National Economic and Social Council

An Chomhairle Náisúnta Eacnamaíoch agus Soisialach

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A Strategy for Competitiveness, Growth and Employment

November 1993

No. 96

NATIONAL ECONOMIC AND SOCIAL COUNCIL

Constitution and Terms of Reference

1. The main tasks 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.
   (vi) 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 Chairperson 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 Irish Business and Employers Confederation and the Construction Industry Federation;
   Five persons nominated by the Irish Congress of Trade Unions;
   Eight other persons nominated by the Government, including one from the National Youth Council, the Secretary of the Department of Finance, the Secretary of the Department of Tourism and Trade, and the Secretary of the Department of Enterprise and Employment.
   Any other Government Department shall have the right of audience at Council meetings if warranted by the Council's agenda, subject to the right of the Chairperson 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 Competitiveness, Growth and Employment

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The Council retains full responsibility for the contents of the report.

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CHAPTER 1

Introduction and Overview of Strategy

INTRODUCTION AND OVERVIEW OF STRATEGY[1]

The extent of unemployment in Ireland, and especially of long-term unemployment, casts a dark shadow over the performance of the economy. Unemployment is a powerful symbol of the under-development of the economy. The low level of employment in the Irish economy, relative to our neighbours, is the root cause of income levels per head which continue to lag behind the European average. Furthermore, had emigration not relieved labour market pressures in the late 1980s, unemployment would be substantially higher than it is now.

These realities constitute an inescapable backdrop to the formulation of public policy. The acceleration of employment growth and the reduction of unemployment constitute the over-riding objective for the Council as it prepares its recommendations for the conduct of economic and social policy in the medium-term.

Were it not for the scale and persistence of unemployment there would be much about which to be satisfied in recent Irish economic performance. As Chapter 2 demonstrates, economic growth has continued to outpace our EC partners. Progress continues towards the goal of reducing our debt burden and the pace and direction of change in this regard, together with the stability and consistency of macroeconomic policy generally, has helped to keep inflation and interest rates low. The steady development of a surplus in our balance of payments has removed a potential constraint on further growth. In many respects, this represents a radical transformation of our fortunes relative to the position which applied in the mid-1980s, when the Council produced its first Strategy report. It is significant that the maintenance of employment levels over recent years, as well as the positive, if reduced rate of real economic growth contrast sharply with the experience of our EC partners. In particular, Ireland maintained employment over the past two years at a time when the UK was in recession. By reference to historic performance this was a major achievement. It suggests that, had international conditions been more favourable, the economy would have been well placed to sustain the very strong employment performance achieved in such circumstances in the late 1980s.

While performance was broadly satisfactory relative to our competitors, it was inadequate in terms of the needs of Irish society. The thrust of policy for

1 The Secretary of the Department of Finance did not consider it appropriate to comment on matters of budgetary policy.

the future must be to improve our performance so that the growth of employment is accelerated and the level of unemployment drastically reduced. The Council believes that the reduction of unemployment is the over-riding priority for policy and that all instruments of policy and all sectors of the economy must be mobilised to that end. The implications of pursuing such an approach, given the context for policy, are set out in this Report.

The Council is satisfied that the broad thrust of the policy set out by the Council in *A Strategy for the Nineties* was correct. It has therefore prepared its recommendations in this Report on the basis of a strategy based on: (i) continued consistency in macroeconomic strategy, across fiscal, monetary and exchange rate policies, supported by (ii) moderate income developments with the priority of employment over improved living standards, allied to (iii) a radical programme of structural reform to increase economic efficiency and improve the growth in employment performance of the economy. These are necessary to build competitiveness which, as outlined below, is the key to improved and sustained economic performance.

The need for consistency, and therefore a strategic approach to economic and social policy is accentuated by developments in the exchange rate area. The widening of the ERM bands has removed for the present a clear and objective nominal anchor for overall economic strategy. The turbulence in the EMS, whose origins and implications are discussed in Chapter 6 below was particularly unfortunate for Ireland since the credibility of our commitment to maintaining the nominal exchange rate within the narrow band of the EMS had been well-established and the benefits, in terms of reduced interest rate pressures, had begun to flow relatively recently. The Council remains strongly of the view that the pursuit of EMU is in the best interests of the Irish economy, given its openness and the direction of its trade. It follows that policy should seek to support moves at Community level to maintain and accelerate progress towards the goal of EMU. In the meantime, exchange rate policy should be geared to maintaining the non-accommodating exchange rate strategy. The credibility of this approach, together with the prospects for lower real interest rates, will depend on the performance of the economy and of its cost base relative to our competitors.

1. SCALE OF THE UNEMPLOYMENT PROBLEM

Despite the fact that employment has grown slightly since 1990 in Ireland while declining significantly in the European Community as a whole, the unemployment rate in Ireland is more than twice the EC average and is second only to that of Spain. Furthermore, this high unemployment rate arises

in a situation where labour force participation rates - that is the proportion of adults in the labour market - are substantially lower than the European average, principally as a result of a much lower rate of female labour force participation. The scale of the unemployment problem is accentuated by the high incidence of long-term unemployment. Expressed as a percentage of the labour force, long-term unemployment in Ireland is among the highest in the OECD. Approximately 80,000 adults have been out of work for 2 years or more. The statistical evidence discussed in Chapter 3 demonstrates the limited prospects of a return to gainful employment for such people, many of whom face the prospect of decades of unemployment with all the consequences for their families and communities.

The extent to which long-term unemployment has become a trap for tens of thousands of Irish citizens is related not only to the performance of the economy but to a population structure which is producing a relatively high rate of increase in the labour force. Net inflows into the labour force for the rest of the decade will require the creation of approximately 25,000 extra jobs annually if unemployment is not to rise even further or involuntary emigration to resume on a substantial scale. The labour force has increased since 1990 at a rate which is more than 12 times that of the EC average. If Ireland had the average labour force increase of the EC, the net inflow to the labour force would be of the order of 3-4,000 per annum. This comparison puts in perspective the enormity of the task which tackling unemployment presents in our society, at least until the rate of labour force growth approximates the EC norm early in the next decade. It is in particular a major challenge to society as it seeks to tackle - as the Council strongly believes it must - the problem of long-term unemployment. School and college leavers are better educated and more effective competitors in the labour market than the long-term unemployed. The Council believes that there is a need for a special focus on the problems of the long-term unemployed, including social employment outside the market economy on the basis set out in this Report, to complement development measures designed to increase employment levels generally in the economy.

The urgency of addressing the issue derives from the very large social costs arising from the scale of Irish unemployment. Not only is it a matter of the lost potential output but, as Kennedy (1993) has pointed out, the associated poverty, psychological distress and, social conflict represent costs which are disproportionately borne by the weakest sections of society, in addition to the high cost of income support measures. In addressing this problem, the Council believes that the primary focus should be on measures to accelerate the rate of increase in sustainable employment. The Council believes strongly that the low rate of employment in the Irish economy makes any suggestion that unemployment cannot be tackled through maximising the growth potential of the economy fundamentally misguided. The desire not only for higher levels of employment but for a more rapid convergence of income standards on European norms requires that the economy grow to sustain a much higher proportion of its population in open employment. Furthermore, such development is essential if we are to be able to sustain alternative opportunities for work and for self-development, as well as social support services, for those who cannot realistically be expected to be successful in open competition in the labour market.

2. ECONOMIC GROWTH AS A BASIS FOR INCREASED EMPLOYMENT

The average rate of economic growth in Ireland since 1960 in Ireland has been slightly below the EC average. However, four other late developing economies examined (Spain, Greece, Portugal and Turkey) each achieved significantly higher average rates of economic growth over the 30 year period. This is a caution against any complacency regarding the adequacy of Ireland's long-run growth rate. Viewed from the perspective of a late-developing, peripheral economy, Ireland's long-run record of output growth is significantly less satisfactory than the comparisons with the EC average might suggest, and this has undoubtedly contributed to a relatively poor employment performance. This long-run trend has, however, been reversed in recent years.

The growth of total employment in Ireland over the past 30 years has been relatively low, at 0.3% per annum, but this again is similar to the EC average (0.4% per annum). Ireland's *non-agricultural* employment performance has been considerably better. Non-agricultural employment in Ireland has grown by an average of 1.3% from 1960 to 1990. This growth has been relatively high by European standards, and well above the EC average (0.9% per annum). However, non-EC economies such as North America and Australia have achieved substantially faster non-agricultural employment growth than the EC.

