

Fiscal Policy and Demand Management in Ireland 1960-70¹

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THIS paper discusses fiscal policy and the management of the Irish economy during the years 1960-70. The role of fiscal policy in demand management, as most economists would probably nowadays see it, is described in Section I. In Section II, the annual current and capital budgets for the years 1960-70 are examined. In discussing the annual budgets, the emphasis is on their role and relevance as seen by the successive Ministers for Finance who introduced them. In Section III, the main conclusions are summarised.

Role of Fiscal Policy

In Ireland, as in other countries, the major economic objectives are high and steady growth, full employment, an acceptable external position, stable prices, the efficient use of all productive resources and equity in the distribution of income and wealth. Fiscal policy, working through the annual current and capital budgets, is a major instrument by which these aims can be pursued. By raising investment, providing infrastructure and improving education, the capital budget lays the foundation for their achievement in the longer-term. By maintaining the right relationship between aggregate demand and the possibilities of meeting it without excessive inflation or unsupportable external deficits, both the current and capital budgets can assist in the short-run by maintaining the conditions necessary for the achievement of these objectives. It is these short-term functions of fiscal policy which are emphasised in the context of demand management.

Fiscal policy can influence the balance between aggregate demand and supply in the economy through changes in government expenditures and revenues. Taken by itself, an increase in government expenditures will raise aggregate demand, and the extent of the rise will depend on the nature of the expenditures. An additional £1 million spent on social welfare payments, for example, will

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raise the incomes of the recipients by that amount. The greater part of the additional incomes will be spent on consumer goods and services, thus generating further incomes for those who produced and sold them in Ireland, for government itself (through the taxes levied on the goods and services bought) or for people outside Ireland (to the extent that the goods were imported or had an import content). An additional £1 million spent on new housing accrues as wages and salaries to the workers employed directly or indirectly on it, to contractors and builders' providers as additional profits, to the government (as additional tax revenue) and as incomes to externals (to the extent that imported goods and services are used). Some (probably the greater) part of the new incomes thus generated by the additional government expenditures will be spent, generating further increases in incomes, and so on in a diminishing series.

An increase in the flow of money to the government will, other things remaining equal, affect the level of aggregate demand, generally tending to lower it. The size of the decrease in aggregate demand will depend on the way in which the money is raised. If the additional funds are obtained from increases in the rates of direct or indirect taxation, or increases in the yield from taxation at the existing rates, purchasing power is transferred from the taxpayers to the government. As a result of this transfer, taxpayers will reduce both their (real) spending on consumption goods and services and their saving.² The reduction in their spending will generate fewer (or smaller) incomes for Irish residents (to the extent that fewer Irish goods are now being sold), smaller revenue for the government (through reduced tax receipts), or for externals (to the extent that the impact of the reduced spending falls on imports).

If the additional funds are raised by borrowing from the Irish non-bank public,³ the effects are more difficult to assess. Like taxation, borrowing from the non-bank public involves a transfer of command over resources from the private sector to the government. If interest-rates are responsive to changes in the supply of and demand for domestic securities, they will tend to rise. The rise in interest-rates is unlikely to have any significant and direct effect on current savings. Its main effect will be to reallocate the available savings between the public and private sectors—to reduce private-sector borrowing and thus help to accommodate the new government borrowing. It may also increase the "voluntary" capital inflow. In addition, wealth effects may follow from the higher interest rates: the associated fall in the value of security portfolios may lead to some reduction in consumption and a rise in saving; and there may be some shift in the asset port-

2. The effects may vary, depending on whether the transfer is effected by increases in direct or indirect taxes. A recent study has concluded that increased direct taxes are likely to be unfavourable to savings while increased indirect taxes tend to raise the savings ratio (that is, tend to reduce consumption). See Kieran A. Kennedy and Brendan R. Dowling, "The Determinants of Personal Savings in Ireland: An Econometric Inquiry", *Economic & Social Review*, Vol. 2, No. 1, Oct. 1970, pp. 19-51.

3. It is assumed that the sums lent by the Irish non-bank public come from current saving. If the monies lent came from the sale of external assets by non-banks, the effects would be similar to exchequer borrowing from the banking system or from abroad.

folios of the private sector from more liquid towards less liquid assets. If the banking system adhered to fixed cash and liquidity ratios, this rearrangement in asset portfolios could lead to some reduction in bank lending (because bank deposits would fall as a result of the shift towards less liquid assets), with some consequential reductions in private expenditures.

Where interest rates are not responsive to changes in the domestic capital market (as is largely the case in Ireland), the government borrowing is met by some form of rationing: for example, the government usually announces the size and terms of a national loan well in advance of the date when subscriptions are invited, so that institutional and other lenders can take the government's requirements into account when planning the additions to their portfolios. To the extent that the loan is taken up, that much less is available for the private sector. Where there is no change in interest rates, there is no wealth effect on consumption and no change in private asset portfolios.

Generally, if there is no change in the money supply,⁴ increased government borrowing from the non-bank public may reduce aggregate spending by the private sector by as much or more than the raising of the same amount by additional taxation. With increased direct or indirect taxes, there will be some reduction in private saving, so that private consumption spending will fall by less than the tax proceeds. With increased borrowing from the non-bank public with no change in the money supply, the fall in private (and mainly investment) expenditures will be of the same order as the additional funds borrowed, except in the unlikely event of current savings rising in response to higher interest rates or of the velocity of circulation rising in response to the squeeze on funds for use in the private sector. To the extent that borrowing from the non-bank public reduces private investment, the growth in output may be smaller in the later periods in which the government will have to raise additional funds to pay interest and repay the principal of its initial borrowings.⁵

The final possibility is that the additional funds required by the government are raised by borrowing from the banking system or from abroad. If the monetary authorities have fixed a ceiling for new credit creation (increase in the money supply), additional government borrowing from the banking system will tend to reduce the amount of new credit available to private borrowers and private spending will be less than it otherwise would have been. If the liquidity ratios of the banks are flexible downwards (as they were in the nineteen-sixties), and if there is no ceiling for new credit creation, or if the "ceiling" is tacitly raised to accommodate the additional requirements of the government, there will be no reduction in private spending. Where the additional requirements of the government are met from external borrowing, or by borrowing from the Central Bank, there will be no reduction in private spending. Indeed, the latter may rise if the banks adhere strictly to fixed cash and liquidity ratios, because foreign

4. For a discussion of what happens if this assumption is relaxed, see next paragraph.

5. This assumes a given level of government expenditures. If the given level of spending could not be sustained without borrowing then this conclusion would, of course, have to be modified.

borrowing, by adding to the cash and liquidity base, would make possible an increase in domestic bank lending.⁶

The argument to this stage may be summarised briefly. An increase in government expenditures will raise aggregate demand in the economy, generally by some multiple of itself. If this increase is financed (for example) by increased direct taxation, there will be some offsetting reduction in aggregate demand as private (mainly consumption) expenditures are reduced, as a result of the fall in private disposable income. The expansionary effects of an increase in government expenditures will normally exceed the contractionary effects of the increase in taxation which finances it; this occurs because to some extent the higher taxes are "paid" from income that would otherwise have been saved, and the government spends all of the funds so raised.⁷ The net expansionary effects will be greater to the extent that taxpayers succeed in passing on the increases in direct or indirect taxes by increases in their money incomes. If the increased expenditures are financed by increased borrowing from the Irish non-bank public, there will also be offsetting reductions in aggregate demand as private (mainly investment) expenditures decline.⁸ Where the increased expenditures are financed by borrowing from the banking system or from abroad, and where monetary policy remains passive, the rise in aggregate demand will be determined by the rise in government expenditures since there will be no offsetting reductions in private expenditures. The government must at least raise the money to finance its expenditures:⁹ by altering the level of its expenditures and/or the balance between the methods by which they are financed, the government can change the level of aggregate demand in the economy, to bring it nearer to what is deemed appropriate.

In the previous paragraphs, no distinction was drawn between different categories of government expenditures (such as current and capital), and no reference was made to the appropriateness of financing any particular category in any particular way (for example, financing capital expenditure by borrowing and current expenditure by taxation). From the point of view of demand management, these particular distinctions and conventions are largely irrelevant. The starting point, when changes in fiscal policy are being planned, must be the existing position. Fiscal policy is applied by marginal changes in individual

6. The argument in this paragraph would need to be modified to the extent that funds borrowed from the banks or from abroad are spent externally. If they were all so spent there would be no internal multiplier effect.

7. This is the concept of the "balanced budget multiplier". See, for example, R. A. Musgrave: *The Theory of Public Finance*, McGraw-Hill, 1959, chapters 18 and 19.

