in the first half of the 1980s was the inconsistency which existed between the various instruments of macro-economic policy. If policy is to be successful in achieving the twin aims of a reversal of the growth of unemployment and a reduction of the public finance imbalances then a consistent macro- economic policy, together with the other elements of the overall strategy, is essential. The fiscal element of macro-economic policy has been described above. The other main elements are exchange rate policy and incomes policy.

Exchange Rate Policy

In the context of a consistent macro-economic policy the role of exchange rate policy is to ensure an external value of the currency which provides a stable environment within which the internationally traded sectors can operate. The exchange rate is a powerful instrument in this regard given its role in influencing the domestic rate of inflation, the level of interest rates and the nature of the planning environment within which business decisions are taken. All these variables have a crucial bearing on the ability of the internationally traded sectors to generate rapid and sustainable growth.

In the context of inflation and income developments the role of exchange rate policy is twofold, firstly, through minimising imported inflation and secondly, through indicating to those involved in the cost-determining mechanisms that any increases conceded above those prevailing in our main trading partners cannot be compensated for by exchange rate adjustments. The discipline inherent in this strategy arises from the fact that such relative cost increases would rapidly erode the profit margins of the traded sectors with adverse output and employment effects. Chapter 8 demonstrates clearly the adverse consequences of using the exchange rate as a substitute for other policies which fail to ensure the competitiveness of the traded sectors.

Chapter 8 also indicates that an explicit non-accommodating exchange rate policy pursued through stability of the nominal effective exchange rate gives rise to expectations of a stable currency with associated beneficial implications for domestic interest rates. These interest rate implications, together with the stable planning environment are very important in reducing the cost of funds for investment and the degree of risk, with consequent beneficial effects on the confidence of investors.

The Council is acutely aware of the tensions inherent in our present exchange rate regime, which become particularly evident when sterling and the dollar diverge from the currencies participating in the EMS exchange rate mechanism. However, exchange rate policy must be formulated by reference to the entire economy. Hence decisions must be taken having regard to overall stability of the trade weighted nominal effective exchange rate.

Policies for Incomes

Policies in relation to incomes constitute one of the key instruments for ensuring the competitiveness of the internationally trading sectors. The appropriate operational objectives of all cost-determining mechanisms (for example, pay, interest rates etc.) should be that the average rate of cost increase in Ireland should not exceed the weighted average of cost increases in our main trading partners.

The policy instruments available to Government to achieve these objectives are primarily indirect. The most notable influence on the evolution of incomes

is the taxation system. A restructured taxation system along the lines suggested in Chapter 10 would provide a much more conducive background to wage negotiations and a growth of incomes more in line with our trading partners. Another influence on the evolution of income increases is the evolution of public sector pay. The role of a non-accommodating exchange rate as part of an integrated macro-economic policy is crucial in providing a low inflation environment within which the rate of domestic cost increase can be reduced to that of our trading partners. Finally, competition policy is a vital indirect instrument in promoting the rapid growth of the traded sectors through the promotion of competition within the economy, particularly in the sheltered sectors. It is imperative that Government policy be directed towards providing the environment most likely to generate a rate of cost increase which does not exceed the average of our main trading partners.

Consistency, continuity, credibility

A continuous theme running through the macro-economic framework has been that of *consistency* within and between the various elements of macro-economic policy. There are two other requirements for an effective economic strategy. One of these is *continuity*. The problems facing the economy which have been outlined in this report did not develop over a short period of time. Some have been building up from the mid to late 1970s. These problems are now such that their resolution will take a number of years, giving rise to the necessity for tough decisions and demanding many sacrifices. The consistent application of these policies must therefore continue over a period and take place within a medium term framework.

A firm commitment to the strategy on the part of Government is a necessary condition for the stabilisation of expectations and the restoration of confidence in the economy. This is the *credibility* requirement. To ensure the credibility of any strategy the targets adopted must realistically be capable of being achieved in the period specified. The choice must avoid a period which is either unrealistically short, or so long that action lacks urgency and credibility. The choice of target for the public finance adjustment, viz. the debt-GNP ratio, is also strongly influenced by the credibility requirement. This is based on the consideration that since debt service now forms such a significant proportion of Government expenditure, conventional budgetary targets are very sensitive to interest and exchange rate movements. Any adverse movements of interest and/or exchange rates would be likely to result in non-achievement of targets with adverse effects on confidence and credibility.

A policy which is derived from an overall framework characterised by the principles of consistency, continuity and credibility, is the one most likely to deliver on the growth, employment and public finance objectives set out in the report. These principles underpin the performance of a number of OECD countries, who have achieved a simultaneous improvement of key

economic variables. It must be emphasised of course that there is no unique strategy corresponding to the principles. The precise strategy can vary depending on the particular circumstances of each country.

The beneficial effects for the internationally traded sectors from a coherent macro-economic policy have already been outlined, e.g. the beneficial effects on output and employment of an improvement in cost competitiveness, reductions in interest rates etc. There is however, a beneficial effect over and above that, which is difficult to quantify, viz. the effects of an improvement in confidence. General improvements in confidence can provide a more conducive environment for investment due to stable expectations, it can reduce the interest rate premia required to cover exchange rate risk, it can provide a better environment for wage negotiations through offering a low inflation environment.

The general effects of an economic strategy based on these three principles are that the economy moves from a downward spiral of low investment, low growth, deterioration in unemployment and the public finances to a virtuous circle with improvements in some areas giving rise to and augmenting the improvements in others.

(ii) Tax Reform

Before discussing the issue of tax reform the Council wishes to emphasise two points, both relating to types of strategies which do not provide a solution to our present difficulties. Firstly, because of the present state of the public finances, across-the-board cuts in taxes cannot be regarded as a realistic option in the medium term. It would require significant reductions in public spending, greater than those necessary just to stabilise the debt/GNP ratio, before reductions in the overall tax burden can be contemplated. Secondly, the scope for selective tax reductions to boost activity in particular areas is limited relative to the size of the overall tax burden. Equally of course increases in taxation have been ruled out in the context of discussing the most appropriate mechanism for effecting adjustment in the public finances. Notwithstanding these constraints on the overall tax burden, reform of the tax system while maintaining the overall burden is a key feature of the Council's overall strategy.

The structure of the present taxation system is generally perceived as contributing to economic inefficiency through resource misallocation. Resource misallocation is an inevitable consequence of a tax system which has been built up by a process of accretion and which is not guided by any particular strategy. In this type of environment market signals to individuals and businesses in labour and capital markets are distorted and activities are pursued for the tax advantages which they confer. Use of the tax system as a vehicle for incentive provision also gives rise to a misallocation of resources.

From a labour market perspective the most disturbing feature in the Council's view is the fact that high marginal tax rates are reached at relatively low levels of income. This feature of the tax system is likely to give rise to a host of disincentive effects through its impact on, for example, competitiveness and poverty traps and through its effect on enterprise and risk taking generally. The differential between gross labour costs and disposable employee income (the 'wedge') also has adverse implications for efficiency.

From an equity perspective the present system also gives rise to serious concern in three important respects:

(i) the different treatment of employees and the self-employed;
(ii) the different treatment of income from different sources, for example PAYE income and income derived from capital gains;
(iii) the regressive distribution of certain discretionary reliefs.

It is argued in Chapter 10 that tax reform may now be one of the most powerful instruments available to Government to promote faster growth in output and employment in the short to medium term. Frequently, when major reform is being contemplated in cases of Government intervention in the economy conflict arises between efficiency and equity considerations with complex trade-offs having to be weighed up before decisions are taken. However, in the case of tax reform, efficiency and equity considerations point in a similar direction. In Chapter 10 the Council sets out a programme of reform based on the principles underlying the reports of the Commission on Taxation.

In particular, the Council believes that the priority of taxation policy must be the widening of the tax base and the simultaneous reduction of tax rates. This is the only way in which tax rates can be significantly reduced in the medium term given the imbalances in the public finances. Widening of the base applies not only to personal income tax but to capital taxation, corporate taxation and to value added tax. It also extends to the taxation of property to which the Council has already committed itself in principle. Finally, the Council wishes to emphasise one point in regard to its tax reform proposals, viz. income gained from widening the tax base must not be used to increase the overall tax burden, thus becoming a substitute for public spending reductions.