During the mid-to-late 1980s, EC employment growth accelerated and the output-employment relationship shifted to a more labour intensive form. The stagnation of the European economy in the past two years has reversed significantly that employment gain. In Ireland growth has been concentrated in high productivity manufacturing (even allowing for distortions caused by transfer pricing), with a shake-out in the labour-intensive, non-market sector. The Council's own analysis has shown that the growth of services employment in Ireland during the 1980s was the lowest in the OECD,

although this primarily reflected slow growth of non-market services employment, which declined in the late-1980s following the unsustainable expansion in previous years. The composition of growth, together with the structural adjustment in the labour force arising from the long-run decline in the relatively large share of employment in agriculture, has attenuated the employment impact of growth.

Fears that Ireland has entered a period of jobless growth are not justified. The Council is convinced of the central importance of securing high rates of economic growth for increasing the rate of employment growth. However, the extent to which economic growth impacts on employment is determined as much by the *structure* and *composition* of growth as by the absolute *rate* of growth. While output growth may not be a sufficient condition for securing employment growth, without it increases in employment can only be achieved by reducing the average income levels of those at work. Given (i) the continued decline in agricultural employment; (ii) ongoing productivity improvements generally in the economy; (iii) an increasing labour force; a very rapid rate of economic growth is required to achieve a reduction in unemployment without relying on emigration. A growth rate in excess of 6% is the type of growth necessary to achieve a combination of rising living standards for those at work and a sufficiently rapid rate of employment growth for the increase in net employment to exceed the increase in the labour force.

This raises the question as to what are the appropriate policies to encourage rapid output growth and an appropriate pattern of growth. At present Ireland has a surplus of labour, while natural resources are under-developed. This demonstrates that Ireland has the capacity to achieve much more rapid output growth. Achieving a more balanced pattern of growth implies securing a better performance from the indigenous sector, and associated with this, a more even balance between domestic and export demand. A strategy for employment must therefore be a strategy for achieving balanced growth. The implications of such a strategic approach are summarised in the following sections.

3. THE EXTERNAL ENVIRONMENT

It is a truism that Ireland is an open economy, indeed a classic example of the text book model of a small open economy. The implication of this is that, to a much greater extent than many of our fellow members of the EC, Ireland's economic and employment performance is integrally related to international trends. A specific example is the close relationship between the Irish and UK labour markets, where migratory flows are highly sensitive to relative conditions in the two economies. More generally, the completion of the single market programme within the EC, while opening up free access to the European market for Irish exporters, has significantly reduced the scale of economic activity which is not exposed to international competition. The domestic market is therefore increasingly subject to external competition and the providers of goods and services face increasing competitive pressure on foreign and domestic markets alike.

Exposure to external influences is evident in the foreign exchange market and in the dynamics which determine Irish interest rates. The competition to attract mobile foreign investment is a further example of the extent to which a vitally important sector of the Irish economy reflects the ebb and flow of external movements both in the volume of globally mobile investment and in the competition to attract it. The existing scale of external pressure is compounded by the gathering pace of globalisation. The integration of global financial markets and the growing significance of transnational corporations are the most obvious examples of this. They, together with the obligations which we have assumed arising from EC membership, have radically reduced the scope for insulating the domestic economy from external factors. It is the Council's view that the formal erosion of autonomy at the national policy level is less significant for a small economy such as Ireland since the size and structure of the economy make for openness to external forces, in any event. However, the pace of external competition is accelerating: the collapse of the command economies in Eastern Europe and the continuing and rapid growth of newly-industrialising countries in South East Asia, including China, represent a further deepening of global competition.

For small countries, adaptability to the external environment is vital for success. The Council's review of Ireland's long-run economic performance suggests that in the past the capacity of some sectors of our economy to adapt and to integrate successfully with the world economy was seriously deficient. For the future, our capacity to innovate in response to changing external conditions, including the continuing rapid pace of technological development, will be the key to our success in accelerating growth and increasing employment. *The fundamental responsibility for ensuring an improved performance lies in our own hands.*

Nevertheless, it is equally important that we take such opportunities as are available to influence the external environment in ways which are compatible with our interests and need for development. The primary opportunity in this regard arises from our EC membership. The Council has consistently argued that Irish policy towards developments at Community level should reflect a strategic approach. In this context, the Council believes that Ireland should take an active role in shaping policies to accelerate the rate of recovery in the

European economy and, in turn, increase the role of the Community in pursuing co-ordinated measures to promote faster growth in the world economy. The proposal from the EC Commission to publish a White Paper on growth, employment and competitiveness provides a particular focus for this approach. The Council believes that such measures should take as their context a desire, in the long-run, to maintain the strong values characteristic of European society, notably principles of social solidarity and social protection. The evidence suggests that the European model and the principles which underpin the European welfare state are widely supported across the different sectors of European society (Jacquemin and Wright, 1993). It may be that the fiscal and incentive structures which have developed in association with this model require adaptation in the context of increased global competition. However, the Council believes that Ireland should play a leading role in formulating European strategies which enhance growth and competitiveness while preserving the best elements of strong traditions of social solidarity.

A related issue which will affect the external environment is the prospect for successful completion of the Uruguay Round of the GATT trade negotiations. A successful outcome to these negotiations would undoubtedly represent a fillip to world trade and a boost to the external environment with, on balance, positive results for exporting countries such as Ireland. The implications for some sectors of the Irish economy of such an outcome will be negative and will require special attention both at the Community and domestic levels. However, the Council believes that, provided such concerns are adequately addressed, a successful outcome to the negotiations should be sought.

With regard to the European Monetary System, the Council believes that the continuation and acceleration of the programme for Economic and Monetary Union should be supported. The Council sets out in Chapter 6 its views on the arrangements which should apply in the interim. The acceleration of progress towards EMU and the development of Community-wide measures to secure real economic convergence as a basis for successful EMU, constitute an important element of the external dimension of the Council's strategy for employment growth.

4. A STRATEGY FOR DOMESTIC POLICY, COMPETITIVENESS AND GROWTH

Competitiveness is determined by a range of factors, both cost and non-cost based. In the medium to long-term, sustained competitiveness in the global economy depends increasingly on technological or innovation-based strengths. This trend is discussed in Chapter 4, and again in Chapter 8 where the focus is on the requirements for an improved performance by indigenous manufacturing industry. Both chapters emphasise the crucial importance of non-cost factors such as product and process development, management, marketing and design in providing a sustainable basis for long-term growth. In the short-term, however, conventional cost competitiveness continues to be an important influence on economic performance.

The primary responsibility for accelerating employment growth rests on domestic policy-makers and economic agents. For any given set of external circumstances, the employment impact will depend on the domestic response. In particular, the acceleration of the rate of growth of output and employment will depend on the competitiveness of the Irish economy in the context of the globalisation process outlined above. Competitiveness has many dimensions, which are discussed in more detail in Chapter 4. At one level, there is the question of cost competitiveness, by which goods and services traded in domestic and foreign markets can compete successfully with rival equivalents. The significance of cost competitiveness is greater for relatively standardised goods and services of which there are many and emerging producers. Such goods and services constitute the core of the indigenous sector in Ireland. Many of these are also labour-intensive activities and therefore wage competitiveness represents a very significant part of overall cost competitiveness. Furthermore, the basis for assessing cost competitiveness in many of the employment-intensive sectors of the Irish economy is comparison with costs, and wage costs in particular, in the UK.

Cost competitiveness also reflects the costs arising from taxation and from the non-traded sector generally. Both through their effect on wage pressures and directly, such costs must be considered as an important target for strengthening the competitiveness of the Irish economy. This has implications both for the effectiveness of management and cost control systems in the public sector and for strategies to increase competition in the private non-traded sector. These implications are developed in Chapter 4.

An important influence on domestic costs is the level of the interest rate, while cost competitiveness in international trade is also influenced by exchange rate movements. In both cases, external confidence in the conduct of domestic policy is a significant influence. The credibility of the overall conduct of macroeconomic policy is a requirement for exchange rate stability and for convergence of domestic interest rates on those applying internationally. These requirements apply irrespective of the formal exchange rate framework which may apply from time to time. It follows that consistency in macroeconomic policy - in particular between fiscal and exchange rate policy, is a basic requirement for competitiveness. The

credibility of macro policy is enhanced if it represents real progress towards the elimination of structural problems, such as a high public debt, and if it is supported by consistent patterns of income development.

Taking these considerations into account, the Council believes that a strategy for employment should reflect the following measures to secure improved cost competitiveness:

- Wage moderation compatible with the evolution of incomes in our trading partners;

- Measures which increase the competitiveness of other labour costs, especially in employment-intensive sectors, such as a restructuring of taxation and PRSI so as to reduce the impact of income tax at relatively low wage levels;

- A continuation of steady progress towards the reduction of the debt/GNP ratio (in accordance with the Maastricht criteria);

- A firm control on the rate of increase in public expenditure in line with the requirements of this strategic approach;

- Measures to improve the structural effectiveness of public expenditure management and control;

- Measures to enhance competition in the non-traded sectors of the economy.