8. Unless the subscriptions to new government loans came from "dishoarding". Until the beginning of the nineteen-sixties, the Associated banks may have been underlent, so that the use of bank deposits to buy new government debt was probably not associated with any offsetting reduction in the funds available to the private sector. This has become increasingly less true over the last ten years or so. The statement in the text is valid for recent years.

9. It may, on occasions, raise more from taxation than is required to meet its expenditures, the excess being applied to net debt redemption.

categories of expenditures or in the total, by marginal changes in taxation and in non-bank or bank and external borrowing, and by marginal shifts in their relative importance. Conventions which relate particular categories of expenditure to particular sources of funds (for example, that current expenditures and current tax revenues should be in balance) are equally irrelevant in this context. Changes in fiscal policy should be determined by reference to the state of the economy rather than by reference to the state of any part or all of the government accounts.

It was stated earlier that the aim of fiscal policy is to achieve an appropriate level of aggregate demand. In its simplest terms, the appropriate level of demand is that which would ensure some "desirable" degree of utilisation of domestic productive capacity while maintaining reasonable price stability and keeping the balance of payments in an "acceptable" or "sustainable" position. Any estimate of this level of aggregate demand must be based on economic forecasts. These forecasts are generally related to the year ahead and are made to fit in with the timing of the annual budget(s). The starting point is usually estimates of potential capacity and of private income and consumption expenditure. To the latter, there are added estimates of exports, private investment and government expenditure. The first of these is a datum since no single country has in the short-run much influence over the demand for its exports. The second (private fixed investment) may be largely determined for the year or so ahead by decisions already made. Government expenditures, both current and capital, are also fixed at some *minimum* level by past decisions, and can only be reduced below that level at the cost of injustice or inefficiency. This means that increases in government expenditures and in private consumption tend to become the only two variables on which fiscal policy can operate, and changes in taxation virtually the sole instrument by which the latter can be achieved.¹⁰ If the forecasted aggregate demand is above the level deemed appropriate by reference to the expected growth in capacity, successful demand management requires that planned or desired increases in government expenditure must be abandoned or cut, and/or private consumption reduced by increased taxation.

The implication in the previous paragraph that the appropriate level of aggregate demand can be uniquely identified is an over-simplification. Even if the likelihood of errors in forecasting is ignored, this would be true only if the sole objective of policy were some particular and consistent combination of capacity utilisation and external position. In fact, all governments simultaneously pursue a number of different objectives: full employment, growth, an acceptable balance of payments position, reasonable price stability, efficient use of productive resources, and equity in the distribution of income and wealth. Very often policies to realise more fully any one of these objectives mean that one or more of the others will be achieved to a smaller extent. Thus, fuller employment may accelerate the

10. Given the level of total government expenditure and of non-bank borrowing, changes in tax revenue mean equal and opposite changes in the residual borrowing requirement (i.e. in borrowing from the banking system and from abroad).

rise in prices; an acceptable balance of payments deficit may be achieved only at the expense of slower growth, or more efficient use of resources may mean higher unemployment. Such "trade-offs" between objectives are a matter for political decision and judgement.

Once the relative importance of the different objectives is decided, the appropriate level and composition of aggregate demand are largely determined, and the task of fiscal policy is to contribute towards their achievement. The desired level of aggregate demand can be sought as described in the preceding paragraphs. The desired composition can be achieved by the appropriate choice of fiscal instruments. For example, if more weight is attached to growth than external balance, the appropriate level of aggregate demand will be higher, increases in current rather than capital expenditures will be curbed, and greater emphasis may be placed on increases in indirect taxes rather than in direct taxes to restrain private spending. If more importance is attached to price stability than to full employment, the appropriate level of aggregate demand will be lower, and increases in direct taxes may be preferred to increases in indirect taxes.

Finally, it must be emphasised that the use of fiscal policy for demand management cannot be determined by any mechanical rule or formula. Different government expenditures will have different effects on the demand for goods and services produced in Ireland and the fraction that reaches households as income will vary from one kind of expenditure to another. Changes in income tax may have different effects on private expenditures from changes in turnover tax. To the extent that profits are affected by the tax changes, investment and the spending of firms' owners could be reduced. If incomes and prices are pushed up following the tax increases, the ultimate location of the burden would in most circumstances be indeterminate. Again, the effects of a deficit or surplus on the current budget will depend on how the deficit is financed or the surplus used. Moreover, the application of fiscal policy is complicated by inescapable time-lags in diagnosing whether (for example) a current budget deficit or surplus would be appropriate, and in deciding which fiscal measures to apply. Even after fiscal measures have been introduced, some time will elapse before their effects on aggregate demand are felt, and this time lag will vary from one fiscal measure to another. These problems are not, of course, peculiar to the use of fiscal policy for the purpose of demand management—they would arise whatever objective was rationally pursued. What matters is what fiscal policy is trying to do.

Irish budgets 1960-70.

In this section the aim is to identify from the annual budget statements what might be called the philosophy of fiscal policy—its aims, rules and conventions. This approach is not wholly satisfactory. Fiscal policy should be judged by the effects on the economy of the fiscal measures actually applied, rather than from statements of its intentions or annual descriptions of its role as it is currently seen. In most countries, there exist conventions (such as that the annual current budget should be balanced) which both inhibit desirable changes and prevent undesirable

changes by the discipline they impose. The problem of effecting change while incurring minimum risks is often solved by describing the new developments in the language, or within the framework, of the old conventions, so that statements of intent may not accurately describe what is in fact done. Moreover, ministerial statements about fiscal policy are often in the nature of exhortations to the public to consume less or to invest more in national loans, and should not be taken at their face value as statements of a budgetary philosophy.

To make sure of doing justice to fiscal (or monetary or any other) policy, judgements should be based mainly on what was actually done and on the effects that followed from it. The effects of changes in fiscal policy can be measured only by comparing the economy after their application with the state the economy would have been in if they had not been applied. It is not possible to make this comparison without a detailed and sophisticated model of the economy. As yet, sufficiently detailed models are not available for any economy to permit an assessment of the full effects of fiscal policy. For some countries (but not for Ireland) there are models which are sufficiently good for an attempt to measure the effects of fiscal policy on aggregate demand.¹¹ Since the effects cannot be measured at this stage for Ireland, an attempt is made in this section to judge fiscal policy by its intentions and actions.

In Ireland there are two parts to the annual budget, the current and the capital. Table 1 gives the estimated and actual figures for the current budget for each head of revenue and expenditure for each of the financial years 1960-1 to 1969-70, with the estimated figures for 1970-1. An alternative and more detailed classification of current government expenditures is given in Table 2. At the bottom of this table, current government expenditures are given as a percentage of the gross national product at current market prices. In all cases, the figures are taken from the tables published with the Annual Budget Statements.

Table 1 shows that in every financial year, the Minister for Finance planned to balance the current budget. A planned deficit appears for only one financial year, 1968-9, and then in the estimates as revised in the light of the supplementary budget of November 1968, and not in the estimates as presented in April. In all years, with the exception of 1964-5, 1966-7 and 1970-1, there was an allowance of between £2 and £4 million for errors of estimation, expressed as a net deduction from estimated expenditure. With the exception of 1965-6 and 1969-70, the allowance for errors of estimation tended to be made in years in which one of the aims of the current budget was expansion or reflation. In the years when the current budget aimed at curbing inflation, no such allowance was made. In some measure and to a modest extent, the allowances for errors of estimation seem to have been varied so as to work towards a small deficit in years when some reflationary influence was required from the current budget, and towards a small surplus when some disinflationary influence was thought to be necessary.

11. For attempts to measure the effects of fiscal policy on aggregate demand, see: Bent Hansen (assisted by Wayne W. Snyder), *Fiscal Policy in Seven Countries 1955-1965*, O.E.C.D., Paris, March 1969.

The increase in annual revenues and expenditures through the period show the effects of automatic and discretionary influences. The private sector and the government current accounts are mutually dependent. Given tax-rates and the decisions and norms relating to expenditure, government revenues and expenditures respond automatically to changes in the national income. If incomes rise so do the receipts from direct taxes; if private expenditures increase, the receipts from indirect taxes will rise; if unemployment falls, current payments to the unemployed will fall; if the sale of subsidised commodities rises, so will government expenditures. These automatic changes provide a measure of the "built-in flexibility" of the current budget. If current revenues rise faster than current expenditures as the national income rises, and decrease faster than current expenditures as national income falls, then the current budget will act as an automatic stabilizer, moderating the fall in aggregate demand during a recession and curbing its growth during an expansion. In Ireland, the current budget may tend to work as an "automatic stabiliser" during a recession (e.g. during 1965-6). During an expansion when prices are rising, its net effect may be destabilising. However, in the absence of a model which includes fiscal variables, these conclusions must rest more on hunch than on analysis.