(iii) Development Policies

The integrated macro-economic policy outlined earlier provides the environment within which the supply side of the economy will have to evolve over the medium term. However, as outlined in Chapter 11 with regard to both industrial and agricultural policies, consideration of the structural characteristics of the internationally traded sectors is required to ensure that they are consistent with ensuring sustained output and employment growth.

Industrial Policy

Chapter 11 outlines the two broad approaches to industrial policy. One approach considers that the overall economic environment is the major influence on the evolution of the industrial sector. A second approach emphasises the weaknesses of the industrial sector by reference to structural factors and the late development of the Irish industrial sector. The broad conclusion reached in Chapter 11 is that these approaches should be viewed as complementary, arguing that while the cost environment is undoubtedly an important influence on the evolution of industrial output and employment, there are many reasons why the provision of a favourable environment will not be a sufficient condition to generate rapid output and employment growth.

In the Council's view an appropriate or conducive cost environment is one in which the total cost of all inputs is equivalent to those faced by our trading partners. This comprises labour costs, interest costs, raw material prices, transport costs and charges for services. The integrated macro-economic policy together with the reform of the tax system is designed to bring labour costs and interest costs into line with our competitors. Competition policy (discussed in Chapter 8) has a key role to play in ensuring that costs emanating from the sheltered sector of the economy are supportive of the development of the traded sectors. In some cases competition is limited because monopoly power is statutory, primarily in the case of commercial state-sponsored bodies. In this context the use of performance indicators and the issue of clear and consitent objectives against which performance can be assessed is vital. The ultimate performance objective should be to bring prices for services into line with those prevailing in our trading partners.

While the Council has previously commented in detail on industrial policy many of these comments bear repitition. Chapter 11 details the major shortcomings of our industrial policy. These include the heavy reliance on overseas firms and a limited number of manufacturing sectors with all the attendant risks. In addition, the strategy has not resulted in the development of strong indigenous firms, particularly in the tradeable goods sectors. Another major shortcoming of industrial policy has been its failure to establish stronger linkages between the foreign-owned sectors and the rest of the economy.

The Council believes that to be effective an active industrial development strategy must be geared towards providing the maximum number of sustainable jobs in manufacturing industry. This will require:

(i) the maximisation of value-added in industry;
(ii) the maximum retention of the wealth thereby created for further employment-creating investment;
(iii) the development of strong indigenous firms;
(iv) the forging of stronger links between overseas firms and the rest of the domestic economy;
(v) the continued attraction of overseas firms.

The instruments required to achieve these objectives should be selective in that they should be focussed on the firms which offer the best possibility of eventually becoming strong self-sustaining internationally trading businessess and on the key cost disadvantages which prevent these firms from breaking into internationally trading businesses.

The more selective application of incentives was announced as an intention of Government policy in the White Paper on Industrial Policy. The White Paper also indicated that there would be a shift of State resources from fixed asset investment to technology acquistion, research and development, and marketing. However, the Council is concerned that declared objectives and intentions were not accompanied by any quantification. This shift in the allocation of resources is critical to the future success of industrial policy. Apart from the fact that it is in areas other than access to capital that indigenous firms face the most significant disadvantages, the use of captial grants distorts the allocation of resources towards capital intensive businesses and away from knowledge intensive businesses and also leads to a labour saving bias in manufacturing businesses.

As indicated earlier, the Council is particularly concerned at the fall off in investment over the last five years. One of the key elements in promoting the growth of investment is the establishment of a conducive environment. The macro-economic policy outlined above will have beneficial effects through an easing of interest rate pressures and the provision of a stable planning environment.

Not alone is there a need for concern about the fall-off in the overall rate of investment but also regarding the nature of the investment which is taking place. A number of considerations are germane here. Firstly, whether the investment is capital-deepening or capital-widening. Secondly, the sectors of the economy in which the investment is taking place and thirdly whether the investment is in physical or in other assets.

The essential difference between capital-deepening and capital-widening investment is that the former is a defensive reaction to an adverse situation and is usually associated with reductions in employment. There is ample evidence for this form of investment in the indigenous sector of Irish manufacturing industry. Capital-widening investment on the other hand is a positive response to market opportunities and is associated with employment growth. The overall strategy recommended in this report would give rise to a positive environment conducive to capacity-expanding investment.

The second issue mentioned above related to the sectors of the economy in which the investment is taking place. A consistent theme running through all the policy discussion has been the importance of the internationally trading

sectors. It is in these sectors that investment is required. The important role for Government here is to ensure that the myriad of interventions through taxation and public expenditure do not result in making the relative rate of return on investment in the non-traded sectors more attractive. One of the criteria in identifying the public spending cuts required as part of the fiscal strategy should be the extent to which various expenditure programmes support non-traded activities or bias the relative rate of return away from investment in the traded sectors. NESC Report No. 76 deals in detail with this issue.

The third issue relates to whether the investment is in physical or other assets. Arguments to the effect that the switch of state support away from fixed asset investment towards other forms of investment has a deleterious effect on overall fixed asset investment must be set against the industrial policy arguments in favour of this switch. In general, the Council believes that an over narrow definition must not be taken. In fact the most appropriate definition of investment is any expenditure which yields a rate of return beyond one year.

While the changes in industrial policy in regard to the mix of instruments and the allocation of resources across the various instruments should contribute to the development of a strong indigenous sector there may still be some factors which prevent the indigenous sector from realising its full potential. One of these factors relates to the inhibiting effect of the small size of the domestic market. Another, which is related to this, revolves around the existence of market opportunities which because of long lead times or high risk exposure are not undertaken by private investors.

Based on such considerations the Council believes that there is a need for more direct State involvement in the development of indigenous industry with particular emphasis being 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. Success by the NDC in achieving its objectives, particularly the achievement of a strong indigenous industrial base, will necessitate the taking of decisions based on commercial principles. It is imperative that investments by the NDC yield, *at least*, returns equal to the cost of borrowing.

If existing state-sponsored commercial enterprises are to contribute to sustained growth in the economy a clarification of their overall objectives and a financial structure geared to the attainment of these objectives will be necessary.

It is also argued in Chapter 11 that a crucial determinant of the success of industrial policy in attaining its objectives will be the effectiveness of

monitoring and control arrangements. These arrangements should revolve around three principal elements:

- an industrial policy budget
- regular published reviews of industrial policy achievements in relation to objectives (promised in the White Paper)
- the application of performance criteria to state agencies.

The food processing sector is a major source of manufacturing output and employment in Ireland. However, if the sector is to contribute to future employment and output growth in the economy a number of factors in both the external environment, i.e. the EEC, and internally with regard to its relationship with primary producers will have to be addressed. Given the likely continued evolution of the CAP the food processing sector may experience restricted supplies of raw materials. This will accentuate the need to re-orientate production towards higher value- added products.

In addition to the overall economic environment and the precise direction of industrial policy there are structural problems peculiar to the food processing sector which require attention. These relate principally to the relationship between the primary producers and the processors and to the existence of surplus capacity at the processing stage. Resolution of the difficulties which are inherent in this relationship will require better synchronisation between raw material supplies and market needs. This will necessitate a reduction in seasonality at the primary level and the institution of long term contracts between primary producers and processors.

The issues surrounding the food processing industry in Ireland have been the subject of numerous reports. However, apart from some individual projects no real progress has been made to solve the deficiencies identified. Because of the proposed changes to CAP away from intervention towards a more market oriented system, and the imposition of the quota system, there is now an urgent need for a national food production policy and programme.

While commercial realities and decisions will ultimately determine the type and scale of production and processing undertaken by farmers and processors the various state agencies supporting agriculture, properly structured, can significantly and positively influence the pace and type of market orientation that will evolve. Greater market-orientation may require that the State institutional support system be reviewed.