These measures would secure the competitive potential of the economy; the transformation of this potential into a competitive performance which yields significantly faster employment growth will require rapid improvement in the non-cost dimensions of competitiveness. The measures proposed in this regard are summarised in the following section.

5. BUILDING LONG-RUN COMPETITIVENESS

Securing an improvement in cost-competitiveness including a stable macroeconomic environment is a necessary but not a sufficient condition for long-run competitiveness and the employment growth for which it is the basis. The significance of increased production from very low labour cost economies, including emerging Asian economies, is such that cost reductions alone cannot be a satisfactory basis on which to build an employment strategy. For many sectors, especially the low-productivity indigenous sector, cost competitiveness in the short-run is essential to survival and therefore to job maintenance. In the medium to long-run, however, competitive strengths require above all a capacity to innovate: to develop new products, to access successfully new markets, to apply new technology, to incorporate best practice in the management of enterprises, to develop skill levels across the full spectrum of the labour force. The long-run performance of the Irish economy in this century reflects the negative consequences of a failure to innovate and to achieve high productivity performance in emerging markets. Above all, such competitiveness requires a much stronger performance on the part of those responsible for shaping strategy and managing activity across all sectors of the economy: internationally traded, domestically traded and non-traded activities. Building the capacity of indigenous enterprises, whether in manufacturing, in agriculture or in services is central to this important dimension of competitiveness. The Council throughout this Report, cites examples of areas requiring urgent attention to enable the indigenous economy to survive and develop within the increasingly competitive international environment. In agriculture, the long-run trend towards competitiveness in agricultural markets requires a focus on the structural impediments to competitiveness, including the development of human capital within the sector (Chapter 9). There is a need to strengthen the capacity of Irish enterprises to compete successfully in the expanding range of internationally-traded services (Chapter 10). In tourism, the potential for increased employment and more profitable investment requires more effective marketing to reduce the seasonality of the industry (Chapter 11). In manufacturing, the development of higher skill levels in marketing, research and development and design are clearly indicated (Chapter 8). For education and training policies, there is a challenge to ensure not only that new entrants to the labour force receive appropriate basic and foundation level education, but that the relatively low education and skill levels of the existing labour force, including the unemployed, are addressed (Chapter 16). Continuing education and training should therefore become a more central aspect of policy and performance. In the financial system, there is a need to address a number of gaps in the financial markets which are thought to constrain the development of indigenous businesses (Chapter 12).

These are formidable challenges. They represent, however, only the most obvious elements of a strategy to enhance the competitiveness of the Irish economy and thus to preserve existing jobs and to begin to approach the rate of net employment creation required to cater for our expanding labour force. They require, above all, a willingness to challenge accepted standards and patterns and an openness to learn from best practice among our competitors. This outward orientation has implications for the thrust of public policy, as well as strategies within the private sector. The Council in this Report outlines its priorities in building capacity within the economy as a basis for achieving more rapid employment growth.

6. SOCIAL EQUITY IN A COMPETITIVE ENVIRONMENT

The Council does not see any conflict between a strategy to boost competitiveness and increase the rate of employment growth, on the one hand, and the pursuit of social equity, on the other hand. On the contrary, in a small economy such as Ireland the acceptability of the thrust of public policy depends on its perceived fairness. Furthermore, the relative economic success of other small economies, especially with regard to employment creation, is strongly related to a commitment to securing equitable participation by all sectors of the community in the process of economic development. This is reflected both in measures to address the education and training needs of all ability ranges of young people from the widest range of social backgrounds, as well as in active labour market policies to prevent social exclusion through unemployment, especially long-term unemployment. The Council, at the same time, recognises that Ireland's future ability to be a caring society depends in part on achieving more rapid economic and sustainable employment growth than hitherto.

The Council recommends continued progress towards important social goals in the areas of education, health, housing and income maintenance. It sets out in Chapters 13 to 17 its recommendations to enhance both the effectiveness and the equity of public policy and provision in these areas. In particular, it recommends an integrated approach to the social and development needs of areas characterised by long-term unemployment and social disadvantage. Such an approach can cater more effectively for the specific needs of those requiring special support, as well as providing a basis for creating work opportunities to encourage the integration into the labour force of those who have become discouraged through long-term unemployment.

The Council is acutely aware of the high social cost of long-term unemployment and the extent to which that cost is borne by the weakest members of society. It has, therefore, concluded that special measures must be taken to address the needs of the long-term unemployed, over and above measures to stimulate employment growth generally. The Council believes that the limited scope for increases in public expenditure in the context of its macroeconomic strategy should therefore be applied primarily to creating opportunities for the long-term unemployed to engage in meaningful work in their own communities. This would be in addition to targeted measures to increase their education and skill levels, and thus potential to compete for open employment. Failure to provide direct work opportunities for the many thousands of long-term unemployed is effectively to condemn them to decades of unemployment without prospect of relief. The Council regards such a prospect as unconscionable. It believes that the resources which would otherwise be applied to their income maintenance should be made available and supplemented to ensure the opportunity for a meaningful work role for a sizeable proportion of the long-term unemployed, both in the interest of social justice and in the interest of reducing the marginalisation of such people and their families (Chapter 3).

7. A STRATEGY FOR IMPLEMENTATION

The Council believes that the best framework within which to secure these strategic requirements is a consensus negotiated between government and economic and social interests. The inter-dependence of the various elements outlined in this strategy require that they be considered together and with due regard to their interaction. Formal agreements, however comprehensive, are possible only if the goals are widely shared and the mechanisms widely understood. The strategy outlined by the Council is demanding: demanding of policy-makers and the social partners in finding innovative ways of addressing our development needs; demanding of society, to accept a lower rate of increase in living standards than might be desired, in the interests of increasing employment opportunities including increased investment; demanding of taxpayers, insofar as the restructuring of the tax system requires a broadening of the tax base to facilitate a restructuring of taxes in favour of employment.

The Council is satisfied that unless the challenges represented by this strategic approach are successfully met, Irish society faces the prospect of accelerating unemployment and a return to high levels of involuntary emigration over the rest of this decade. Furthermore, it faces the prospect of many tens of thousands of people becoming more marginalised through lengthening periods of long-term unemployment, with all of the social consequences which are likely to follow. The pressures experienced in society as a result of such an evolution would be much greater than the pressures generated by adherence to the type of strategy outlined in this Report. The Council believes that it is necessary to mobilise the same degree of consensus and determination in support of radical programmes to stimulate employment as were mobilised to secure recovery in the mid-1980s from the imminent prospect of fiscal crisis. The energy and commitment required at this point are even greater than when the Council issued its first Strategy Report in 1986. It is in that spirit that this report has been prepared.

CHAPTER 2

Recent Performance and the Context for Future Policy

RECENT PERFORMANCE AND THE CONTEXT FOR FUTURE POLICY

1. INTRODUCTION

It is now three years since the Council published *A Strategy for the Nineties: Economic Stability and Structural Change*. In that report the Council considered the outlook for the economy over the period 1991 to 1994 on the basis of no policy change. The projections envisaged economic growth of 3% and net growth in employment of 9,000 per annum. At that time emigration was expected to average 19,000 per annum over the period 1991 to 1994 while unemployment was projected to fall by 2/3,000 per annum.

The Council considered this scenario to be entirely unacceptable:

> "Growth of employment of 9,000 per year implies continued involuntary emigration and only a modest fall in the level of unemployment. Not only would this be a failure to achieve the central aim of rapid employment growth but it would imply a comprehensive failure to overcome the gross inequalities in Irish society which, as the Council has stressed, are linked to unemployment." (NESC, 1990, p.413).

Rejection of this scenario motivated the Council to propose a new strategy for economic and social development. We now wish to examine how the economy has performed since 1990. Subsequently, in Section 2, we will review the conduct of recent economic policy to see to what extent it has evolved in line with the strategic principles set out by the Council. Finally, in Section 3, we will consider the medium-term outlook for the Irish economy and outline the broad context within which future policy must be developed and implemented.

2. ECONOMIC PERFORMANCE SINCE 1990

2.1 Economic Growth

The period since 1990 has been characterised by a slowdown in Irish economic growth, following a period of exceptionally strong growth in the late 1980s (see Table 2.1). The extent of the slowdown was relatively modest at first, and GNP grew in volume terms by 4.3% in 1991 and by 3.9% in 1992. These growth rates, while lower than in the immediately preceding years, were high by international standards and remained above the long-term trend of output growth in Ireland.