Discretionary changes mean government decisions to change individual items of current expenditure or tax-rates. These affect disposable income and expenditure in the private sector, and changes there react back on current revenues and expenditures. It is these discretionary changes in revenues and expenditures which give an indication of actual budgetary policy in each year, and not the historical record of the budgetary outcomes which shows the combined effects of discretionary and automatic changes.

A very crude attempt is made in Table 3 to distinguish automatic and discretionary changes in Irish current budgets over the last ten years. For each year, the differences between the actual current revenues and expenditures in the previous financial year, and the estimates of current revenues and expenditures for the financial year ahead as they emerge from the Budget Statement, are taken as a measure of the combined effect of automatic and discretionary changes. The discretionary changes are equated with the tax and expenditure changes made in the current budget, and the balance of the difference between the outcome for the past year and estimate for the next year is attributed to automatic changes.

This approach is subject to a number of very obvious defects. For example, some part of the estimated increase in expenditure in each year is due to the introduction of new heads of expenditure based on recent enactments; this increase is not a result of the effects on the budget of changes in the private economy. Indeed, even a cursory perusal of the detailed estimates for any financial year suggests that there may be a fairly wide margin for varying the increases in expenditures within the framework of existing legislation. It seems probable that a sizeable part of at least some increases shown in the estimates is based on "discretionary" decisions which are influenced by the expected tightness (or otherwise) of the budgetary position for the year ahead. In addition, with this approach increases in public sector wages

and salaries which are expected to occur in the year ahead would be regarded as a discretionary expenditure. However, given the policy decision that public sector incomes should be kept in line with those paid for comparable work in the private sector, it could be argued that it would be more appropriate to regard increases in public sector wages and salaries as automatic. The same would apply to some increases in expenditure on health and education. If standards are to be maintained, then increases in the demand for these services (for example, as a result of an increase in the number of children of school age) will require unavoidable increases in the expenditures on them. Again, relatively few "discretionary" changes have their full impact on current revenues and expenditures in the fiscal year in which they are introduced, and this is especially true of changes in social welfare payments, direct taxation and public sector salaries. This means that relatively small "discretionary" changes in one year can account for the greater part of the "automatic" changes in the following fiscal year.

The only argument in favour of the crude approach in Table 3 is that it relates discretionary action to what is actually done in the budget after allowance has been made for all automatic changes and all previous "discretionary" decisions. The discretionary changes in revenue and expenditure never exceeded 5 per cent of total revenue and expenditure, and were generally very much less than this. The figure of 5 per cent was reached for revenue only in 1963-64 and 1966-67—years which followed large current budget deficits.

With the exception of 1963-4 (when Corporation Profits Tax was increased) and 1966-7 (when the standard rate of income tax was raised,) the discretionary changes in revenue were made by major increases in indirect taxes (or the introduction of new indirect taxes such as turnover tax and the wholesale tax), often offset in part by minor alleviations in direct taxation. This shift towards indirect taxation was an integral part of government policy throughout the period. The most recent statement of the philosophy lying behind it was given by Mr. Haughey in his Budget Statement in 1970.¹² "The incidence of direct taxation on individual taxpayers is already relatively high"; moreover, "income tax is paid by a comparatively small section of the community" and "can now represent a considerable burden on a wide variety of small incomes". The system of P.A.Y.E. means that the impact of an increase in income tax "is little different in its effect on pay claims from a corresponding amount of indirect taxation." Furthermore, "direct taxes tend to discourage effort and to have widespread disincentive

12. As early as 1959, Dr. Ryan said in his Budget Statement: "... the incidence of taxation can be a serious disincentive to individual effort. It can and does militate against managerial, executive and professional ability being fully applied to the raising of the levels of production and employment. It also adds to the comparative attractions offered for such talent outside the country. . . . A lightening of income taxation, sur-tax as well as income tax, is necessary to improve the position." The Commission on Income Taxation in its Third Report recommended the introduction of a purchase tax at wholesale level at a rate or rates between 7½ per cent and 15 per cent, the proceeds to be used to reduce the rate of income tax. See also Second Programme for Economic Expansion (pp. 262-8) and the Budget Statement 1968 (p. 21) for statements of policy on direct and indirect taxation.

effects." If the direct tax base is narrow, it can be extended; indeed, it could be argued that its extension (e.g. to farm incomes) would pose no greater difficulties than those associated with the introduction of turnover tax. If the direct tax burden on small incomes is considerable, so is the burden of indirect taxes, and the latter are on balance regressive. In the absence of empirical tests, it is impossible to judge whether or not the Minister's hypotheses about the incidence and effects of direct (as compared with indirect) taxes are correct.

Table 1 shows that the tax and expenditure changes made in each current budget had the effect of bringing the estimates for current revenue and expenditure for the fiscal year ahead into balance. The fact that a balanced current budget was a specific aim of policy was made clear in successive budget statements. Thus, Dr. Ryan (Dail Debates, 27 April 1960) conceived it his duty "to make sure that the current budget is kept in balance". In 1963, (Dail Debates, 23 April 1963) he stated: "we must do something effective this year . . . towards bringing the current finances back into balance." In 1967, Mr. Haughey, (Dail Debates, 11 April, 1967) stated that "the government are not prepared to allow this (increase in current expenditure) to destroy the balance achieved in the current budget." In 1968 (Dail Debates, 23 April 1968), his aim was "to maintain the balance on current account which has ruled for the past two financial years." In 1969 (Dail Debates, 7 May 1968) he proposed "to balance the current account for 1969 at a level which is likely to facilitate the achievement of our economic and social aims." In years in which there was no specific statement that the aim was to balance the current budget, the estimates of revenue and expenditure emerging from the budget statement were always in balance.

Two main reasons were often given for bringing the current budget into balance or for keeping it in that position. First, the need to contain inflation and especially to reduce (or prevent an increase in) the balance of payments deficit, which was seen as a critical external symptom of domestic inflation. This reason was emphasised by successive Ministers for Finance in each year since 1964, and it tended to get greater emphasis in years which followed deficits in the current budget. The second reason was to husband resources for the public capital programme. Thus, Dr. Ryan (Dail Debates, 23 April 1963) stated that the persistence of the deficit on the current budget "would divert into the financing of current expenditure savings needed to finance the higher capital expenditure which is nationally desirable." Again, in 1966 Mr. Lynch stated (Dail Debates, 9 March 1966): "The plain fact is that if we run a deficit on current account, the borrowing incurred to finance it will subtract from our capacity to finance capital expenditure." The general tone of the budget statements throughout the period suggests that this view was important in all years. While these two reasons to contain inflation and to husband resources for the public capital programme were used to justify a balanced current budget, they would together have justified a current budget surplus, especially towards the end of the period.

The aim in the current budget each year was, then, to balance estimated revenues and expenditures. Deficits were unplanned and unintended—they were

things that happened during a financial year as a result of unexpectedly low buoyancy in revenue or unexpected increases in expenditure. Once current deficits appeared, action was speedily taken to remove or reduce them—often in the course of the financial year in which they emerged (for example, the supplementary budgets of 1966 and 1968); at the latest, action was taken in the next budget to prevent a deficit in the next financial year. Given the inflationary pressures that characterised most years in the past decade, this policy operated in the right direction. Towards the end of the nineteen-sixties, surpluses on the current account might have been desirable. This possibility was aired only in one budget statement. In 1967 (Dail Debates, 27 April 1967) Mr. Haughey, when discussing the distinction between current and capital expenditures said: “There is, of course, a distinction between the accounting principles involved here and the economic principles which must determine, from year to year, how much of total government expenditure should be financed from taxation and how much from borrowing . . . This year, a reflationary rather than a deflationary budget is called for and it would not be appropriate to increase taxation in order to cover any of the items now classified as capital. The question must, however, remain open for consideration in relation to the circumstances of future years.” Even though inflationary pressures grew in strength from 1968 through to 1970, the aim continued to be balance in the current budget. It would be improper, however, to base a judgement of fiscal policy on the posture of the current budget. It is necessary to look also at the capital budgets,¹³ since fiscal policy must be judged by reference to total government expenditure and the manner in which it is financed.