Agricultural Policy

The critical parameters for the future of agriculture are (i) the domestic environment, the principal indicator of which from the agricultural perspective, is the price/cost squeeze; (ii) the evolution of the CAP; and (iii) the evolution of the structural deficiencies in the sector. Not all the parameters, of course, are external to the farm enterprise. Efficiency improvements at the level of the individual farm are vital for a healthy agricultural sector.

As indicated in Chapter 2 one of the critical parameters for the future health of the agricultural industry is the likely path for the price-cost squeeze. The importance of the price/cost ratio can be gauged from the fact that the bulk of the observed annual changes in farm income over the 1980-85 period is accounted for by nominal variables, principally output and input prices. The price side of this equation is determined primarily by the EEC Commission and Council of Ministers. The cost side of the equation on the other hand is domestically determined and a close relationship exists between farm input costs and the domestic inflation rate. The integrated macro-economic policy recommended above would keep the domestic rate of inflation under firm control and would thus minimise any squeeze emanating from the cost side.

The CAP has had a high degree of success in achieving many of the objectives originally set for it. One of the most notable successes has been with regard to ensuring security of supply of agricultural commodities. However, this success has given rise to some problems, notably the budgetary cost of the policy, most of it in recent years related to financing market surpluses. One of the fundamental constraints now facing Community agriculture is that expenditure cannot grow at rates comparable with the past.

Aside from the overall growth of expenditure the pattern of such expenditure is noteworthy. In the early 1970s it was envisaged that about one quarter of the agricultural budget would be committed to structural policies. This, however, has never materialised and the proportion spent on structures has now fallen below five per cent. Partly as a consequence of the greatest degree of support being directly related to production, there is a maldistribution of support both between farm businesses of different size and across member states. On either a per unit area or per holder basis, Dutch, Danish and Belgian producers retain the top positions in terms of support. Notwithstanding this unequal distribution, Ireland has been a substantial net beneficiary from the Community budget since accession. The level of agricultural support received by Ireland is of strategic importance to the Irish agricultural sector, being equivalent to 64% of gross agricultural product at market prices in 1985.

In considering the most appropriate Irish stance in the context of European negotiations regarding the future of the CAP it is necessary to firstly acknowledge that the reform of the CAP is necessary. If we persist in defending what is economically and politically unsupportable within the EEC we may fail to increase support for common policy measures which may be beneficial to us. It is essential to be clear on one issue at the outset, viz. nationalisation of agricultural policy within the EEC would fundamentally threaten Irish interests.

Having accepted that the CAP is in need of reform it is necessary to consider what are acceptable EEC policies and secondly how the prospects of Irish agriculture can be enhanced within an acceptable EEC framework. It is

essential that Ireland try to build consensus across the Community around a number of key issues.

In the view of the Council the first such issue is the necessity for an international dimension to the solution of worldwide surplus agricultural production. In particular, the Council believes that sacrifices by Community producers in restraining production should be matched by similar sacrifices from other major world food exporters.

However, this would not remove the need for a serious tackling of the Community's internal agricultural problems. In attempting to seek some consensus across the Community on the means of restraining EEC production the Council believes that the future evolution of common prices must have regard to the fact that high food prices entail a cost to the consumer as well as a benefit to the producer. Moreover, reform of the CAP should be used as an opportunity to reorientate the policy to address the low income problem in farming. Finally, in seeking consensus Ireland must adopt an approach which acknowledges the very real difficulties now facing the CAP. This involves acceptance of the fact that Ireland must participate in the adjustment inherent in reform of the CAP. However, sacrifices must be determined by reference to the importance of agriculture in the individual states, the structure of agriculture in each state and the nature of the objectives in the Treaty.

As part of adopting a realistic approach it must be acknowledged that price policy within the Community must have regard to the cost to the consumers and to the surplus production situation. Price policy must also have regard to costs of production within the Community, including any costs associated with the peripheral location of some regions. Chapter 11 of course points out that a restrictive price policy has been in operation for a considerable number of years.

The Council, however, emphasises that it would not wish price policy to be the only instrument used to bring about greater market balance. Greater equilibrium in agricultural markets will therefore necessitate quantitative restrictions. As part of the strategy of building community wide agreement around a reform of the CAP, reform should incorporate the objective of dealing more effectively and systematically with the problems of low income farmers. Preferential access to production opportunities may have to be devised in order to achieve this objective. This strategy could be relatively favourable for Ireland.

It is essential, in the view of the Council, that any reform of the CAP must have regard to the fundamental objectives of the Community as articulated in the Treaty of Rome. In particular, the Council would be concerned to ensure that community agricultural policy continues to fulfil the objective of assuring a fair standard of living for the agricultural population. In this

context the Council would wish to see the distribution of support across the Community more attuned to the disparities between the various agricultural regions. This would be partly achieved through a reorientation of support towards alleviating the low income problem in farming.

As with the industrial sector the agricultural sector is also beset by structural deficiencies. These are detailed in Chapter 11. With regard to structural issues the Council would emphasise the desirability of a new land use policy taking account of the changed production and marketing environment within the EEC. The move in the EEC towards quota restrictions on milk and declining real price support generally reduces the scope for increasing output and for development generally. There is therefore a changed context within which land use policy must be considered. This, however, does not diminish the need for more efficient and effective use of land. If anything it increases the premium on effective land use in both conventional and non-conventional enterprises. The precise instruments to achieve efficient land use have, however, to be tailored to the new environment.

(iv) A More Equitable Society

The implementation of the economic policies outlined above are not intrinsically antagonistic to the pursuit of social objectives. On the contrary the constraints on the public finances present a renewed opportunity for, and heighten the arguments in favour of, more effective and more equitable social policies. Such policies should have a number of strands.

Firstly, policy should be more selective, not only in the contined use of means tests, but in the sense of identifying very specific priorities and allocating resources accordingly. The Council has therefore recommended for instance, that the relatively generous treatment of the owner occupied sector should give way to a more targetted use of public resources on those whose housing needs are extreme (such as travellers and the homeless). Similarly in social welfare; a more redistributive and adequate system of payments will evolve if it is recognised that some recipients have more pressing claims, and if this recognition is carried through into decisions about increases in social welfare payments. The Council has also argued in Chapter 9 that the financing of third level education and private health care should be made more redistributive, and that expenditure and taxation policies in these areas should be reformed.

Secondly, policy should be more coherent in that the links between different areas of policy and different services should be brought into focus. The unintended social policy consequences of aspects of the complex system of tax allowances, and the 'tax expenditures' to which they give rise, for example, are to create an implicit, and inequitable array of subsidies which disproportionately benefit middle and higher income groups. Social and equity

considerations in health, housing and other areas converge with the compelling arguments in favour of a comprehensive, efficient and simple taxation system, on the strategy of limiting tax allowances. Of particular importance is the need to have coherent links between economic objectives and social programmes. As the Council has pointed out in Chapter 9, efficiency implications in terms of employment, savings and investment, may arise from the level and structure of social provisions; these implications should be an explicit part of the agenda of social policy formulation.

Thirdly, policy should have some continuity and stability, against a background of regular, public review and analysis. Thus, the Council has indicated that the real value of higher education grants has gyrated over the period since their inception: significant increases in one year followed by a sequence of declines, but no explicit official criteria for determining the nature of higher education financial support and no overall official analysis of policy despite a clear need for review. The housing system embodies a plethora of grants, subsidies and incentives with continual modifications and additions being made in a policy vacuum. Clear, specific statements of policy, effectively implemented on a continuous basis and subject to public review should be the basis of social policy formulation.

The limits of social policy should not be ignored. In Ireland today the single most important contribution to social development would come, not from more comprehensive and equitable social provisions, necessary though these are, but from significantly reduced unemployment and the development of a dynamic economy. Sustained economic growth and structural development of the economy will bring, not only higher output but also greater employment, higher incomes for those who become re-employed and a reduction of the poverty and social ills associated with unemployment. The 'economic' policies required to bring this state of affairs nearer are also, therefore, 'social' policies. Social services such as payments to the unemployed, pensions to those who are elderly, and health and housing services to those who need them can mitigate the problems caused by lack of employment, low incomes and inadequacies in housing and health. However, the Welfare State's policies in these areas will always be seriously compromised if it must continuously sustain one sixth of the labour force.