The prospects for 1993 point to a considerable reduction in the rate of economic growth this year. The year started with very high interest rates and the Irish pound at exceptionally high levels vis-a-vis Sterling; the long awaited recovery in the UK economy still appeared vulnerable and there were growing concerns about the health of the other European economies. As the year has progressed, conditions have improved on a number of fronts: by July, nominal interest rates had fallen to their lowest level since 1977 (although *real* interest rates remain high), and the recovery in the UK economy had begun to take hold. Important concerns remain however, most notably in respect of the continuing poor prospects for the continental European economies which have remained in recession and the greatly increased uncertainty in foreign exchange and interest rate markets which followed the breakdown of the European Exchange Rate Mechanism in August 1993. It now appears likely that GNP will grow by about 1.75% in real terms this year. This is a considerable achievement, given the volatile conditions which have prevailed and the fact that most other EC countries will have experienced a fall in GNP in 1993. It does, however, represent a substantial slowdown on previous years and falls far short of the rate of growth necessary to secure sustained increases in employment and reductions in unemployment.

TABLE 2.1

Annual Change in GNP and its Expenditure Components
% Change per Annum (Volume)

	1986-90	1991	1992(p)	1993(e)
GNP	5.5	4.3	3.9	1.75
Domestic Demand[1]	3.4	-0.1	1.9	2.5
of which:				
Private Consumption	4.1	1.6	3.0	2.5
Public Consumption	-1.4	2.4	2.2	1.5
Investment	5.3	-7.3	-1.9	1.25
Exports	10.4	5.2	12.9	4.0

1 Excluding stock changes.

Source: CSO, National Income and Expenditure, July 1992. Secretariat estimates for 1993.

The benefits of economic growth, in terms of its ability to support higher levels of employment and increased living standards, are influenced, not just by the *rate* of growth, but also by its *composition*. Table 2.1 shows that output growth in 1991 and 1992 was driven predominantly by the external sector. Domestic demand, which had grown strongly in the late 1980s (by an average of 3.4% p.a. in 1986-1990), fell marginally in 1991 and was weak again in 1992. This slowdown in domestic demand was felt immediately in the real economy and meant that, notwithstanding the strong growth of GNP in 1991 and 1992, the economy displayed many of the characteristics of much slower growth.

The downturn in domestic demand in 1991 reflected a sharp fall in the volume of investment (-7.3%) and a slowdown in the rate of growth of private consumption (from 4.1% per annum in 1986-1990 to 1.6% in 1991). Private consumption recovered somewhat in 1992 (to grow by 3.0%), and the rate of decline of investment activity eased considerably (to -1.9%). Public consumption grew in real terms in both years (by an average of 2.3% per annum), exerting a positive influence on the growth of domestic demand.

The trends so far in 1993 suggest that the composition of growth will be more evenly balanced this year. The principal cause of the slowdown in economic growth in 1993 has been the substantial reduction in the rate of growth of exports. The volume of total exports is now expected to grow by only 4% this year compared to 12.9% in 1992. This reflects the weakness of demand in many of our main trading partners and highlights the poor external environment which has prevailed this year.

The reduced contribution to growth from the external sector in 1993 will be partly offset by a resumption of somewhat faster growth in domestic demand, although the pace of this growth remains slow relative to the late 1980s. Personal consumption and investment were depressed in the first quarter of the year, under the pressure of extremely high interest rates and considerable uncertainty regarding the prospects for the domestic economy. The subsequent sharp falls in interest rates should lead to some recovery in the latter months of the year. Current indications suggest, however, that business and consumer confidence remains low and the expected turn-around in consumer spending and investment has been slow to take effect. It now looks as though it may be next year before any significant response to the new lower interest rate regime is apparent. On the basis of a fairly modest recovery in the second half of the year, the volume of personal consumption could rise by about 2.5% in 1993, with investment volumes up by perhaps 1.25%. Government consumption is set to rise by about 1.5% in volume terms this year, on the basis of budget estimates.

By international standards, Ireland's recent economic growth has been very strong. In the late 1980s, economic growth in Ireland was the highest in the OECD area. Since 1990, there has been a generalised slowdown in economic growth, particularly in the EC. Ireland, as was shown above, has participated in this slowdown. Notwithstanding this. Table 2.2 shows that the Irish economy has continued to outperform other EC and OECD economies. Ireland's growth rate of 4.3% in 1991 and 3.9% in 1992 compares with average growth for the EC of only 1.4% and 1.1% respectively in those years, and was achieved at a time when our principal market, the UK, was in recession. Many of the main continental economies, including France and Germany, moved into recession into 1993 pulling the average growth rate for the EC down to an estimated decline of 0.4% this year. Significantly for Ireland, the UK economy is out of phase with this general European cycle and has begun to move slowly *out* of recession just as other EC economies have begun to slowdown. Ireland has benefited from this lack of synchronisation, with recovery in the important UK market partly offsetting the contraction in continental markets. Against the background of weak international demand and slow (but positive) growth in the UK market, Ireland's expected growth rate of 1.75% in 1993 represents a creditable performance.

TABLE 2.2

GDP GROWTH
% Change per Annum (Volume)

	1986-1990	1991	1992	1993(e)
Germany	3.4	3.7	2.0	-1.9
United Kingdom	3.0	-2.2	-0.6	1.8
France	3.2	0.7	1.3	-0.7
US	2.6	-1.2	2.1	2.6
OECD	3.3	0.7	1.5	1.2
EC	3.3	1.4	1.1	-0.4[1]
Spain	4.8	2.3	1.0	-0.6
Portugal	4.7	2.2	1.4	0.6
Greece	1.7	1.8	1.4	1.1
Ireland (GNP)	5.5	4.3	3.9	1.75

1 European Economy. No. 6/7. June/July 1993.

Source: OECD (1993) Economic Outlook No. 53. Irish data as for Table 2.1.

2.2 Employment

Ireland's labour market performance deteriorated in 1990-1992, following a number of good years in the late 1980s. During the period 1987-1990, total employment in Ireland grew by an average of 15,300 per annum. Since 1990, however, the level of employment has remained stable. Unemployment, meanwhile, has risen substantially (by an average of 23,000 per annum), reflecting the very rapid growth in the labour force during 1991 and 1992. The latter, in turn, was prompted by a sudden cessation of emigration, which had previously been running at very high levels. These facts are set out in Table 2.3.

TABLE 2.3

Annual Average Changes in Employment, Unemployment, Labour Force and Net Migration
(000s)

	Employment	Unemployment	Labour Force	Net Migration
1987-90	+15.3	-17.7	-2.3	-36.3
1990-92	+0.0	+23.0	+23.0	+0.5

Source: CSO. Labour Force Survey.
CSO. Census of Population 1986 and 1991 (preliminary results).
CSO. Monthly Economic Series.

The prospects for 1993 are for a modest increase in the level of employment, of the order of 4,000 to 5,000. Growth in public and private services will be partly offset by a decline in agricultural employment. Some decline in industrial employment is expected, reflecting a fall in employment in the construction industry and a modest drop in manufacturing employment.

Unemployment continued to rise in the first seven months of 1993, reflecting the lack of employment growth and the continued growth of the labour force. There has however been a marked deceleration in the rate of increase in the live register, and the August figures showed a fall in the numbers unemployed. The improved trend in unemployment reflects a resumption of emigration over the past twelve months. This in turn has been facilitated by the stronger than expected recovery in the UK economy and the associated decline in UK unemployment.

While the overall *level* of employment was stable in 1991 and 1992, there were substantial changes at sectoral level, as shown in Table 2.4.

Employment in *agriculture, forestry and fishing* fell by an average of 8,500 per annum over the two years. This marked a resumption of the secular decline in agricultural employment, which had temporarily abated during 1987-1990. The drop in agricultural employment in 1990-1992 was above the long-run trend and may have included an element of "catch-up", following the unexpected stability recorded in the preceding period. An indication of the underlying trend in agricultural employment is obtained by considering the results for the period 1987-1992 as a whole. This shows an average decline in agricultural employment of 2,800 per annum over the five year period.

Employment in *industry* declined by an average of 2,000 p.a. in 1990-1992. The decline was concentrated in building and construction, and in mining, quarrying and turf production. *Manufacturing* employment was stable. The overall trend in manufacturing employment has been influenced for some years now by the increasing tendency for firms to contract out many of their service activities (eg. security, catering, cleaning, etc.). This has resulted in jobs which were previously classified as manufacturing being recorded under service sector employment.