The capital budget sets out the capital expenditure of government departments, local authorities and State bodies and the manner in which that expenditure is financed. The details of the capital budget in each financial year from 1960-1 to

13. The statutory basis for the distinction between current and capital in the Exchequer Account was section 14 of the Sinking Fund Act, 1875. In 1875 the view was taken that all voted expenditure was necessarily “current” and that the difference between income and expenditure “above the line” was the true deficit or surplus on the income account of the Exchequer. The practice arose of treating a small amount of expenditure “above the line” as capital outlay and of deducting it when assessing at Budget time the charge to be made against current revenue. In 1950 a large scale extension of this practice was introduced, with the description “Capital Service” (and therefore proper to be met from borrowing) being bestowed rather lavishly. These “Capital Services” were authorised by the annual Appropriation Act and appeared “above the line” in the Exchequer Account. In the Budget of 1952 this equation of capital services with borrowing was abandoned for the reasons (*inter alia*) that (a) it was necessary to reconsider the validity of the description “capital services” in particular cases, and (b) the extent to which capital expenditure should be met from borrowing could be assessed only in relation to the general economic and financial position. In 1953, the Minister for Finance (Mr. McEntee) questioned the appropriateness of including certain items as capital in the Budget but due to the then existing economic position stated that it was not a year “for categorically assigning to taxation charges which for some years past have been met by borrowing”.

In the years since 1953, successive Ministers for Finance have probably found themselves in the same position as Mr. McEntee, and “voted capital services” with marginal additions or subtractions have continued to be financed from borrowing.

1970-1 are set out in Table 4, with comparisons between the estimate and the outturn for each year (save the last for which estimates only are given).

The main reasons why funds were needed are classified under *requirements*. The main requirement was the financing of the public capital programme, which accounted for about 90 per cent or more of the total in each year, except in 1965-6 and 1968-9 when it was around 80 per cent. The second heading on the requirements side in Table 4 is provision for debt redemption and the refinancing of borrowings of earlier years by State bodies. This item increased almost ten fold over the period and by 1970-1 consisted mainly of provision for the redemption of maturing government securities. By itself, net debt redemption (i.e. the extent to which holders of maturing securities opt for payment in cash) increases the liquidity of the private (and probably non-bank) sector. It involves the substitution of an exchequer liability to the private sector by one to the banking system or to external lenders, from which the funds needed for the redemption are obtained. The third heading is the deficit on the current budget which reached its highest levels—£8 million and £9 million—in 1965-6 and 1968-9 respectively. The final item is the miscellaneous category, the content of which varied from year to year. It includes payments to the World Bank, the International Monetary Fund and the International Development Association, aids to industry (to help meet the cost of the British Import Levy after 1964), government assistance towards the costs of the British Special Imports Deposits (after 1968), and net reductions in the public's holdings of Exchequer Bills. This item reached its highest levels in 1965-6 and 1968-9, when the only payments to the I.M.F., I.B.R.D. and I.D.A. were made in this period, and when the largest reductions took place in the public's holding of Exchequer Bills.

The sources of the funds to meet these requirements are shown in Table 4 under *resources*. The first heading consists of the internal resources of local authorities and State bodies (for example, from annual depreciation allowances or increases in pension funds) and monies raised by them from banks, insurance companies or stock issues. These latter might be raised within Ireland by borrowings from the non-bank public (and these were probably the main sources in the first half of the period), or from Irish banks¹⁴ and external borrowing (and this was increasingly the case in the latter half of the period), and these borrowings were guaranteed by the State. These resources provided by local authorities and State bodies provided about one-third of the total expenditure on the public capital programme from 1963-4 onwards. The second item—loan repayments—is self explanatory. The third item is the investment resources of departmental funds. This consists of that part of the annual contributions to sinking funds (which is a Central Fund charge on the current budget) that is not applied to the purchase (i.e. cancellation) of the government securities to which the funds relate; of the net interest on the Post Office Savings Bank Fund, the Social Insurance Fund and other departmental funds, and net sales of government securities held in Departmental Funds. Varia-

14. In the published statistics for Associated bank lending, local authorities and State bodies are included in the private sector.

tions between the estimate and outcome of the contribution to the capital budget from Departmental Funds is probably explained by unexpected movements in the last of these three constituents—for example, net purchases (sales) of government securities rather than the net sales (purchases) which were anticipated when the capital budget was being prepared. The fourth item—small savings and prize bonds—consists of the net increase in deposits with the Post Office Savings Bank and the Trustee Savings Banks, and sales less redemptions of prize bonds, during each year. The fifth is a miscellaneous category: the small sums available under this head up to 1964-5 came from the National Development Fund; the entries for 1965-6 and 1968-9 related to borrowing from the Central Bank to meet payments to international bodies (such as the I.M.F.) and were offset by corresponding items on the requirements side of the account; the figures for the remaining years represent miscellaneous minor borrowings.

The final item—other borrowings by the Exchequer—shows the proceeds of the sale of national loans to the public and of borrowing from the Irish banking system and from abroad. During this period the annual sales of new government securities to the public lay in the range £18½ to £25½ million. Exchequer borrowing from the banking system rose from less than £5 million in 1961-2, to over £33 m. (which included £20 million from the Central Bank) in 1965-6, it fell to just over £16 million in 1966-7 and rose rapidly to over £50 million in 1968-9 at which level it remained in 1969-70. Foreign borrowing by the Exchequer first appeared in 1965-6, providing almost £15 million. It was also important in 1966-7 and 1969-70 at around £10 million. The counterpart in Irish currency of foreign borrowings, including the drawings of £8 million from the I.M.F. in 1965-6, were used to finance public expenditure.

In Table 5, the sources of finance for the capital budget (as set out in Table 4) are summarised under three main heads: “internal” resources (i.e., resources of local authorities and State bodies other than Exchequer advances and grants, loan repayments, investment resources of Departmental Funds and the miscellaneous item), borrowing from the non-bank public (i.e. small savings, prize bonds and the sales of national loans and Exchequer Bills to the public), and borrowing from the banking system and from abroad. The first of these items is overstated (and the second and third correspondingly understated), by amounts rising from just less than £5 m. in 1960-1 to over £35 m. in 1969-70 and nearly £46 m. in the estimate from 1970-1, by the inclusion in it of State-guaranteed borrowings of local authorities and State bodies from the public, from banks and from abroad, and of miscellaneous minor borrowing from undivulged sources. It is also inflated by the inclusion in it of payments to the I.M.F. of £4.35 million in 1965-6 and £16 million in 1968-9: these payments were matched by corresponding payments in foreign currencies on the requirements side of the capital budget. The broad picture which emerges is an increase of about fivefold in “internal” resources and little change in the amounts borrowed from the non-bank public, with borrowing from the banking system and from abroad acting as the residual source of funds and increasing tenfold.

Four main conclusions may be drawn from Tables 4 and 5 and from the relevant budget statements. *First*, the capital budget was regarded as the principal instrument for achieving the faster growth which was the main aim of government economic policy throughout the period. The role attributed to the capital programme was not without justification. By 1970-1 about 35-40 per cent of the public capital programme—advances and grants for private housing, industrial and agricultural grants and loans—went directly to finance capital expenditure by the private sector. In addition, the availability of these grants and loans induced substantial investment from private sector funds.

In this current financial year, the public capital programme is estimated to be directly responsible for more than half of gross domestic fixed capital formation.¹⁵ The importance of the capital budget for economic growth was emphasised in the annual budget statements throughout the nineteen-sixties. Thus, Dr. Ryan (Dail Debates, 19 April 1961) argued that “intelligent investment, at the highest sustainable level, is a necessary condition for sound and rapid national progress”. Again, in 1963 (Dail Debates, 23 April 1963) he stated: “Clearly it is right that the State should, directly and indirectly, increase the volume of productive investment and do everything else in its power to promote as rapid a growth of the economy as can be sustained without excessive strain on the balance of payments.”

Second, Ministerial statements taken at their face value seem to suggest that the size of the annual public capital programme was not determined by reference to the expected balance between aggregate demand and supply in the year ahead, but rather to an estimate of the funds that could be obtained to finance the work that it was felt had to be done. For example, “This year’s programme is heavier but with the support of the community which, I am sure, will be generously given, I expect that we shall be able, no less successfully, to raise, from our own resources, the finance necessary to ensure its completion.” (Dr. Ryan, Dail Debates, 27 April 1960). Again “A substantial volume of public investment is planned for 1961/62 but not, I believe, more than national savings can be relied upon to finance.” (Dr. Ryan, Dail Debates, 19 April 1961). In 1967 (Dail Debates 27 April 1967) Mr. Haughey explained that: “The decision to expand the public capital programme is based on the expectation that normal home resources will continue to increase and that resources will not have to be drawn upon to finance any sizeable deficit on current account.” In 1970 (Dail Debates, 22 April 1970) the Taoiseach stated: “The public capital programme dominates national capital formation. It is therefore necessary to provide it with sufficient funds to maintain and, if possible, to increase national investment.” During the nineteen-sixties, the emphasis in Ministerial statements seemed to change: in the earlier years, the emphasis was more on constraining public capital expenditure within the limits of national savings; towards the end, as the words of the Taoiseach (deputising for Mr. Haughey) in 1970 show, the emphasis was rather on the necessity of providing the public capital programme with sufficient funds to maintain or increase it.