4. CONCLUDING REMARKS

The economic and social problems now confronting policy makers are grave. The continuation of existing policies is not a viable option. It would give rise to continued emigration, further deterioration of the public finances and continued reduction in the flexibility of policy makers. It would also lead rapidly to an erosion of confidence in the economy.

While the problems are severe they are not intractable. The Council believes that the determined pursuit of the above strategy will ultimately bring desirable

results. However, the nature of the problems is such that remedial action is possible only in a medium term context with individual decisions continuously related to the medium term framework. The return of confidence to the economy is crucial for any economic and social strategy to be successful. Confidence is created if markets and individuals believe in the overall strategy.

Another major requirement for a successful strategy is acceptability. This requirement relates particularly to those who are called upon to make sacrifices to facilitate the attainment of targets. It is particularly important that the burden of adjustment is not borne by the less advantaged members of society.

Sacrifices will be accepted if some return can be demonstrated and if major inequities are removed from our economic and social system. This highlights the importance of the simultaneous pursuit of the four elements of the Council's strategy. For example, failure to reduce inequities while undertaking public spending cuts will consign the entire strategy to failure. It will fail because the burden of adjustment will not be accepted by those on whom it is being placed because of a perception of inequities in the system. Demands for compensation will be made with the entire planning process becoming socially divisive and inimical to the long term interests of the economy.

Finally, while the Council has reached broad agreement on the measures which are necessary to confront the present economic and social difficulties it is of the view there is a need to foster a greater degree of consensus in Irish society if these measures are to be implemented without giving rise to conflict. This consensus is necessary both on the national level and the level of the workplace. The Council intends to pursue this issue further, through examining the institutional arrangements for economic and social planning in a number of European countries and particularly at the mechanisms in place for the achievement of consensus.

APPENDIX 1

THE COMPONENTS OF FARM INCOME CHANGES

The observed annual changes in farm income may be decomposed into the following additive elements:

$$D\%FY = (1/1-S_{fy})\,[(D\%P_q - S_i D\%P_i) + (D\%Q - S_i D\%I) + S_s D\%S - S_e D\%L - S_k D\%K - S_w D\%W]$$

where,

- D% = annual percentage change,
- FY = nominal value of farm incomes,
- P_q = price of farm output,
- P_i = price of farm inputs,
- Q = volume of farm output (Gross Agricultural Output),
- I = volume of farm inputs,
- S = nominal value of subsidies not related to sales,
- L = nominal value of production levies
- K = nominal value of depreciation of fixed capital,
- W = nominal value of farm employee wages

S_{fy}, S_i, S_s, S_k, S_w = share of nominal farm income, farm input costs, cost of levies, cost of depreciation and employee wages, respectively in the value of Gross Agricultural Output.

The terms $(D\%P_q - S_i D\%P_i)$ and $(D\%Q - S_i D\%I)$ are variants of the familiar price-cost squeeze and input productivity respectively.

The use of the input share as a weighting factor provides a more complete picture of the influence of nominal and real factors on the evolution of the nominal value of agricultural incomes.

*See Boyle, G: "Measures of Real Farm Income: A Note", *Irish Journal of Agricultural Economics and Rural Sociology*, Vol. 10, No. 2, 1985.

APPENDIX 2
ASSUMPTIONS UNDERLYING POPULATION AND LABOUR FORCE PROJECTIONS

(i) Population

The assumptions regarding survivorship and the proportion of females married are the same as those use in the CSO publication *Population and Labour Force Projections 1986-1991* (April 1985).

The assumptions on fertility are the same as the high fertility assumption used in CSO (1985).

It has been assumed that net outward migration of 25,000 per annum will occur over the remainder of the decade yielding a total net outflow of 125,000 between 1986 and 1990. The assumed distribution of this outflow by age is broadly the same as that used in CSO (1985).

(ii) Labour Force

The age and sex-specific labour force participation rates projected for 1991 are detailed in Table A2.1

Table A2.1
Labour Force Participation Rates 1991

	15-19	20-24	25-29	30-34	35-39	40-44	45-49	50-54	55-59	60-64	65+
	(– per cent –)										
Males	34.0	86.0	96.5	96.5	95.0	95.0	91.0	91.0	80.1	58.0	9.0
Single Females (1)	30.0	85.0	87.0	87.0	75.0	75.0	55.1	55.1	34.0	34.0	4.0
Married Females	35.0	48.0	44.0	26.0	22.0	25.0	24.0	17.0	13.0	8.0	2.0

(1) Including widows.

APPENDIX 3
WOMEN AND SOCIAL POLICY

1. INTRODUCTION

The Council, cognizant of the important and changing role of women in society, the widespread awareness of discrimination against women, and the domestic and international initiatives in pursuit of sexual equality* commissioned in 1982 a study "Women and Social Policy".** This study reviewed progress over the decade since the publication in 1972 of the Report of the Commission on the Status of Women. The Government published a similar report to that of the NESC consultant, entitled "Irish Women: Agenda for Practical Action", and referred to hereafter as the Working Party Report.

A comparison of the two reports, as provided in summary form in Table A3.1, shows their similarity in the topics examined and in the broad thrust of their recommendations. Generally, the same topics are discussed in each report, and they both contain around 80 proposals. There is broad agreement in each chapter on the main issues discussed: the main differences relating to additional sections. The additional sections in the Working Party Report outline developments in official policy and advocate further research; in the NESC consultant's report the additional sections deal with issues such as equal pay legislation, family planning and housing policy which are not the subject of recommendations in the Working Party report.

A summary and brief discussion of the proposals and recommendations in the Working Party report is given in Section 2. As it is the Council's view that the social, demographic and economic aspects of female labour force participation are crucial to the analysis of women and social policy, and that these issues were not sufficiently addressed in the Working Party or consultant's report, a brief discussion of these issues is given in Section 3.

*For instance EEC Directives 75/117/EEC, 76/207/EEC, 79/7/EEC; OECD Report, 1979, on Equal Opportunities for Women, and OECD Report, Women and Employment: Policies for Equal Opportunities, 1980; adoption in 1981 of UN Convention on the Elimination of all Forms of Discrimination against Women; establishment of a Dail Committee on Womens Affairs, appointment of a Minister of State for Women's Affairs.

**Copies of the NESC study, which was prepared by Ms Eithne Fitzgerald, are available on request from the NESC.

Table A3.1
Women and Social Policy, Summary of Proposals

Topic	Working Party Report	NESC Consultant
1. Employment		
No. of Proposals	19	18
Broad Agreement on:	Training, part time work, facilitation of joint employment/family commitments	
Main Differences:	Discusses EC Initiatives	Pro legislative action on equal pay
2. Education		
No. of Proposals	3	5
Broad Agreement:	Thrust of official policy as outlined in Progamme for Action in Education	
Main Differences:		Positive discrimination
3. Health Services		
No. of Proposals	12	16
Broad Agreement:	Health education, maternity service provision, extended eligibility for wives of insured workers	
Main Differences:	Additional sections on: smoking/alcohol violence; occupational health; home help services	Additional section on family planning
4. Child Care Facilities		
No. of Proposals	10	12
Broad Agreement:	Day care provision, play groups, creches	
Main Differences:	Advocates tax deductible child care expenses and aid to needy parents	
5. Social Welfare/Social Protection		
No. of Proposals	5	9
Broad Agreement:	Exploration of social insurance credits re-work in the home, changes in the prescribed relatives allowance	
Main Differences:	Additional sections: child support; occupational social security; single womens work in the home	Additional sections: widows pensions; separated spouses; mortgage protection; marriage preparation; family home
6. Rural Women		
No. of Proposals	7	none
7. Women in the Home		
No. of Proposals	7	12
Broad Agreement:	Planning of residential areas and facilitation of women with prams re-footpaths and public buildings	
Main Differences:	Additional sections on: research; social welfare entitlements; support self help and re-entry programmes	Additional sections on: housing needs; community facilities
8. Single Parents		
No. of Proposals	17	3
Broad Agreement:	Need to rationalise social welfare support, including improved aid for accommodation	
Main Differences:	Promote research and publicity	
9. Family Law Reform		
No. of Proposals	2	2
Broad Agreement:	Family law courts	
Main Differences:	More detailed discussion of progress	
10. Womens Status		
No. of Proposals	5	3
Broad Agreement:	Promotion of women on public bodies and extension of anti-discrimination regulations to cover goods and services	
Main Differences:	Additional Sections on: amending official forms; publication of information on women in labour force; examinations of reform of administrative structures	
Total Recommendations	87	80

2. PROPOSALS AND RECOMMENDATION

(i) Employment Related Recommendations

The Working Party report made a number of employment related recommendations, which are listed in Table A3.2.