The level of *services* employment continued to grow in 1990-1992, by an average of 10,000 per annum. This was *higher* than the growth in services employment over the period 1987-1990 (7,700 p.a.). The composition of services employment growth has also changed. During 1987-1990, public sector employment was declining by over 6,000 per annum so that the overall increase in services employment reflected strong growth in private services. By contrast, over the period 1990-1992, public service employment increased by 3,300 per annum, so that the contribution of private services was lower.

The overall increase in *non-agricultural employment* in 1990-1992 was 8,000 per annum. This was somewhat below the long-run trend in non-agricultural employment growth of 10,000 per annum[2]. The above-average decline in agricultural employment in these two years served to further depress the growth of *total* employment.

2 See NESC Report No. 94 (1992b).

TABLE 2.4

Annual Average Change in Employment (000s)

	1980-87	1987-90	1990-92
Agriculture, Forestry & Fisheries[1]	-6.4	+1.0	-8.5
Industry:	-10.1	+6.7	-2.0
Manufacturing	-5.6	+5.0	0.0
Building & Construction	-4.6	+1.7	-1.0
Utilities & Mining, Quarrying & Turf	0.0	0.0	-1.0
Services:	+5.7	+7.7	+10.0
Commerce, Insurance & Finance	+1.6	+4.0	+3.5
Transport & Communications	-0.6	+0.7	0.0
Public Admin. & Defence	-0.1	-2.0	+2.0
Other Services	+4.9	+5.0	+4.5
Total Public Services (Whole Time Equivalents)	-1.4	-6.6	+3.3
Total Non-Agricultural Employment	**-4.4**	**+14.3**	**+8.0**
Total Employment	**-10.9**	**+15.3**	**0.0**

1 A more accurate indication of the underlying trend in employment in Agriculture, Forestry and Fishing is given by looking at the results for 1987-1992 as a whole. This shows an average decline in employment of 2,800 per annum over the five year period.

Source: CSO, Labour Force Survey. Public Services figures from Department of Finance. Note that the definition of public service employment (whole time equivalents) differs from the Labour Force Survey definition (numbers).

Table 2.5 shows that Ireland's experience of maintaining stable employment since 1990 compares favourably to many other countries, although relative to Ireland's *growth rate*, the employment performance has been disappointing[3]. Employment in the EC fell by 1.2% in 1992, and a further decline of 1.7% is expected this year. The United Kingdom, in particular, has experienced a very sharp decline in employment, with the total numbers at work down by an estimated 7.3% over the period 1990-1993. France, Germany and Spain have also recorded a reduction in employment since 1992. The recent decline in employment in a number of European countries

3 It does, however, reflect the composition of output growth and the consequential trend in productivity.

has partly offset the strong gains in employment recorded during the late 1980s.

TABLE 2.5

Change in Employment in Selected Countries
1987-1992
% Change per Annum

	1987-1990	1991	1992	1993(e)
Germany	1.8	2.6	-1.7	-2.4
United Kingdom	2.1	-3.2	-2.9	-1.2
France	1.1	0.1	-0.5	-1.0
US	1.6	-0.9	0.6	1.1
OECD	1.7	0.0	-0.1	-0.1
EC	1.7	0.3	-1.2	-1.7[1]
Spain	3.2	0.2	-1.9	-4.6[1]
Portugal	2.3	3.0	0.8	-1.5[1]
Greece	0.9	-1.3	1.9	0.0[1]
Ireland	1.4	0.0	0.0	0.4

1 European Economy No. 6/7. June/July 1993

Source: CSO Labour Force Survey and OECD Economic Outlook, No. 53. June 1993. Secretariat estimate for Ireland in 1993.

2.3 Investment

Table 2.6 shows the changing pattern of investment since 1986. Over the period 1986-90, the volume of investment grew rapidly, at an average annual rate of 5.3%. The annual growth rate of the volume of investment in machinery and equipment, at 6.5%, was somewhat greater than the 4.2% rate recorded for building and construction. In contrast to its performance in the four years up to 1990, the trend in investment over the past three years has been very weak. Total investment fell significantly in volume terms in 1991 (by 7.3%). A further real decline was experienced in 1992 (-1.9%) and, although some recovery is expected this year, the rate of growth will be modest, at around 1.25%. The marginal volume increases in building and construction investment in 1991 and 1992 were completely outweighed by sizeable reductions in machinery and equipment investment, especially during 1991. The expectation this year is for a resumption of modest (but positive) growth in machinery and equipment investment, accompanied by

further slow growth in building and construction. Investment in the construction sector has been boosted this year by EC-funded construction projects in the public sector. These are expected to offset an anticipated decline in the volume of private sector construction, allowing overall investment activity to register a small increase.

TABLE 2.6

Gross Fixed Capital Formation
1986-1994
Annual Percentage Change (Volume)

Category	1986-90	1991	1992	1993[1]
Building & Construction	4.2	0.6	0.3	1.0
Machinery & Equipment	6.5	-15.2	-4.4	1.5
Total	5.3	-7.3	-1.9	1.25

Source: National Income and Expenditure. 1992; Secretariat estimates for 1993.

Table 2.7 provides a view of the relative shares of the residential (private and local authority) and non-residential sectors in new construction output for the years 1990-1993. As can be seen, the non-residential sector of the industry currently accounts for just under 60% of new construction output, with the bulk of the remaining output being produced in the private residential sector. However, the non-residential share of activity has fallen somewhat since 1990, while private house-building has increased in significance. Local Authority house-building, although very small in comparison with total construction output, is forecast to register an increase of over 60% in output value in 1993.

TABLE 2.7

Sectoral Shares in New Construction Output (%)

	1990	1992	1993[1]
Residential New Construction			
— Private	34.3	39.8	38.8
— Local Authority	1.1	1.8	2.7
Non-Residential			
— New Construction	64.6	58.4	58.5

1 Forecast.

Source: Department of the Environment.

Under the non-residential heading, significant increases in output value are forecast for 1993 in the case of both road construction (26%) and water and sanitary services (52%). The semi-state bodies are also expected to undertake significantly higher construction investment in 1993, expanding their outlays by around 33%.

TABLE 2.8

Gross Fixed Capital Formation and Non-Residential Construction as a Percentage of GDP

Country	GFCF 1992	NRC 1990
Netherlands	20.6	5.7
France	20.0	6.3
Germany	23.5	5.8
Belgium	19.9	5.6
Italy	19.4	5.1
Greece	17.5	6.0
UK	15.6	7.2
Ireland	15.9[1]	5.5
Denmark	15.6	5.9
Spain	22.6	10.6[2]
Luxembourg	29.7	8.7[2]
Portugal	25.1	8.4[2]
EC	19.8	6.5
Japan	31.1	12.4
USA	15.4	4.4[1]

1 Using GNP rather than GDP as the denominator, the figure for Ireland in 1992 would be 17.8%.

2 1989 Figure.

Source: OECD Historical Statistics, 1960-1990 and, European Economy No. 54, Annual Economic Review 1993, Table 20, p. 201.
Irish data on gross fixed capital formation: National Income and Expenditure, 1992.

In considering Ireland's investment performance over the previous number of years, it is useful to adopt a comparative perspective on investment shares and recent growth rates. Table 2.8 provides a cross-country comparison of the shares in GDP of both Gross Fixed Capital Formation and non-residential

construction investment. A number of features emerge from an analysis of these data. First, as a proportion of GDP, total Irish investment expenditure in 1992 was roughly four percentage points below the EC average, and significantly below the ratios for Luxembourg, Portugal, Germany, and Spain. During the period 1981-1990, Irish gross fixed capital formation represented on average a slightly higher proportion of GDP than in the EC as a whole. However, in 1986, Irish investment expenditure began to decline in relation to GDP, falling below the EC average. Second, although Ireland's non-residential construction investment share in GDP does not diverge markedly from the EC average, it is significantly below the ratios for Luxembourg and two of the late-developing EC economies, Spain and Portugal. For example, the share of Irish non-residential construction investment in GDP, 5.5%, compared with a figure for Spain of 10.6% and a figure for Portugal of 8.4%. A third feature to emerge from Table 2.8 is the comparatively low figures for total and non-residential construction investment, 15.4% and 4.4% respectively, in the United States.

2.4 Sectoral Developments

Manufacturing Industry

In view of the major influence of the manufacturing sector on overall economic growth in Ireland, it is worth examining recent trends in this sector in some detail. Because of the major differences which exist between different categories of manufacturing industry, we will distinguish between four broad categories:

(a) *Leading Sector*: This section consists of rapid-growth, export-oriented firms, the vast majority of which are multinational companies operating out of Ireland. It includes most of the chemicals sector, office and data processing, electrical engineering, instrument engineering and other foods. It accounted for 29.8% of total manufacturing employment in 1992 (57,400 employees).