However, it would be fairer to recognise that these Ministerial statements were

15. See Capital Budget 1970, Part II, published in *Budget 1970*.

perhaps more in the nature of exhortations than descriptions of a fiscal philosophy. A closer approach to this latter is to be found in the White Paper on Public Capital Expenditure published in October 1965. It was there stated that by the mid-nineteen sixties "the earlier problem of a surplus of capital in relation to development ideas was rapidly transformed into a problem of too many development projects in relation to the capital immediately available . . . indeed, the forces generating demand and causing increased spending from incomes and credit grew so strong that resources—current production and capital inflow—became insufficient to match them. The possibility of demand becoming excessive was a risk . . . deliberately taken by the Government in the conviction that all available resources should be used to promote the fastest possible rate of progress in output and employment." This policy of "running on the outside of the fiscal track" is a valid one for a developing economy. However, the White Paper went on to state that only experience could establish "what level of resources . . . could be continuously counted upon . . . and how fast could money incomes, credit and capital expenditure expand without creating excessive pressure on resources." By 1969-70, and certainly by 1970-1, experience had already established that the limits for domestic demand pressures and for domestic incomes inflation had both been passed. Nevertheless, the posture of fiscal policy remained unaltered.

If the quotations in the paragraph before last seem to suggest that public capital expenditure was not assessed in the context of the expected balance between aggregate demand and supply, there are others which show that it was in fact so weighed. For example, as early as 1953, Mr. MacEntee stated (Dail Debates, 6 May 1953, Column 1202) that "the contribution by the State towards the stimulation of economic activity is determined, not by deficits on the current budget but by the overall effect of State expenditure, capital as well as current." Similar statements were made by Mr. Lynch in 1965 and 1966, and by Mr. Haughey in 1967, 1968 and 1969. Together, these would be consistent with the following fiscal philosophy. The current budget was not seen as an effectively available instrument of demand management. Current expenditures were inevitably on a rising trend; once they had risen, they could not be reduced because of their predominantly social and redistributive character. The only effective way of arresting their growth was by insisting on increases in current expenditures being fully met from increases in tax revenues. Demand management could best be done by varying the rate of growth in public capital expenditures. This was a much better way of stimulating demand, or dampening its growth, than running current deficits and surpluses. Despite the difficulties associated with using capital expenditures as an economic regulator, they were in fact used in this way on several occasions—for example, in 1965-6 and 1966-7 and to a much smaller degree in 1969-70.

The philosophy set out in the preceding paragraph is consistent with Ministerial statements. Within it, the emphasis seemed to be more on variations in public capital expenditures rather than on the net effects on aggregate demand of these variations together with the way in which the capital expenditures were financed.

For example, as a disinflationary measure, the growth in the public capital programme was reduced from 25 per cent in 1964-5 to 1½ per cent in 1965/6. Between these two years, however, the residual borrowing from the banking system and from abroad rose from £19 million to over £48 million, and this must have gone some way towards offsetting (if not exceeding) the disinflationary effects of the slower growth in expenditures. Again, in 1968-9 when it might have been prudent to take early action to dampen the growth in aggregate demand, the public capital programme was increased by almost 28 per cent (or £30 million). Between 1967-8 and 1968-9, however, the residual borrowing rose from £25 million to nearly £55 million. Finally, in 1970/1 the growth in the public capital programme was reduced to just over 12 per cent as compared with 23 per cent in 1969-70, and the anticipated residual borrowing rose by over £14 million to £75 million. Even allowing for the supplementary budget of 28 November 1970, the residual borrowing could exceed this figure in the current financial year, so that the net impact of the public finances on the economy may be expansionary, and not disinflationary as seemed to be the intention.

Third, borrowing from the banks and from abroad became progressively more important during the period as a source of funds. It accounted for over 11 per cent in 1960-1, nearly 8 per cent in 1961-2 and an estimated one-third in 1970-1, of the total. If requirements rose faster than expected, or if the resources becoming available under other heads fell short of the estimates, the deficiency was made good by increased borrowing from the banks and from abroad. Given the growth in the public capital programme, the growth in this source of funds is in large part explained by the relative stability in the funds raised by borrowing from the non-bank public (see Table 5). Between 1960 and 1969, there was a three-fold increase in net savings (i.e. excluding depreciation provisions), yet over this period the sums raised by borrowing from the non-bank public fell by £3 million from £25 million in 1960-1 to £22 million in 1969-70. This suggests that the terms offered by the government became progressively less attractive, as compared with the terms offered by other borrowers, through the nineteen-sixties.

The sluggishness in the yield from borrowing from the non-bank public was used to justify greater reliance on bank borrowing. Throughout the period and especially during its latter years, time deposits held in Associated banks increased, and at least some part of this increase was regarded as a "diversion" of the growth in national savings away from small savings and national loans. Therefore, "a contribution by the commercial banks to the financing of public capital expenditure is legitimate, because in Ireland these banks receive a large part of the current increase in public savings." (Mr. Lynch, Dail Debates, 9 March 1966). It is difficult to assess the substance of this line of argument. If the "diversion" of deposits from (for example) the Post Office Savings Bank to the commercial banks had not occurred, it is probable that *total* deposits in the latter would have risen by much the same amount.¹⁶ The proceeds of the increased deposits in the

16. See: National Board for Prices and Incomes: Report No. 34, *Bank Charges*. HMSO, Cmnd. 3292.

POSB would have been immediately available to the Government and would have been reflected in increases in the Government's current account with the Bank of Ireland. The effects of the expenditure of this new money on total commercial bank deposits held by the private sector would have been much the same, irrespective of whether the deposit had been made in the first instance with the POSB or with a commercial bank. It is possible, however, that the balance between current and deposit accounts would have been different as between these two positions, but it is very difficult to demonstrate how great the difference would be. Moreover, the official line of argument was both partial (necessarily so at that time)¹⁷ and deficient even on its own plane: partial in that it looked only to increases in deposits with the Associated banks; deficient in that it seemed to regard the whole of the rise in time deposits as coming from current savings, ignoring the extent to which it may have been due to a shift in private portfolios towards more liquid assets.

The argument described in the previous paragraph can be presented in more general terms. The commercial banks in Ireland were the custodians of the nation's savings to a much greater extent than in other countries. By borrowing from the banks (e.g., to finance grants and loans), the government channels savings to the private sector for desirable investment—a function that would be performed elsewhere by the Stock Exchange or other intermediary. However, this argument tends to equate the growth in the resources of the commercial banks with increased current savings, and ignores the effect which government borrowing from these banks may have on the money supply. More important, this argument—like that in the previous paragraph—by-passes what may have been the real problem, namely that the terms offered by the government to the non-bank public became progressively less attractive than those offered by other borrowers. This provides the most satisfactory explanation of the relative stability in the funds obtained from this source during the past ten years. The problem might have been solved if the government had offered the non-bank public the same terms as those on which it borrowed from the Associated banks, thus enabling the public to enjoy the difference between the banks' borrowing and lending rates.

The notion that it was legitimate for the Government to expect a contribution towards the public capital programme from the commercial banks was usually associated with the notion that the new resources of the banks should be shared fairly with the private sector (in which local authorities and State bodies were included). Thus, in 1966, Mr. Lynch (Dail Debates, 9 March 1966) stated that he "would not seek to defend a situation in which the new resources of the banks were claimed almost exclusively by the public sector and credit had to be unduly curtailed for productive private needs." In large part, this may be a non-problem, because funds borrowed by the government are very quickly channelled back into the private sector. When concern was expressed, the real problem was not so

17. Figures for deposits, etc., in non-Associated banks were first collected by the Central Bank for December 1966, and were first published in July 1967.

much the distribution of any increase in bank credit between the Exchequer and the private sector as the fact that the total demand for new bank credit exceeded the increase which the Central Bank for the time being deemed permissible. The government was in a position to make its demands effective. At the same time, the Associated banks, operating in an increasingly competitive environment, were loathe to refuse accommodation to their clients. The conflict was usually resolved by an increase in the amount of new credit extended beyond the Central Bank's limit, sufficient to accommodate both the Government's needs and the banks' desire to maintain contact with their customers. These issues arose in their most acute form in 1965-6. In that year, it was estimated that £20 million would be required from the banking system and from foreign borrowing. In the event, because funds from other sources fell far short of the estimates and requirements rose significantly, £46½ million was required from the banks and external borrowing. This was obtained from the Central Bank (£20 million), by making a drawing from the IMF to support national reserves (£8 million), by the issue of a Sterling-Deutschemark Loan (£7 million) and by borrowing from the Associated banks (about £11 million). The exceptional finance from the Central Bank enabled the Government's requirements to be met without bank credit for the private sector being unduly curtailed.¹⁸