Table A3.2
Summary of Employment Related Recommendations

	Estimated Cost
A Training	
(i) training in science and technology in second level education for all students (para 2.18)	not costable
(ii) welcome existing training facilities for women and girls and recommend a strengthened approach	Nil
(iii) urge women's organisations to suggest special women's projects for ESF funding (2.29)	Nil
(iv) encouragement of training of women entrepreneurs (2.34)	Nil
(v) welcomes the Social Employment Scheme and its impact on women who have been long-term unemployed (2.37)	Nil
B Working Conditions	
(vi) review age limits for entry competitions to public service (2.47)	Nil
(vii) admission of women to entry competitions for army and Aircorps (2.51)	Nil
(viii) support present review of equality legislation	Nil
(viv) consideration by wider public sector employers of measures like flexible working hours, job sharing and career breaks (2.59)	Nil
(ix) welcome modifications of protective legislation regarding women doing shift work and working underground (2.65)	Nil
(x) favour collective bargaining over the scope for transfer of pregnant women to alternative work (2.70)	Nil
(xi) exploration of adoption leave (2.73)	Nil
(xii) recommend changes in appointment procedures for subordinate posts in Government Departments (2.75)	Nil
(xiii) recommends review of apprenticeship age limits (2.76)	Nil
(xiv) recommends creche facility costings be included in ESF applications (2.77)	Nil
(xv) recommends giving practical effect to Government proposals on implementing employment equality (2.89)	Nil
(xvi) welcomes civil service initiatives and recommends same to other public and private sector employers (2.91)	Nil
C Other	
(xvii) increased funding of child care facilities (5.27)	£½m
(xviii) consideration of provision of tax credits for child expenses (5.27)	not costable
(xix) review, training and research on occupational health issues (4.97)	Nil
(xx) provision of training and extension of work flexibility schemes to health service employees (4.112)	not costable
(xi) labour force re-entry programmes for women (8.18)	not costable
(xxii) special attention to the needs of rural women in relation to training and employment (7.29)	not costable

Of these 22 recommendations few would qualify as likely to have significant impact on the employment decisions of married women. Many of the proposals are tentative, involving reviews, consideration, and welcoming of recent developments. Four which have cost implications might be identified, however, as likely to affect married womens' decisions:

- the provision of increased funding of child care facilities for working parents in need with a suggested outlay of £0.5m
- tax credits for parents with child care responsibilities (which is said to be non-costable)
- career breaks, job sharing and flexible working time in the wider public sector (not costed)
- labour force re-entry programmes for married women.

The Council notes that both of the last two proposals are being implemented, in that career breaks are currently widely available throughout the public sector and ANCo has initiated a number of re-entry programmes. The Council believes that both of these developments should be carefully monitored for their effects on employment and the labour market generally. The Council does not support the proposal concerning tax credits nor the proposal regarding state financed child care facilities for working parents on a selective basis. However, the Council supports the broad thrust of the other recommendations to do with improvements in training, entry to particular occupations and further research and information on women in the labour market.

(ii) Recommendations about Support Services for Women with Children

Both the Working Party report and the NESC consultant's report contain lengthy sections on health and child care services and also on women in the home, with no less than 29 of the Working Party recommendations dealing with these topics.

The main recommendations in respect of health services entail the following:

- improvements in ante-natal and maternity services;
- extension of social insurance treatment benefit to wives of insured workers (the 1985 Budget extended dental care eligibility to pregnant wives of insured workers);
- health education programmes to include pregnancy, parenthood, and child welfare (already being developed);
- promotion of awareness of health risks for women including cancer, alcohol, smoking, occupational hazards and family violence;
- development of home help services; female representation in health service administration.

The recommendations of the Working Party report related to childcare deal with:

- public regulation of private child care facilities (which is included in the recently published Children's Bill);
- support to the playgroup movement;
- negotiations between the social partners on the provision of workplace creches;
- use of schools for after-school child care.

Finally, the recommendations on women in the home cover the following:

- research on women working in the home;
- examination by the Commisson on Social Welfare of the scope for inclusion of homeworkers in social insurance and of social assistance for accidents in the home;
- improved physical design of residential areas to take account of the needs of women and children.

With the exception of the recommendations to do with extension of social insurance treatment benefits to wives of insured workers none of these proposals have significant cost implications, being aimed rather at rationalising and improving the present provision of services. The cost of extending Dental and Optical Benefit to the spouses of insured persons would amount to an estimated £6.27m or an extra PRSI contribution of 0.12% (in 1985). The Working Party considered that extension of full eligibility of spouses be "pursued in the light of the prevailing public finances situation over time" (p131). The Council supports the broad thrust of the proposals aimed at improving the main support services, including the health services, child-care and home and environment, as suggested in the Working Party Report. However, the Council notes the analysis of the Commission on Social Welfare in respect of the general extension of social insurance to women in the home: the Commission did not reach agreement on "either the case for extending social insurance to housewives or on the appropriate means of doing so".*

(iii) Issues Relating to One Parent Families

The Working Party report has 15 recommendations in this area, eight of which relate to the rationalisation of social welfare support, three refer to aiding voluntary agencies dealing with single parents and the remainder refer to research, taxation, day care and training. The NESC consultant's study is less detailed on these topics.

* Report of the Commission on Social Welfare. Stationery Office, Dublin, 1986, pages 243-245.

Three of the Working Party recommendations on social welfare involve referral of proposals to the Commission on Social Welfare for consideration. These include ways of eliminating anomalies, means of resolving problems to do with maintenance payments to deserted wives, and examination of different age restrictions on widows and deserted wives. The other social welfare proposals in the two reports are as follows:

- wider discretion to Social Welfare deciding officers in paying assistance to wives;
- consideration of means of harmonising payments for child dependents;
- examination of means of improving administrative procedures to do with 'cohabitation';
- higher rent allowances to single parents reliant on Supplementary Welfare Allowance;
- More generous 'disregards' policy with respect to earnings of single parents so that there are incentives to earn.

Table A3.3 below lists these proposals and summarises the Council's views on these issues — the latter in turn are a general endorsement of the Commission on Social Welfare's proposals.

The three recommendations to do with voluntary agencies are as follows:

- priority should be given to increasing the funding of single parent housing by increasing the grants from local authorities within the constraints on public finances to the relevant voluntary bodies;
- the Departments concerned should keep under review the services provided by the various single parent voluntary organisations, including counselling of persons in need;
- funding should be provided through one of the Departments concerned to one of the single parent voluntary bodies to launch a publicity and information programme.

The cost implications of these proposals, although unclear, are very modest except perhaps for the proposal to do with funding housing, which is qualified by reference to the public finance constraints. The Council supports these proposals.

The remaining four proposals are:

- drawing together data on single parents and examination of implications;
- improved tax allowances/relief for single parents;
- greater availability of nurseries for children of single parents;
- particular attention by training and employment agencies to the needs of single parents.