(b) *Primary Food*: This section includes firms engaged in the primary processing of agricultural produce. Output growth is linked to the growth in the volume of agricultural output. The sectors included are meat, dairy and grain milling. These three sectors employed 20,300 persons in 1992, representing 10.6% of manufacturing employment.

(c) *Naturally Protected Industries*: This includes non-metallic minerals, metal articles, mechanical engineering, wood and furniture, paper and printing and drink and tobacco. Total employment in these industries amounted to 58,800 in 1992 (30.6% of manufacturing employment). These industries benefit from some degree of natural protection in the domestic market. This natural protection is not absolute and will tend to fall over time. In the case of highly fragmented activities such as simple metal fabrication, carpentry, welding and pressing of steel, and paper and printing, some degree of protection is afforded by the need to be located close to the final purchaser and to respond to particular customer requirements. Drink and tobacco is included on the basis that the Irish market has traditionally been dominated by a few, large firms who had considerable market power. This may be changing with the rapid internationalisation of Ireland's drinks industry in recent years.

(d) *Internationally Traded Industries:* The remainder of the manufacturing sector comprises internationally-traded activities which are highly exposed to international competition. The principal industries in this sector are textiles, clothing and consumer foods.

Table 2.9 shows annual output growth in manufacturing industry over the period 1987-1993, distinguishing between trends in the four main categories of industry. Overall manufacturing output grew strongly in the late 1980s, with average growth of 11.5% per annum in 1987-1989. This growth was driven by the very rapid growth of output in the leading sector, but was supported crucially by the solid performance of the largely Irish-owned 'other industry' sector. Output in the 'naturally-protected' segments of manufacturing industry grew by an average of 5.8% p.a. during 1987-1989, reflecting the strong growth of domestic demand at that time. The internationally-traded' segment also contributed to growth, with average output growth of 3.2% per annum.

The years since 1990 have been much less buoyant for manufacturing industry than the late 1980s. Manufacturing output growth slowed considerably in 1990 and 1991 (to an average of 3.9% per annum) before recovering in 1992 to 10.2%. Output growth in the first six months of 1993 was up 6.9% on the same period of 1992. The out-turn for the year as a whole is likely to be somewhat similar, in the region of 6.5-7.0%. The overall trend in manufacturing output growth is dominated by trends in the performance of the leading sector. From the point of view of gauging the competitiveness of Irish industry or assessing the health of the domestic economy, however, it is the performance of the 'Other Industry' segment which is of most

interest. Here, the data identify 1991 as a 'low-point' of recent performance, with a substantial decline (-3.2%) in the output of internationally-traded industries and the stagnation (+0.2%) of the 'Naturally-Protected' segment. There was some improvement in performance in 1992, although growth remained very subdued (+0.9%) in the internationally-traded segment. The evidence to date for 1993 points to further declines in output in both categories of 'Other Industry' this year.

TABLE 2.9

Output Growth in Manufacturing Industry
% Change per Annum (Volume)

	1987	1988	1989	1990	1991	1992	1993[1]
Leading Sector	23.7	21.5	15.7	5.1	4.7	16.3	10.5
Primary Food	0.7	-2.0	3.0	10.3	5.5	3.9	2.5
Other Industry							
— Naturally Protected	2.0	5.5	9.9	2.5	0.2	2.2	-0.5
— Internationally Traded	1.8	5.3	2.5	4.6	-3.2	0.9	-1.0
Total Manufacturing	**10.4**	**12.3**	**11.7**	**4.7**	**3.2**	**10.2**	**6.9**

1 First six months of 1993.

Source: Secretariat calculations from CSO, Industrial Production Index. For details of categories used, see text.

Manufacturing employment increased each year from 1987-1991, reversing the pattern of continuous decline which had begun in 1981 (see Table 2.10). The Leading Sector has been the main source of net employment creation, with employment consistently increasing in this sector each year, from 45,200 in 1987 to 57,400 in 1992 (+27%). Employment in the Primary Food sector has been broadly stable since 1987, at around 20,000. In 'Other Industry', both the Naturally Protected and Internationally Traded sectors experienced net gains in employment in 1989 and 1990, the first time in many years that this has occurred. Since 1991, however, employment in 'Other Industry' has once again begun to decline, reflecting the slowdown in output growth in these segments after 1990.

Agriculture

The evolution of key indicators for the agricultural sector is set out in Table 2.11 below. Over the six years 1986-1992, gross agricultural output (GAO) grew at a modest rate of 2.9% per annum. The volume of inputs grew at a slower annual rate of 1.0%, so that the growth of gross agricultural product (GAP) which is an indication of real value-added for the agricultural sector, grew at quite a strong rate of 4.5%. The rate of output growth in 1990-1992 was *below* this six year average: GAO grew by an average of 2.8% per annum in these two years, while GAP grew by 3.8% per annum over the same period.

TABLE 2.10

Employment in Manufacturing Industry
(000s)

	1987	1988	1989	1990	1991	1992
Leading Sector	45.6	48.0	50.9	53.3	55.7	57.4
Primary Food	20.0	19.9	19.7	20.2	20.6	20.3
Other Industry:	116.7	115.1	116.9	118.6	117.0	114.6
— Naturally Protected	(58.5)	(57.9)	(59.3)	(60.4)	(59.7)	(58.8)
— Internationally Traded	(58.2)	(57.2)	(57.6)	(58.2)	(57.3)	(55.8)
Total Manufacturing	**182.4**	**182.8**	**187.0**	**191.8**	**192.7**	**192.2**

Source: CSO, Industrial Employment Series. For details of categories used, see text.

TABLE 2.11

Evolution of Key Indicators for the Agricultural Sector
1986/87 — 1991/92

	Percentage Change						Annual Change	
	1986-87	1987-88	1988-89	1989-90	1990-91	1991-92	1986-90	1990-92
Vol. of Gross Agricultural Output	1.1	1.8	2.2	7.4	0.4	4.9	3.1	2.6
Vol. of Inputs	-3.6	1.0	5.5	1.5	0.8	1.1	1.0	0.9
Vol. of Gross Ag. Product	5.7	2.6	-0.7	12.9	0.1	7.6	5.0	3.8
Output Price Index	4.0	10.5	5.0	-11.3	-3.2	3.0	1.7	-0.3
Input Price Index	-4.7	2.7	5.4	0.2	0.3	0.2	0.9	0.2
Terms of Trade	9.2	7.5	-0.4	-11.5	-3.4	2.8	0.8	-0.4
Real Farm Income	17.9	16.0	0.9	-4.8	-11.7	15.5	7.1	1.0
Real Direct Payments	2.4	21.8	-4.6	71.7	-14.8	16.7	19.6	-0.3

Source: Secretariat calculations based on Department of Agriculture, Compendium of Irish Economics and Agricultural Statistics and 1992 Annual Review and Output.

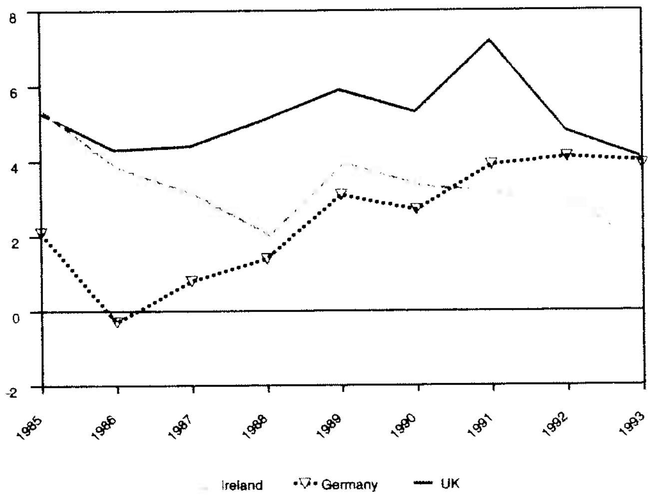
Real agricultural incomes fell substantially in 1990 and, in particular, in 1991. There was a substantial recovery in 1992, however, and the prospects for 1993 are for further growth in real agricultural incomes, reflecting a rise in activity levels and favourable terms of trade effects following the Green Pound devaluation in February of this year.

2.5 Inflation

Ireland's status as a low-inflation economy has gained further credibility over the past three years. Inflation eased back slightly from 3.4% in 1990 to 3.0% in 1992, remaining below both the EC and OECD averages. Within the EC, Irish inflation has been below the UK rate for some years now and, since 1990, it has also fallen below the German rate (see Figure 2.1).