The *fourth* conclusion that may be drawn is that the capital budgets may on balance have been destabilising. There was a tendency to press public capital expenditure up to the limit of the funds that it was thought would be available or obtainable, on terms that the government was prepared to contemplate. Together with the expansionary effects of the growing (though in intent balanced) current budget, this ensured that the level of aggregate demand was generally

18. The Annual Report of the Central Bank for 1965-6 gives a more detailed account on pages 45-6 of what happened: "At the beginning of September 1965, the Minister for Finance indicated additional borrowing requirements of £18.0 million from the banks. To meet these requirements in full, while complying with the Central Bank's advice on credit policy, would have involved severe curtailment of credit to the private sector. In these circumstances an arrangement was made under which the Central Bank, as an exceptional measure, purchased on 30 September from the Associated Banks £20.5 million (nominal) 6 per cent Funding Loan, 1969, which was issued by the Minister for Finance for this purpose. Immediately prior to this operation the total amount of outstanding Exchequer Bills which had been issued directly to the Associated Banks was £40.3 million, of which £13.7 million had been rediscounted and was held by the Central Bank. Following the issue of the Funding Loan the Minister paid off £20.0 million Exchequer Bills which matured on 30 September, namely, the £13.7 million held by the Central Bank and £6.3 million held by the Associated Banks. On the same date the Associated Banks took up £18.0 million fresh Exchequer Bills. As a result of these transactions there was an increase of £11.7 million (£18 million less £6.3 million) in the Associated Bank's holding of Exchequer Bills."

In addition to the £20 million provided in this way, the Minister for Finance obtained another £8 million from the Central Bank as a result of the transactions associated with the drawing from the IMF.

(The latest figures show borrowing from the banking system and from abroad somewhat higher at over £48 million in 1965-6.)

buoyant and often excessive. This contributed in its turn towards rising deficits in the current balance of payments (which were acceptable for as long as they were financed by voluntary net capital inflows) and rising prices and money incomes (which required substantial increases in public capital expenditure if it was even to be maintained in real terms). In these circumstances, the economy was vulnerable if capital inflows fell or growth slackened, and this was shown in 1965-6. Even though the increase in the public capital programme at current prices was cut to 1½ per cent (as compared with 25 per cent in 1964-5), there were great difficulties in financing it. Residual borrowing by the Exchequer rose to over £48 million as compared with £19 million in 1964-5; and while there was little change in the "internal" resources of local authorities and State bodies, the extent to which these were obtained from external borrowing rose significantly. The disinflationary intention of the smaller increase in the capital programme may therefore have been offset by changes in the manner in which it was financed. In the following year 1966-7, public capital expenditure was reduced by about 1·7 per cent as compared with 1965-6 (implying a fall of a larger order in real terms) and a much closer correspondence was achieved between estimate and outcome on both the resources and requirements sides of the capital budget. However, the residual borrowing from the banking system and from abroad was reduced to £26 million, so that the disinflationary impact may have been greater than was intended. Thereafter, an expansion developed which was in many respects similar to that which culminated in 1964-5. The sequence of expansion and an accelerating rate of increase in prices, followed by correction which was to some extent at least enforced by financial exigencies, probably made for a slower average rate of growth in real GNP. This sequence made for a somewhat higher average annual increase in prices and money incomes, because the accelerating increases in prices and in the rates of contractual incomes during the expansion were not offset by any offsetting reductions when corrective measures were being applied. If the management of aggregate demand had been more effective during the expansion phase, there would have been less need for correction.

Summary and conclusions

The use of fiscal policy for demand management requires that changes in the government's current and capital expenditure and in its revenues (from taxes, borrowing from the non-bank public and borrowing from the banks and abroad) be determined by reference to their impact on the level of aggregate demand. In the most general terms, if inflationary pressures are expected to develop, the growth in total government expenditures should be moderated and a larger proportion of the funds required to finance them raised from taxation and by borrowing from the non-bank public; if it is thought that aggregate demand will become deficient, then (assuming the balance of payments is acceptable), the growth in public expenditure should be accelerated and/or a smaller proportion of them financed by taxation and borrowing from the non-bank public. If fiscal policy is used in this way, in conjunction with monetary and other policies

that are consistent with it, the average annual rate of growth in prices, money incomes and external deficits will be moderated in periods of expansion, and taking periods of expansion and recession together the average annual rate of price—and income—inflation will be lower and the real growth rate higher. Conflicts between the aims of demand management and the objectives of growth and full utilisation of productive resources will arise only when price—and income—inflation occur when the economy is operating at less than capacity. A choice between fuller employment and price-stability must then be made: if the latter is chosen, proper demand management can contribute towards its achievement; if the former is chosen, other policies will be required to contain the balance of payments deficits.

In Ireland in the nineteen sixties, the budget statements of successive Ministers for Finance do not always suggest that the role of fiscal policy was thought of in these terms. Demand management, however, was frequently mentioned as an aim of the current budget, but always strictly within the context of a balanced current budget. Demand management within the framework of a balanced current budget requires a delicate appreciation of the effects of different taxes and expenditures which was not shown in the budget statements. Without exception, the aim was to balance the budget in each fiscal year. Action was usually quickly taken to arrest any tendency towards the appearance of a current budget deficit, but the emphasis was often less on the impact of a current deficit on aggregate demand than on the fact that it would usurp a part of the funds available to finance public capital expenditure. Public capital expenditure was regarded as the main cause of economic growth and seemed to be mainly determined by reference to the funds that were expected to be available (or obtainable) to finance it. When it was feared that demand pressures were excessive (as for 1970-1), only the impact of the expenditure side of the capital budget seemed to be considered relevant, and no reference was made to the effect on aggregate demand of the extent to which it was planned to raise funds from borrowing from the banks and from abroad.

The difference between how fiscal policy should have been used and how it was in fact applied is not to be explained by any lack of awareness of the former in the minds of those responsible for the latter.¹⁹ The explanation must lie in the reasons why the balanced current budget rule was followed, in the full knowledge that, taken in any one year by itself, balance (as opposed to deficit or surplus) in the current budget could have been economically injurious. The explanation must also lie in the reasons why the impact on aggregate demand of the manner in which the capital budget was financed was generally ignored.

19. See, for example, *Second Programme for Economic Expansion*, Part II, (Pr. 7670). "It is desirable that total community spending—capital and consumer spending in due proportions—should be sufficient to keep productive activity at the highest rate consistent with a competitive level of prices and costs and a reasonable degree of external balance." (page 295, paragraph 1) "... it may be necessary to depart, at the margin, from the traditional methods of financing in order to give greater flexibility in the means available for moderating tendencies towards inflation or deflation." (page 273, paragraph 8).

The balanced budget rule may have been followed for a number of reasons. First, it may have been regarded as good national house-keeping. The good housewife keeps her expenditure within the limits of her housekeeping allowance. If she does not, she runs into debt and the dire consequences for herself and her family will ultimately come home to roost. This analogy between national and private housekeeping would have been recognised as an example of the fallacy of composition by those responsible for budgetary policy. However, the public at large, including many who make their living by lending to households to enable them to spend in excess of their current incomes, would probably consider this sort of analogy as having some relevance. Public opinion may therefore have acted in some sense as a constraint on budgetary policy.

Second, and more important, there may have been a feeling that once the balanced budget rule was relaxed, all discipline on the public finances would disappear, and rising deficits and accelerating inflation would follow. One part of this argument would be fallacious, namely, that current budget deficits are always and necessarily inflationary. Inflation would follow only where the economy's resources were already fully utilised, and not where idle capacity existed (except where this was itself associated with continuing price—and income—inflation). Its main assertion, however, rests on an assumption about the nature of a democratic government in a modern western economy. If there were no balanced budget rule, there would be no limit on government expenditure. But if the rule is strictly applied, the political advantages of more spending have to be balanced against the political disadvantages of the additional taxation needed to finance it. In other words, governments will only then continue spending "until the marginal vote gain from expenditure equals the marginal vote loss from financing."²⁰ The description of the role of fiscal policy in demand management in Section II above contains no simple and easily comprehensible formula for containing government expenditures similar to the balanced budget rule.²¹ If the latter goes it would be argued that probity and financial discipline may go with it. However, if the first deviation from the balanced budget rule were to introduce a surplus, this would have met the argument against "irresponsible" government.