The Council endorses the above recommendations with the exception of the taxation proposal. In principle the Council are of the view that financial

support to one parent families should be directed through the social welfare system.*

(iv) Other Issues

Under this fourth heading may be grouped the following chapters in the Working Party Report:

- Education (the chapter broadly endorses the thrust of official policy against sexism)
- Social Welfare (refers several suggestions for sexual equalisation to the Commission on Social Welfare)

Table A3.3
One Parent Families and Social Welfare

Working Party/Consultant	Commission on Social Welfare Endorsed by NESC
Working Party Referred to Commission: Anomalies	Payments for all one parent families should be the same:
Maintenance Payments	State, where necessary, should pay deserted wives payments and procure maintenance directly.
Age Restrictions on Eligibility	Childless applicants for all schemes should have the same age criterion.
Other Issues Wider discretion in paying assistance to wives ("split payments")	If legally permissible, personal rate of payment plus child dependant additions payable to spouse with child responsibilities; D.S.W. to review.
Harmonise Child Dependant Additions	Child Dependant additions to be the same for all recipients of social welfare.
Higher Rent Allowance under Supplementary Welfare Allowance	Housing costs to be supplemented by means of a nationally uniform, statutory housing benefit consistent with differential rent criteria.
More generous means testing of earnings of one parent families	No differentiation in means tests between different categories of recipient.
Improvement of procedures to deal with co-habitation	Cohabiting couples treated as married couples in respect of the unit of payment for social welfare.

*This view is accepted by the Commission on Taxation and the Commission on Social Welfare.

- Rural Women (advocates improved training, education and participation)
- Family Law Reform (reviews work in progress and advocates Ireland's accession to the UN Convention on Elimination of all Form of Discrimination Against Women)
- Other Issues (recommends the appointment of more women to public bodies, an anti-discrimination policy in goods and services, and administrative reforms to promote sexual equality).

The Working Party's five proposals in relation to social welfare are that:

- the level of support provided by Children's Allowance should not be diminished with the introduction of the new Child Benefit;
- there should be an urgent response to the draft EEC proposal regarding equality in occupational pensions;
- the framework for a National Pension Plan should examine the possibility of giving credits for time spent on care within the family;
- the Commission on Social Welfare's recommendations should recognise the social value of work in caring for relatives at home;
- the Commission on Social Welfare should support the payment of Prescribed Relatives Allowance to the carer rather than the cared and that, as resources permit, the allowance should be increased.

It is clear that the above proposals are mainly at the level of exhortation and as such have neither quantifiable employment or public finance implications. There is considerable overlap between the Working Party and the the NESC consultant's report, particularly in relation to the promotion of care in the home. The Council views the above issues in the light of the Commission on Social Welfare's analysis and endorses the Commission's approach as follows: a structure of child income support based on a combination of child dependant additions, childrens allowances and Family Income Supplement, the payment of prescribed relatives in their own right through a reformed social assistance scheme: the Commission did not refer to the draft equality directive on pensions which, the Council notes, has now been signed by the Government.

With regard to rural women, the working party made six recommendations (excluding that pertaining to the IDA referred to above) which are as follows:

- Curriculum and Examinations Board to give particular attention to agricultural subjects;
- ACOT to adopt an equal opportunities programme;
- That "there could be merit" in the abolition of the stamp duty in relation to the transfer of a farm into joint ownership of spouses.
- consideration should be given to the possibility of granting independent insurance rights to married women who share the running of a family farm or business;

- community organisations should encourage greater participation by rural women;
- the major farming organisations should encourage women to become more actively involved at all levels in their organisations. Once again there do not appear to be any strong implications either for employment or public finance in these proposals. The Council sees these proposals as desirable.

Although there is an extensive discussion of Family Law Reform in the Working Party Report, particularly on reforms which are in progress, the only recommendation made is that Ireland should accede to the UN charter on the Elimination of all forms of Discrimination against Women, with reservations as necessary.

On education there are three proposals:

- welcoming the committment to equality and maintaining the pace of reform;
- pursual of specific proposals to ease existing financial barriers in further education;
- provision of creche facilities in adult education should be pursued by the women themselves with the school authorities.

The Council endorses these general proposals.

On the miscellaneous category "other issues" the following recommendations are made:

- appointment of women by Ministers to boards under their aegis;
- appraisal and amendment of the format of official forms by state agencies;
- publication of information and analysis of women's labour force activity by CSO and Office of Minister of State for Women's Affairs;*
- consideration of the issue of discrimination in the area of goods, facilities and services;
- establishment of a small working party to examine the best administrative structures for implementing a programme of reform.

The Council endorses these proposals also.

3. BROADER ISSUES

(i) NESC Study and Working Party Report

In this section brief reference is made to the wider aspects of female labour force participation which were not central to the Working Party Report or the NESC consultant's report.

*The Council welcomes the initiative of the Employment Equality Agency in publishing Women in the Labour Force, a Statistical Digest. (Employment Equality Agency, Dublin, 1986).

(ii) Female Labour Force Participation in Ireland

There has been a significant change in female labour force participation in Ireland in the past decade, and most of this change is attributable to a rise in the participation rate of married women. Their numbers in the labour force grew from 79,000 in 1975 to 135,000 in 1985. These important changes notwithstanding the traditional relativities between the participation rates of males and females persist, with male rates higher at all ages.

(iii) Determinants of Female Labour Force Participation

An analysis of female labour force participation should distinguish the supply and demand aspects. On the supply side a variety of interrelated economic, social, demographic and cultural trends are associated with increased female labour force participation — higher educational qualifications, lower fertility, increased desire for women for financial independence, a need for a career as a financial buffer against marital instability or divorce, and the substitution by households of market produced commodities and services for home produced commodities and services, with an increase in the "opportunity cost" of housework.

The demand for female labour has been affected by: the expansion of sections of the services sector which employ mainly women; the growth of specific areas of the public sector (education, health, social services) with high proportions of female employees; the increase in part time employment and short term and casual employment which are also largely the domain of women.* The latter trends are discussed in the policy literature in terms of 'internal' and 'external', or 'primary' and 'secondary', labour markets; in these discussions married women are analysed as part of a wider group with less than complete attachment to the labour force. This group enters and leaves the labour force in response to changing opportunities and to their evolving domestic, education and social circumstances. Employers use this segment of the workforce as a 'secondary' labour force which enhances their flexibility in conditions of changing product demand. However, this analysis is probably relevant to a sub segment of the female labour force only. A significant proportion of married females are employed in professional, skilled and semi skilled occupations and are not part of the 'secondary'or 'external' labour market.

(iv) Policy Issues Affecting the Rate of Change in the Labour Force Participation Rate of Married Women

Any discussion of public policies in this area needs to distinguish those factors which are amenable to policy change from those which are not. Thus, aside

*In the Irish case regular part time employment grew by 93% from 1977 to 1983; married women comprise 54% of regular part time employees; family responsibilities is the most common reason given by married women for engaging in part time employment. (A. Vaughan, The Social Insurance Implications of Part Time Employment, M.SC. Thesis, Trinity College, 1985)

from economic factors, the decisions of women about labour force participation will be shaped by their educational backgrounds, attitudes to their relative roles as spouses and employees, availability of fertility control, and a host of other such factors. These factors are not directly amenable to policy manipulation. However there are also a range of economic variables which impinge on labour force participation decisions some of which may offer, in principle at least, some scope for policy movement.

The participation of females in education

The evolution of the labour force participation rates of married women must depend to some extent on the participation rates of single women and on trends in the rate of educational participation at senior cycle second level and at third level. In the short term the growing participation of females in the upper tiers of the educational system will reduce the labour force participation rate of young women in the 15-19 age group, and to a lesser extent the 20-24 age group. Over the ten years from 1975 to 1985 the labour force participation rate of single women aged 15-19 declined from 43.2% to 33.1%; simultaneously the educational participation rate for all females over 15 years rose from 20.6% to 27.4%. Among married women, participation in the labour force rose considerably; for instance the participation rate in the 20-24 age category increased from 24.0% to 40.5%, and the corresponding increase for the 25-44 category was from 14.7% to 23.6%.

There is therefore a complex interplay between the educational participation of females on the one hand, and the labour force status of married and single females on the other. In an arithmetic sense the effect of increased participation in education by females is to reduce the labour force participation of females in younger age groups. However, an increasingly educated female population is likely to have a stronger labour force attachment. Firstly, higher educational status will raise the 'opportunity cost' of withdrawal from the labour force and secondly, improved educational standards among women will indirectly strengthen labour force participation through its effect on expectations, fertility levels, and desire for economic independence.