FIGURE 2.1

Irish, German and UK Inflation



Source: Irish data: CSO. Secretariat estimate for 1993.
Other Countries: European Economy, No. 6/7, June/July 1993.

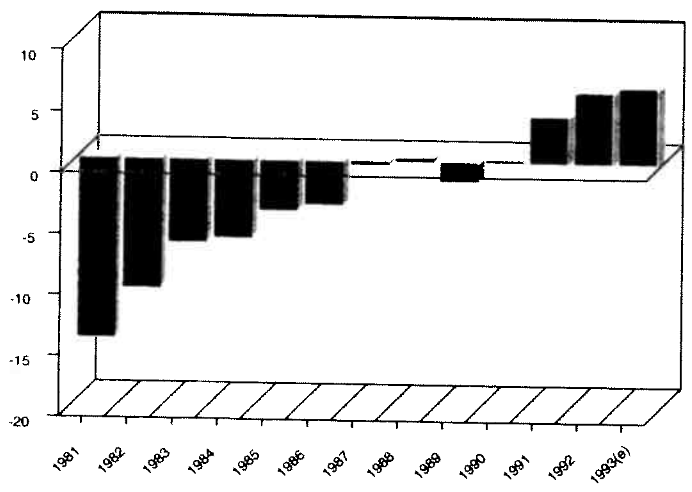
Inflationary pressures have remained subdued in 1993, and the average rate of inflation for the year now seems likely to stand at around 1.6%. The pressure on prices which might have been expected to follow the end-January devaluation of the pound has so far been muted. In addition, a number of offsetting factors have served to dampen prices in the economy, in particular the substantial reduction in interest rates in the first half of the year. It is likely, however, that there will be some acceleration in inflation over the balance of the year and into 1994 as the effects of the Irish pound's depreciation feed through.

2.6 Balance of Payments

Since 1990, Ireland has been running a large and growing surplus on the current account of the balance of payments. The surplus amounted to £1.5 billion in 1992 (5.8% of GNP), and some further increase is expected this year. This movement of the balance of payments into strong surplus represents the culmination of a trend of falling deficits evident since 1981 (see Figure 2.2).

FIGURE 2.2

Current Account Balance
1981-1993
% of GNP



Source: CSO National Income and Expenditure 1992. Secretariat estimate for 1993.

The current account can be decomposed into three main elements: (i) Goods and Services Balance (ii) Factor Incomes and (iii) International Transfers.

Table 2.12 shows how each of these elements has evolved over the past six years.

TABLE 2.12

Balance of Payments
(£ Million)

	1987	1988	1989	1990	1991	1992
Goods and Services	1174	1713	1777	1602	1821	2953
Factor Incomes	-2112	-2662	-3233	-3131	-2865	-3158
International Transfers	879	1011	1108	1567	1969	1740
Current Account Balance	-60	62	-348	37	925	1535
- As % GNP	(-0.3)	(0.3)	(-1.6)	(0.2)	(3.7)	(5.8)

Source: CSO, National Income and Expenditure 1992.

Ireland has a large surplus in *goods and services*, estimated at £3 billion in 1992. A major factor contributing to this surplus is the very strong export performance of the multinational sector. This has its counterpart in a high level of profit repatriations and associated outflows of royalties and dividends. The Council has previously noted[4] that, because of the significance of these countervailing flows in Ireland's balance of payments, outflows of profits, royalties and dividends may need to be netted off in order to show the underlying state of Ireland's trading balance. This is done in Table 2.13 and shows that, when profit outflows are deducted, the surplus on goods and services is turned into a deficit in each year except 1992.

Factor Incomes constitute a large deficit item in Ireland's Balance of Payments. The largest element of factor incomes is the outflows of profits, royalties and dividends which were discussed above. A second, major debit item in this category is interest payments on the national debt. These amounted to £940 million in 1992.

International transfers constitute an important positive element in the current account. The main receipts here are monies received from the EC, including both current and capital payments made under FEOGA, the ESF and the ERDF. With a net value of £1.7 billion in 1992, these transfers are large in

4 NESC No. 89, p.127

relation to the Irish economy (6.6% of GNP in 1992). Their value in 1992 was greater than the overall surplus on current account.

TABLE 2.13

Impact of Profit-Outflows on Ireland's Trading Balance

	£ Million					
	1987	**1988**	**1989**	**1990**	**1991**	**1992**
Balance on Goods and Services **net** of outflows of profits, royalties, dividends etc.	-268	-380	-787	-905	-556	+218

Source: CSO, National Income and Expenditure 1992.

Honohan (1993) has explored the reasons for the movement of the current account of the balance of payments from a large deficit in 1981 to substantial surplus in 1992, using a flow of funds approach. He finds that change in the fiscal behaviour of government played a role, but that the private sector also had an important influence. In particular, he notes that business savings (retained earnings) have increased without a corresponding increase in business investment in Ireland. Most of the increased business savings of the last few years appears to have gone into the acquisition of foreign assets.

2.7 Overview of Economic Performance 1990-1993

Economic growth slowed after 1990 following a period of rapid growth in the late 1980s. The slowdown in 1991 and 1992 was relatively modest, but was accompanied by a substantial change in the composition of growth and a narrowing of its base. The most significant change in these years was the sharp deterioration in the performance of domestic demand: domestic demand grew by an average of 3.4% per annum in 1986-1990, making an important contribution to the strong growth of that period. In 1990 to 1992 by contrast, domestic demand slowed considerably to an average of 0.9% per annum, so that the impetus for growth came predominantly from the external sector. The performance of the economy in 1993 points to a substantial reduction in the growth rate this year to about 1.75%. The impact of this slowdown on the real economy will be alleviated somewhat by a resumption of somewhat faster growth in domestic demand, of around 2.5%. The growth of export volumes in 1993 will be significantly down on recent years (c.4%), reflecting the difficult international environment.

The reduction in economic growth and, in particular the slowdown of growth in domestic demand in 1990 to 1992, was reflected in a weakening of Ireland's labour market performance. The level of total employment remained stable, but unemployment rose sharply reflecting a substantial increase in labour supply following the cessation of emigration. The latter reflected the down-turn in the UK economy and the closing off of job opportunities overseas. The resumption of emigration in 1993, as the recovery in the UK began to take hold, has arrested the increase in the live register. Employment levels could increase slightly in 1993, by perhaps 4,000 to 5,000.

Overall, the first three years of the 1990s have proved difficult ones. Ireland did well to secure economic growth of around 4% per annum in 1991 and 1992, in the face of a slowdown in international growth rates and a recession in our main market, the UK. The structure of growth was not, however, conducive to increasing employment. In 1993, Ireland's expected growth rate of 1.75% will again compare favourably with other EC countries, and the structure of that growth will be more broadly-based. The absolute *level* of growth in 1993 will, however, be below that which would be required to secure any significant increase in employment and is considerably below the potential, non-inflationary growth rate of the Irish economy, which now appears to stand in the region of 5%.

3. THE CONDUCT OF ECONOMIC POLICY

In 1990, the Council's rejection of the evolution of the economy under the assumption of no policy change caused it to propose a new strategy of economic and social development. This strategy comprised three broad, mutually-supportive components:

(i) a consistent economic strategy for budgetary, monetary and exchange rate policy designed to achieve the continuation of economic stability;

(ii) a continuation of the consensus on income developments of the previous three years to provide improvements in competitiveness and to resolve distributional conflicts without disruption to the functioning of the economy;

(iii) a programme of structural reform covering industrial and agricultural policy, manpower policy, tax and social welfare reform, reform of the public sector, and changes in health and education policy designed to: (a) improve the economy's internal efficiency, enhance international competitiveness and overcome barriers to long-run development; and (b) obtain fundamental reform of policies which generate social inequalities while minimising any adverse economic impact (NESC, 1990).

The Council believes that these remain the essential ingredients in a strategic approach to boosting growth in the economy and achieving the rapid expansion of sustainable employment, which must be the over-riding objective of public policy. The implementation of such a strategy can be assisted by an analysis of past performance. The purpose of this brief review, therefore, is to examine the extent to which the evolution of policy since 1990 has been consistent with the principles outlined by the Council. A more detailed examination of progress towards achieving these strategic goals, especially the issue of structural reform (the third strand), will be provided in the later individual chapters on these subjects.