In fact, adherence to the balanced budget rule, taken by itself, generally worked in the right direction during the nineteen sixties. In all years with the exception of 1966-7, deficits would have been inappropriate, and the action taken either to prevent deficits from appearing, or to remove them once they had appeared, made inflationary pressures less than they otherwise would have been. However, the balanced budget rule was apparently equally successful in preventing the surpluses on the current budget, which might have been appropriate in 1964-5

20. Anthony Downs: *An Economic Theory of Democracy*, Harper & Row, New York 1957, page 73.

21. It is worth noting that the balanced budget rule does not prevent *wasteful* government expenditures—it merely ensures that if they occur, because of pressures from interest-groups in the public or private sector, they will be paid for from taxation.

and would certainly have been desirable in 1968-9 and the years since then. This is less easy to understand, since the arguments used against a deficit often seem to make a surplus even more desirable than balance in the current budget.

There was no discipline similar to that provided by the balanced budget convention to govern the capital budget. It would be difficult to conclude from Ministerial statements and what was actually done, that the requirements of demand management influenced the successive capital budgets overmuch: the aim seemed to be to keep public capital expenditure at as high a level as could be financed. In a developing economy, it is difficult not to sympathise with the desire to keep investment (both public and private) high and buoyant. But this does not in itself fully justify the level of public capital expenditure, because even its economic components were not all of a productive character, promising a yield commensurate with the interest payable on the borrowed funds with which they were financed. The fault lay also with the manner in which public capital expenditure was financed. The extent to which the capital programme was financed from taxation was limited to that part of the annual accrual to sinking funds (a charge against current tax revenue) which was made available for this purpose through the Departmental Funds, and probably provided no more than 5 per cent to 7 per cent of the annual requirements throughout the nineteen-sixties.²² The proportion raised by the Exchequer borrowing from the non-bank public fell from about 44 per cent in 1960-61 to just under 11 per cent in 1969-70 and a projected 13 per cent for 1970-71. The proportion raised by Exchequer borrowing from the banking system and from abroad rose from 11 per cent in 1960-61 (and under 8 per cent in 1961-62) to 33 per cent in 1969-70, with a similar percentage contribution projected for 1970-71.²³ This shift in emphasis from borrowing from the non-bank public towards borrowing from the banking system and from abroad added to the demand pressures in the economy, because no significant offsets in private demand were associated with the latter. In other words, the rising expenditures on investment were not offset by reductions in expenditures on consumption, so that aggregate expenditure rose excessively.

In the latter half of the period, fiscal policy was often not consistent with monetary policy. When the demands of the public sector could not be met within the credit ceiling without restricting the private sector (as in 1965-6 and since 1968), the public sector sought external funds, and as these were spent, the domestic credit supply increased beyond the limits of the Central Bank's advice. When fiscal policy is expansionary, monetary policy cannot for long succeed in being restrictive if the funds to finance the expenditure commitments of the Exchequer are to be provided.

22. The percentages for non-bank borrowing and for borrowing from banks and from abroad understate public sector borrowings because borrowings by local authorities and State bodies are not included. See above.

23. The narrow direct tax base and the price-raising effects of indirect taxes will of course, impose some limit to the contribution from current taxation towards capital expenditure, but this limit will not be as low as the five per cent-seven per cent that characterised the nineteen-sixties.

TABLE 1: Current Budgets 1960-61 to 1970-1: Comparison between estimates and outcome.

	1960/1		1961/2		1962/3		1963/4		1964/5		1965/6		1966/7 ¹		1967/8		1968/9		1969/70		1970/1	
	Est.	Act.	Est.	Act.	Est.	Act.	Est.	Act.	Est.	Act.	Est.	Act. ²	Est.	Act.	Est.	Act.	Est. ³	Est. ⁴	Act.	Est.	Act.	Est.
<i>Revenue</i>																						
1. Tax Revenue (excl. 2 below)	106.72	108.43	111.64	119.22	129.12	128.76	144.63 ⁵	146.80 ⁵	173.01	176.61	196.81	193.92	217.44	221.55	238.51	247.98	270.23	281.03	282.30	322.32	337.57	393.70
2. Motor Vehicle Duties	6.00	6.46	6.65	6.93	7.15	7.40	7.70	8.24	9.00	8.80	9.40	9.40	11.05	10.43	11.50	11.60	12.16	12.16	12.70	13.10	13.41	14.83
3. Non-tax Revenue																						
Post Office	9.65	9.70	10.30	10.50	11.64	11.44	12.15	12.10	15.10	14.90	16.20	16.40	17.40	18.33	20.50	20.50	} 50.30	22.90	21.70	27.10	27.35	} 66.36
Miscellaneous	14.26	14.25	14.98	15.03	15.64	15.88	17.09	17.28	18.02	18.73	20.40	20.62	21.84	22.53	24.71	25.33		28.23	28.78	31.80	32.68	
4. Deficit	—	0.73	—	0.71	—	4.85	—	2.22	—	4.07	—	8.00	—	—	—	0.21	—	7.12	8.37	—	0.54	—
Total	136.63	139.57	143.57	152.39	163.55	168.33	181.57	186.64	215.13	223.11	242.81	248.34	267.73	272.84	295.22	305.62	332.69	351.44	353.85	393.22	411.55	474.89
<i>Expenditure</i>																						
1. Central Fund Services (excl. 2 below)	24.65	24.65	26.97	27.23	29.61	28.83	32.32	32.05	35.54	36.15	40.20	41.55	46.90	47.84	54.58	54.16	64.00	65.20	65.11	76.45	76.98	88.36
2. Payments to Road Fund	6.00	6.46	6.65	6.93	7.15	7.40	7.70	8.24	9.00	8.80	9.40	9.40	9.75	9.22	10.00	10.22	10.70	10.70	11.16	11.50	12.00	12.85
3. Supply Services (non-capital)	108.48	108.46	112.95	118.23	129.19	132.10	143.55	146.35	170.59	178.16	197.21	197.39	211.08	214.99	234.64	241.24	261.99	275.54	277.58	307.27	322.57	373.68
4. Savings and overestimation (net deduction from expenditure)	2.50	—	3.00	—	2.40	—	2.00	—	—	—	4.00	—	—	—	4.00	—	4.00	—	—	2.00	—	—
5. Surplus.	—	—	—	—	—	—	—	—	—	—	—	—	—	0.79	—	—	—	—	—	—	—	—
Total	136.63	139.57	143.57	152.39	163.55	168.33	181.57	186.64	215.13	223.11	242.81	248.34	267.73	272.84	295.22	305.62	332.69	351.44	353.85	393.22	411.55	474.89

Notes : (1) The estimate and outcome for 1966-7 take account of adjustments made in the March and June Budgets, 1966.

(2) The figures in this column are the revised estimates for 1965-6 made at 9 March, 1966.

(3) Estimates as at 23 April, 1968, including tax and expenditure changes made at that time.

(4) Estimates taking account of the November Budget, 1968.

(5) Includes £2 million revenue balances.

These conclusions about the use of fiscal policy in Ireland over the last ten years may seem harsh, but a recent OECD study²⁴ has shown that not dissimilar strictures would apply to the use of fiscal policy in a number of western countries over the same period. The full recommendations of that study, which are too lengthy to summarise here, are equally applicable to Ireland.²⁵ A first step is to relax rigid fiscal rules (such as that the current budget should always be balanced), because "a government's ultimate responsibility is to balance the economy as a whole rather than to balance its own accounts; and rigid fiscal rules are not only insufficient but are a hindrance to this end." To ensure that policy "is based on economic realities and needs rather than on political expediency . . . an informed public opinion is essential, and governments should play an active role in nurturing it."²⁶

To this end, "a correct appraisal of current economic trends" is needed. Economic forecasts should be published in greater detail and with fuller documentation than is now the practice. These forecasts should (*inter alia*) attempt, on the basis of current policies, to identify the gap between aggregate demand and aggregate supply in the period ahead. The forecasts would provide the framework within which the annual current and capital budgets could be judged. The annual budget statement should include an analysis of the impact of current and capital budgets of the previous year on the economy, and explicit estimates of the impact on the economy of the current and capital budgets proposed for the year ahead.

However, it is not necessary to spell out what the use of fiscal policy for demand management would require. The need for demand management, the contribution that fiscal policy can make towards it, the improvements in statistical information and the changes in administrative arrangements that would be necessary to facilitate it, have all been set out in various official publications, notably, the Second Programme for Economic Expansion²⁷ and the Third Programme for Economic and Social Development.²⁸ What is needed at this stage is a fuller awareness in the community at large of the importance of managing demand. If this is not achieved, the "political" costs of demand management to control inflation may continue to be allowed to outweigh the immediate and prospective economic benefits that would follow from it.

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24. Walter Heller *et alia*: *Fiscal Policy for a Balanced Economy: Experience, Problems and Prospects*, OECD Paris, December 1968.