Conditions of employment which facilitate family responsibilities

The 1970s were marked by legislative changes towards ameliorating employment conditions, prompted largely by the EC as noted above. The marriage bar in the public sector was removed with the result that considerable (but unknown) numbers of women remained at work after marriage and motherhood, particularly in teaching and nursing. The adoption of equal pay legislation, particularly by the public sector, no doubt accelerated this process, as did the introduction of paid maternity leave, while employment equality legislation may have contributed to making continued employment more feasible.

Although it could be argued that further moves towards facilitating employed women in combining family responsibilities would further increase the number of married women remaining in employment, (for example paternal leave and workplace creches), it seems likely that the impact of these schemes is likely to be much less than those discussed above, particularly equal opportunity legislation and maternity leave. The remaining disincentives are likely to be weaker and action to remove them may be more to do with rationalising existing arrangements for women already employed.

Absolute and relative pay levels

It has been shown econometrically in the UK that both absolute and relative pay levels have significant effects on household decisions, and particularly on the birth rate.* Dual earner and single earner families (i.e. man, wife, with or without children) respond differently to changes in pay. Real pay increases, it is argued, tend to encourage single-earner families to have extra children. By contrast, increases in real and or relative pay raises the opportunity cost for employed married women to have a child, thus reducing this group's fertility. The above does not imply that couples decide to have children solely on the basis of such rational decision-making; rather that on average, over time, such factors appear to influence fertility.

No such detailed work has been done in Ireland on the determinants of fertility (which for historical and other reasons may be less controllable in any case), However, the advent of equal pay legislation, and the increase in the number of employed married women may have depressed fertility for this group. The effect of taxation however on disposable income may also be a significant factor.

The income tax treatment of married women

From the point of view of each employed individual, the transition from single status to married makes no difference in income tax liability. However, from the point of view of the married couple, their tax liability varies dramatically according to whether one or both are employed. Essentially this is due to the fact that married couples have virtually the same tax free allowances and rate bands regardless of whether one or both are employed. Since higher tax rates come into force at relatively low levels of income, from the point of view of the household, the net gain from the wife remaining employed is much reduced by the higher tax rates.

It seems clear that the sharply progressive nature of Irish income taxation constitutes a financial disincentive to employment for married women. This disincentive, however, is presumably counterbalanced by the social, cultural and demographic changes which are associated with increased participation.

*J Ermish, The Political Economy of Demographic Change, London, 1984.

This is reflected in the fact that considerable numbers of married women have chosen to remain in full-time employment, despite the taxation regime, presumably choosing to work for very low net incomes over the period before their children enter primary school. Policy developments which would reduce further the disincentive to remain in employment might include career breaks and reform of income taxation towards a single rate of income tax, as proposed by the Commission on Taxation.

Public Child Minding Facilities

Probably the main proposal which would facilitate married women combining employment and family responsibilities would be improved public provision of child-minding facilities, particularly for younger children. At present it appears that such facilities are mainly provided informally.* The thrust of public policy appears to be towards regulation of the quality of that care rather than direct provision.** To the extent that such care is currently part of the informal economy, its incorporation into the formal, taxable economy may increase the prices charged for such services. Presumably for this reason both the Working Party Report and the NESC consultant's report suggest that the approach of the public authorities should be flexible in order to ensure that regulation does not drive the sector further underground.

Social Security Provisions

A number of aspects of the social security system which may affect the labour force decisions of married women require analysis: at present Child Benefit is paid, non taxable, to all mothers without any differentiation between working and non working mothers; the disposable annual income of a family exclusively dependent on social welfare may be higher than that of a low paid employee's family because of the non taxation of short term social welfare payments; one of the effects of the implementation of the Equality of Treatment legislation in social welfare will be to alter the manner in which a spouse's earnings are considered for purposes of determining the amount of unemployment payments to a family; the general exclusion from social insurance contributions of part time employees, the majority of whom are married women, will raise the disposable income/gross income ratio above what it would be for full time employees, but this effect may be diminished by their exclusion from social insurance benefit entitlements.

(v) Concluding Comments

The analysis above has shown that a range of very fundamental factors — economic, social, demographic, as well as institutional arrangements and public policies affect the role of women in the economy, and in the labour force

*The age of entry of children to primary school may also be a consideration.

**A small number of employers with significant numbers of female employees now provide child minding facilities, the Universities and Aer Rianta for instance.

in particular. It is clear that there are countervailing trends and policies: on the one hand a range of social, demographic, and cultural trends and public policies which implicitly or explicitly encourage female labour force participation, and on the other hand public policies (notably income taxation of married women, absence of public provision for child care) which must act to some extent as disincentives to female labour force participation. The questions arise therefore as to what the goals and the instruments of public policy in this area should be: potential policy instruments range across taxation, family income support, social security coverage, child care policies and other areas. A comprehensive discussion of these issues, however, requires an overall analysis of the labour market in general, an analysis which to date has not been undertaken. In future work therefore, the Council will be examining more fully the labour market in Ireland and analysing the female labour force, and other segments of the labour force, in the context of labour market policies as a whole.

APPENDIX 4
RECOMMENDATIONS OF THE COMMISSION ON TAXATION TO BE IMPLEMENTED IN THE FIRST PHASE OF REFORM

INCOME TAX

(i) Extension of the tax base

— taxation of short-term social welfare benefits;
— charging to tax of foreign pensions;
— repeal of artists' exemption;
— repeal of tax exemption on profits of certain sweepstakes;
— abolition of medical insurance relief;
— abolition of relief in respect of permanent health insurance premiums;
— withdrawal of reliefs for new covenants;
— withdrawal of relief in respect of life assurance premiums;
— realistic assessment of the value of fringe benefits;
— repeal of relief for individual investors in certain companies.*

(ii) Lump-sum receipts and windfalls

The following items to be liable for tax at a single rate of 30 per cent:
— compensation payments for loss of office;
— lump-sum retirement benefits;
— payments under the Redundancy Payments Act;
— that part of compensation payments for injury attributable to income loss;
— prizebond and sweepstake winnings;
— net gambling winnings.

(iii) Reform of personal income tax structure

— adoption of the family as the unit of personal taxation;
— replacement of income tax allowances by tax credits;
— abolition of the general exemption limits;
— introduction of a universal child benefit to replace the income tax child allowance and the social welfare childrens' allowances;*
— abolition of most secondary allowances and their replacement by direct payments.

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*Repealed in 1983 Budget.

*Broadly similar measure anounced in 1986 Budget.

(iv) Reduction in tax rates

— the maximum marginal rate of tax not to exceed 50 per cent;
— widening of the rate bands.

(v) Adjustments for inflation

— Schedule D taxpayers to be brought onto a current year basis of assessment;
— the Schedule E (PAYE) tax free allowance to be abolished;
— indexation of personal income tax structure;
— substantial increase in the exemption limit for bank deposit interest;
— withdrawal of deduction for interest paid in full (mortgage interest).

CAPITAL GAINS TAX

— extension of range of chargeable assets;
— abolition of many of the existing reliefs;
— treatment of death as a disposal;
— abolition of roll-over relief;
— allowance of real losses;
— repeal of the exemption of small gains;
— capital gains should be charged at a single rate;
— this single rate of CGT to be adjusted downwards as the maximum rate of income tax is reduced;
— all new Government securities to be treated as chargeable assets.

CAPITAL ACQUISITIONS TAX

— the family should be adopted as the unit of taxation, transfers between spouses to be exempt;*
— aggregation of all gifts and inheritances received by a beneficiary from all sources to determine tax liability;
— the rates of tax to be reduced from their existing levels, and further reduced as progress is made in reducing the top rate of income tax;
— relief for productive assets should be replaced by the adoption of fair market value at existing use;
— reduction of tax thresholds for the immediate family given the exemption of inter-spousal transfers.

CORPORATION TAX

— introduction of witholding tax on distributions accompanied by an increase in the rate of imputation on distributions;**
— abolition of special rate of tax on small companies;

*Exemption of inter-spousal transfers granted in 1984.
**Withholding tax effectively instituted with introduction of ACT in 1983.

— close companies to be charged to tax on a partnership basis;
— income arising in the form of capital gains in companies should be charged to tax at the same rate as other company income;
— reduction of the rate of corporation tax in line with income tax rates;
— the cost of sales adjustment to be extended to all business sectors.