25. *Ibid.*, Ch. VIII.

26. The quotations in this and the next paragraph are from Heller *et al.*, *op. cit.*, pp. 146, 158 and 159.

27. Government Publications Sale Office, Dublin 1964. (Pr. 7670).

28. Government Publications Sale Office, Dublin 1969. (Pr. 431).

TABLE 2: *Main Heads of Government Current Expenditure, 1960-71.*

£ million

	60-1	61-2	62-3	63-4	64-5	65-6	66-7	67-8	68-9	69-70	70-1
										Prov.	Esti- mate
<i>Service of Public Debt</i>	28.4	31.1	34.4	38.2	42.8	49.0	56.5	63.7	75.9	88.8	101.6
<i>Social Services</i>	50.4	51.9	57.5	63.2	75.2	84.2	93.1	102.9	118.7	144.2	160.8
Social Welfare	26.1	25.7	27.9	30.9	34.9	38.7	43.0	45.1	49.1	59.2	64.2
Education	15.6	16.6	18.9	20.6	26.1	29.6	31.3	35.8	44.0	52.9	59.6
Health	8.8	9.6	10.7	11.7	14.2	15.9	18.9	22.1	25.7	32.1	37.0
<i>Economic Services</i>	24.9	30.6	35.0	39.2	47.9	55.2	59.9	75.2	84.4	97.5	103.4
Agriculture	14.1	18.9	22.3	24.0	30.0	35.8	40.8	53.3	60.0	70.8	73.6
Industry	1.5	1.6	1.9	3.1	3.7	4.7	4.8	6.6	7.5	9.2	10.8
Transport	8.3	8.9	9.4	10.7	12.2	12.5	12.1	13.0	14.4	14.4	15.5
Forestry, Fisheries	1.0	1.2	1.4	1.4	2.0	2.2	2.2	2.3	2.6	3.1	3.4
<i>General Services</i>	26.4	28.3	30.8	33.6	41.1	43.0	44.1	46.4	51.2	58.2	62.1
Post Office	7.8	8.8	9.7	10.1	13.3	13.8	14.9	15.3	17.2	20.0	21.8
Defence	7.1	7.5	8.1	8.7	11.3	11.7	10.4	11.4	12.9	14.4	14.3
Justice	5.7	6.0	6.3	7.3	8.2	8.4	9.3	9.4	10.2	11.8	12.6
Public Service Pensions	5.7	5.9	6.7	7.5	8.2	9.1	9.6	10.3	10.9	12.1	13.3
<i>Other Expenditure</i>	9.6	10.4	10.9	12.2	15.0	16.6	17.1	18.7	20.5	22.8	25.0
Total	139.7	152.3	168.6	186.5	222.0	248.0	270.6	307.0	350.8	411.6	452.9
Remuneration included in above figures	43.8	45.3	51.2	55.3	71.0	75.5	80.9	84.8	93.9	110.6	118.5
	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970
<i>Gross National Product</i>	673	723	778	830	950	1,018	1,071	1,159	1,288	1,444	n.a.
Govt. current expenditure as percentage GNP	20.8%	21.1%	21.7%	22.5%	23.4%	24.4%	25.3%	26.5%	27.2%	28.5%	n.a.

TABLE 3: *Automatic and Discretionary Changes in Current Budgets*

(£ million)

Year	Automatic		Discretionary	
	Revenue	Expenditure	Revenue	Expenditure
1960-1	£7.00	£7.85	£0.225	£2.60
1961-2	£5.32	£4.80	£0.59	£2.20
1962-3	£8.14	£8.17	£3.23	£4.49
1963-4	£8.66	£12.25	£9.43	£2.98
1964-5	£23.93	£23.32	£6.78	£5.17
1965-6	£18.22	£17.67	£5.55	£6.02
1966-7 (March Budget)	£9.70	£13.93	£12.58	£0.35
1967-8	£20.68	£20.24	£1.60	£6.93
1968-9 (April Budget)	£23.05	£26.45	£4.23	£4.62
1969-70	£42.11	£32.89	£5.33	£8.24
1970-1	£51.18	£41.38	£12.70	£21.96

TABLE 4: *Capital Budgets 1960-1 to 1970-1:**Estimate and Provisional Outcome (£ million)*TABLE 5: *Summary: Capital Budget Resources*

Resources	1960-1	1961-2	1962-3	1963-4	1964-5	1965-6	1966-7	1967-8	1968-9	1969-0	1970-1*
	£ million										
1. "Internal" †	24.9	28.4	38.9	43.5	51.5	50.5	54.7	63.4	96.9	102.5	117.6
2. Borrowing from non-bank Irish public	25.1	27.1	26.9	25.9	32.7	17.6	31.8	31.0	30.5	22.1	31.0
3. Borrowing from the banking system and abroad	6.6	4.6	8.3	14.6	19.0	48.2	26.0	25.0	54.8	60.9	75.0
Total	56.6	60.1	74.1	84.0	103.2	116.3	112.5	119.4	182.2	185.5	223.6

*Estimate.

†Internal resources include resources of local authorities other than Exchequer advances and grants, loan repayments, investment resources of Departmental Funds and the miscellaneous item in Table 4.

TABLE 4:

	1960/1		1961/2		1962/3		1963/4		1964/5		1965/6		1966/7		1967/8		1968/9		1969/70		1970/1*
	Est.	Act.	Est.	Act.	Est.	Act.	Est.	Act.	Est.	Act.	Est.	Act.	Est.	Act.	Est.	Act.	Est.	Act.	Est.	Act.	Est.
RESOURCES																					
<i>Local Authorities and State Bodies</i>																					
Resources of local authorities and State bodies other than Exchequer advances and grants	12.6	10.2	11.5	10.9	15.3	16.4	21.8	26.1	25.3	29.7	31.4	28.1	30.5	33.0	32.1	35.4	46.2	52.6	66.0	63.8	73.8
EXCHEQUER																					
Loan repayments	3.6	3.7	3.5	3.8	3.7	5.4	4.4	4.4	4.6	4.8	5.7	5.8	6.3	6.2	6.7	5.7	6.2	11.0	7.3	7.7	8.4
Investment resources of departmental funds	8.0	10.6	9.0	13.3	12.0	16.7	14.0	12.5	16.0	16.4	17.0	12.9	14.5	14.3	19.0	20.3	23.0	17.3	25.6	28.0	30.0
Small savings and Prize Bonds	12.0	6.4	8.0	7.4	8.5	7.8	8.5	7.0	10.0	9.7	10.0	2.3	7.0	7.0	9.0	6.2	7.5	5.0	6.0	2.9	6.0
Miscellaneous	0.5	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.6	0.6	4.35	3.7	0.2	1.2	2.0	2.0	0.3	16.0	2.8	3.0	5.4
Other borrowings :																					
National loans and Exchequer Bills etc.-public Banks	19.7	18.7	24.9	19.7	27.9	19.1	31.9	18.9	40.5	23.0	43.6	15.3	22.0	24.8	24.0	24.7	24.0	25.5	26.0	19.2	25.0
Foreign borrowing	—	6.6	—	4.6	—	8.3	—	14.6	—	19.0	—	33.3	28.0	16.2	25.0	25.0	33.0	52.0	53.0	50.0	75.0
Total	56.3	56.6	57.3	60.1	67.9	74.1	81.0	84.0	97.0	103.3	112.1	116.3	108.5	112.5	117.8	119.3	141.2	182.2	186.7	185.5	223.6
REQUIREMENTS																					
Expenditure on public capital programme	54.4	50.6	55.5	57.2	66.9	65.1	79.7	78.5	96.1	97.8	103.7†	99.3	97.8	99.0	108.5	111.4	136.4	141.6	166.8	173.4	194.5
Refinancing of borrowings of previous years	1.7	1.8	1.3	1.5	0.6	1.6	0.8	0.8	0.4	0.5	2.1	3.4	7.4	8.3	7.1	6.6	2.8	10.7	11.9	8.9	16.2
Current budget deficit	—	0.73	—	0.71	—	4.85	—	2.22	—	4.07	—	7.8	—	—	—	—	—	9.0	—	0.5	} 12.9
Miscellaneous	0.3	3.5	0.5	0.6	0.4	2.5	0.6	2.5	0.5	0.9	6.3	5.9	3.3	5.2	2.2	1.3	2.0	20.9	8.0	2.7	
TOTAL	56.3	56.6	57.3	60.1	67.9	74.1	81.0	84.0	97.0	103.3	112.1	116.3	108.5	112.5	117.8	119.3	141.2	182.2	186.7	185.5	223.6

*Estimate only.

†This estimate was cut by £3.4 million in October, 1965.