SOCIAL INSURANCE CONTRIBUTIONS

— abolition of separate health contribution and the youth employment levy;
— income tax credits should be allowed against liability to employees' social insurance contributions;
— single rate of social security tax to be levied on all income;
— employer's social insurance contributions to be phased out and replaced by the contribution at the employee rate on the income of self-employed persons and on income which arises in the first place to companies.

TAXES ON EXPENDITURE

(i) Value-added tax

— all goods and services to be subject to VAT at a single rate;
— the transition to a single rate of VAT to be effected as quickly as is feasible;
— consequential changes in the incidence of VAT to be monitored and compensatory increases in social welfare payments to be made as appropriate.

(ii) Excise duties

— reduction in level of taxation on certain items where prices are significantly in excess of those obtaining in Northern Ireland;
— indexation of specific excise duties;
— reduction of betting duty from present levels.

(iii) Stamp duties

— progressive rates should apply to the excess of value over the value thresholds rather than the total value of the property;
— subsequently, housing transactions should be charged at a single rate.

INCENTIVES

— reduction of accelerated capital allowances in respect of multi-storey car parks and new purpose-built moderate-cost rented accommodation;
— abolish special tax concessions for schemes to encourage profit sharing;
— introduce direct aid for expenditure on market development.

LOCAL PROPERTY TAX

— a local property tax on all residential, industrial and commercial property (except land) should be introduced on a self-assessment basis;
— the rate of property tax should be related to the average rental yield on houses and the (eventual) single rate of income tax.

APPENDIX 5

THE AGRICULTURAL SECTOR AND THE MACRO-ECONOMY

The income difficulties experienced by the primary sector in the past few years and the poor medium-term outlook for agriculture projected in Chapter 5 will have repercussions beyond the farm gate. The primary sector interfaces with the macro economy in a number of key ways*:

(i) the agricultural sector is a major net exporter and it thereby contributes to easing the balance of payments constraint on Government policy;
(ii) it provides raw materials for the food processing industries, and
(iii) it purchases raw materials, capital inputs and services from the manufacturing and service sectors.

In summary, therefore, the significance of a buoyant agriculture can be seen by (a) its contribution to the evolution of GNP and (b) the related issue of agriculture's impact on employment and unemployment.

In a very preliminary but useful way we can examine the contribution which the agricultural industry makes to economic activity through household expenditure, capital formation and exports. Estimation of the role of these channels and the sectoral contribution to employment are furnished in Table A5.1.

Because of the absence of readily available data this table excludes the impact contribution of expenditure by agents in the food processing sector and also the extent of capital formation in these industries. Agricultural exports (including food) accounted for around 14 per cent of GNP for the period 1980-1985. These data are subject to two sets of factors which bias the estimated impact contribution of the sector to national economic welfare in opposing directions. The contribution is understated since the agricultural export figure which are typically cited are net of EC transfers which would not have accrued in the absence of exports. These subsidies could account for up to three per cent of GNP. The ratio of exports to GNP overstates the impact contribution to the overall economy since the consumption of imports is required in the production of the exports. Moreover, in comparison to other sectors of the economy, the import content of agricultural exports is relatively low and repatriation of profits is not an issue as with other high

* The argumentation in this section follows the discussion of Cox et. al. (1981, pp 16-25).

Table A5.1
Indicators of agriculture's role in the macro-economy, 1980-1985

	1980	1981	1982	1983	1984	1985
1. Estimated expenditure of farm households (£m)(1)	531	629	785	891	1054	952
2. Capital formation (£m)	246	346	319	270	274	276
3. Agricultural exports (£m)(2)	1432	1484	1568	1781	2134	2290
4. Primary sector employment ('000)(3)	209	196	193	189	182	n.a.
5. Employment in the food industries ('000)(4)	47	45	44	41	40	37
6. (1) as % of GNP	6	6	6	7	7	6
7. (2) as % of GNP	3	3	3	2	2	2
8. (3) as % of GNP	16	14	13	13	14	15
9. (4) + (5) as % of total employment(5)	22	21	21	20	20	n.a.

Notes: (1)"Income from self employment and other trading income" less an assumed 20 per cent for savings.
(2)These data comprise exports of the primary and food sectors. The figures are net of EC subsidies, which Henry (1983-84) estimated to be worth £356 million in 1982. Assuming a similar proportionate value for other years, the economic contribution of agricultural exports would be as follows (net of estimated trade and transport margins):

Year	1980	1981	1982	1983	1984	1985
(£million)	1690	1751	1850	2101	2518	2701

(3)Labour Force Survey basis
(4)NACE Code 411 - 423. December data except for 1985 which refers to June.
(5)Labour Force Survey basis.

Sources: Irish Agriculture in Figures (An Foras Taluntais), Economic Review and Outlook, 1985 (Dept. of Finance), Irish Statistical Bulletin (CSO), Central Bank of Ireland Reports.

export growth industries. Before discounting imports and ignoring expenditure by households in the food sectors, we can say that at best one fifth of GNP is supported by the agriculture and food sectors.

One in every five working persons are dependent on the primary and food sectors for employment. These data understate the impact contribution to total employment since they ignore the employment content of the industries which service the primary and food processing sectors. Such activities would include the numbers engaged in the fertiliser industry, in the retailing and wholesaling trades and especially the building industry all of which tend to be highly labour intensive. The trend in employment in the primary and processing sectors is downwards in common with many other countries. This

trend has been steady (at least up to 1984) and not unduly affected by buoyant growth periods. It is the inevitable consequence of the introduction of labour-saving technologies. While the adjustment process is highly disruptive for the individuals immediately affected, the changes are necessary to enhance agriculture's wealth creation role in the economy generally. While jobs are likely to continue to be lost in the primary and processing sectors the capacity of these industries to generate employment in remoter sectors is a key concern of policy.

Thus far we have ignored the contribution to GNP and employment of the industries upstream of the primary and processing sectors. Also ignored are the induced effects on GNP and employment of the household expenditure stimulated by activity in these industries. A key *datum* for policy intervention is the likely consequences for economic growth and employment in the economy as a whole of a disruption in the growth of agricultural exports. To trace the full effect of *changes* in agricultural exports on *changes* in these variables we need to employ the methodology of input-output (I-0) analysis*. The most recent analysis available is for 1982 (Henry 1983-84). The key parameters in I-0 analysis are the GNP and employment multipliers which attempt to show the relationship between a one unit change in economy GNP and employment attributable to the GNP and employment content of the agricultural and food export complex. Henry (1983-84, pp 122-3) gives the following estimates for 1982:

GNP Multiplier	Employment Multiplier
1.32	1.5

Thus these data suggest that every £1 million of GNP in the agriculture and food complex (this includes the direct and upstream GNP effects) supports an additional 0.32 million GNP elsewhere in the economy. The employment multiplier indicates that every two jobs in the agriculture and food sectors "... could be considered to support or generate one job or man-year elsewhere throughout the economy" (Henry 1983-84, p 123). An increased level of agricultural exports is unlikely to be accompanied by commensurate employment gains in the primary or processing sectors and hence the employment multiplier must be treated with some circumspection. Nonetheless it is probably reasonable to conclude that a healthy industry is necessary to at best maintain the employment *status quo* in these sectors. Apart

*The use of the method of I-0 for the stated purpose is fraught with many difficulties and hence interpretation of the outcome of such analysis needs to be cautious. Matthews (1983-84) provides a good critique in the agricultural context. Despite the deficiencies in the I-0 methodology it is really the only adequate means available to comprehensively explore the issues addressed in this section.

from labour demand, the supply of labour from the primary industry can impinge significantly on unemployment in the economy generally. A buoyant agriculture will reduce the pressure on low income farmers to seek off-farm employment. Efforts to reduce unemployment in the off-farm economy are more likely to be successful if income conditions in the primary sector are such as to not induce people to partake in off-farm employment creation programmes. The upshot of the multiplier estimates is that a diminution in the rate of growth of agricultural exports will have serious negative implications for living standards and employment growth in the economy as a whole.

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