3.1 Fiscal, Monetary and Exchange Rate Policy

(i) Fiscal Policy

National Debt/GNP Ratio

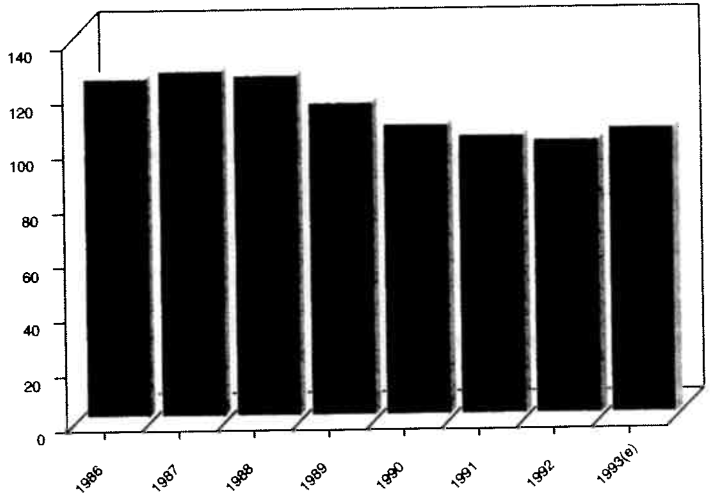
In *A Strategy for the Nineties* the Council argued that a key target for fiscal policy must be to reduce Ireland's debt/GNP ratio from the then level of 106%[5] in 1990) to around 100% by 1993. It argued that this reduced debt/GNP ratio would enhance the flexibility of the budgetary system, reduce its vulnerability to external shocks (such as interest rate changes) and protect the medium-term growth potential of the economy.

The evolution of the debt/GNP ratio over the period 1983-1993 is shown in Figure 2.3. The Council's target of reducing the debt/GNP ratio to 100% was met in 1992. Some *increase* in the ratio is expected in 1993, reflecting the rise in the Irish pound value of the national debt following the devaluation of January 1993. This is a once-off adjustment and is not necessarily a cause for concern. The circumstances of the January devaluation were such that, over time, the devaluation is likely to lead to GNP being higher than it otherwise would be. This will help to correct the initial rise in the debt/GNP ratio.

5 At the time of writing A Strategy for the Nineties, the debt/GNP ratio was understood to be in the region of 111%. Subsequent revisions to the national accounts by the CSO brought the ratio down to 106%.

FIGURE 2.3

National Debt/GNP Ratio — 1986-1993



Source: Finance Accounts

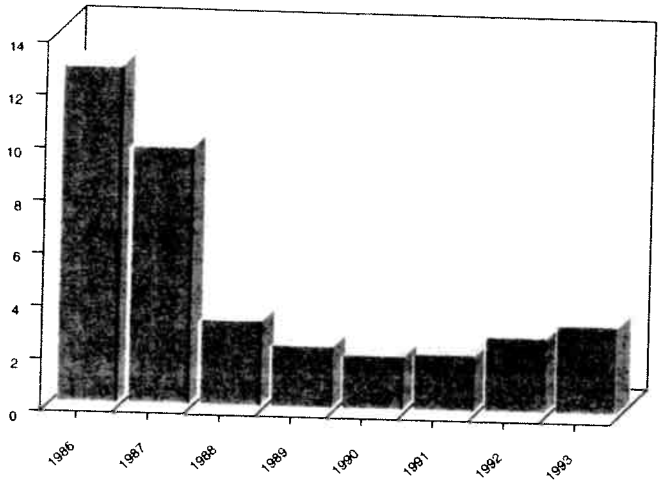
Exchequer Borrowing Requirement

After declining sharply during the late 1980s, the Exchequer Borrowing Requirement (EBR) has increased slightly in the past two years. In 1992 the EBR was 2.7% of GNP, up from 2.0% in 1991. The budget target is for an EBR of 2.8% of GNP in 1993.

Regarding the computation of the budgetary balance, the Council has emphasised that receipts from privatisation do not alter the fundamental budgetary position. Consequently the Council recommended that such receipts should not form part of the budgetary arithmetic ie. they should be kept off budget (NESC, 1990). This principle was followed with respect to the receipts from the flotation of Irish Life. It has not been followed for other privatisation receipts. In particular, the 1993 budgetary arithmetic includes £150 million from the sale of State assets. These receipts have been used to reduce the recorded EBR. If the EBR is adjusted to reflect this, the target EBR becomes 3.3% in 1993.

FIGURE 2.4

Exchequer Borrowing Requirement
% of GNP



Note: 1988 EBR includes once-off tax receipts from tax amnesty.
1991 figure is exclusive of Irish Life flotation receipts (£270 million).
1993 figure is exclusive of privatisation receipts.

Source: Budget Booklets.

Expenditure

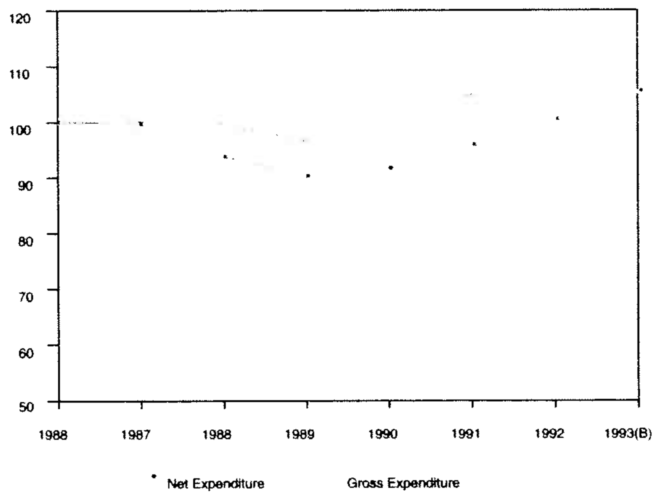
The Council recommended that there be no real increase in current public expenditure for the years 1991 to 1994[6]. Figure 2.5 shows the trend in current spending over the past eight years. Current spending fell in real terms from 1986 to 1989. It increased slightly in 1990 and has since begun to rise at an accelerating rate. The overall increase in the volume of gross current government spending between 1990 and 1993 is estimated at 4.9% per

6 Technically, the appropriate deflator for calculating real changes in public expenditure would be a weighted average of the PANCE deflator (public authorities net current expenditure on goods and services) and the CPI. The PANCE deflator has been rising faster then the CPI in recent years and a real increase in public spending based on the PANCE deflator would thus be lower than that calculated using the CPI. However, the faster rise in the PANCE deflator itself largely reflects the fact that public sector pay per head had been rising faster than the CPI in recent years. The Council therefore considers it appropriate to use the CPI deflator in assessing the *real* (ie. inflation-adjusted) trend in public expenditure.

annum, while net current expenditure grew by 4.8% in real terms compared to a real decline in expenditure between 1986 and 1990[7]. Current public expenditure has also risen as a percentage of GNP, increasing from 36.8% of GNP in 1990 to an estimated 39.3% in 1993. The factors underlying this growth in public expenditure are discussed in detail in Chapter 5 on Fiscal Policy.

FIGURE 2.5

Current Government Expenditure
1986-1993
Volume Index (1986=100)



Note: There is a discontinuity in the series for net expenditure due to a classification change concerning the Local Loans Fund in 1988. This resulted in a downward adjustment of around £300 million in recorded net expenditure in 1988.
1993 figure based on budget estimate for 1993 deflated by the estimated inflation for the year (1.6%).

Source: Department of Finance figures deflated by CPI.

Overall, fiscal discipline has not been as tight over the past three years as it was during the late 1980s, when sharp real reductions in public expenditure were implemented to reverse the rise in the debt/GNP ratio. The debt/GNP

7 Net current expenditure is defined as gross current expenditure minus PRSI receipts and Appropriations-in-Aid. The latter include ESF receipts.

ratio was reduced to 100% in 1992. Despite a rise in 1993, the underlying trend remains downwards, but the pace of adjustment has slowed considerably. In addition, the EBR has started to drift upwards and current public expenditure has grown substantially in real terms.

(ii) Exchange Rate and Monetary Policy

In 1986, the Council set out an exchange rate strategy for Ireland[8]. This position was subsequently reaffirmed in *A Strategy for the Nineties*. The Council supported the policy of maintaining the nominal value of the punt within the narrow band of the ERM. It favoured an explicit non-accommodating exchange rate policy which it believed would create expectations of a stable currency and thereby allow Irish interest rates to converge to (lower) international levels.

The Council defined a non-accommodating exchange rate strategy as one where the nominal exchange rate is held constant irrespective of the evolution of domestic costs relative to those in our main trading partners. If domestic costs rise but receipts in foreign currency terms remain fixed, the internationally-traded sector will suffer a decline in its terms of trade with the non-traded sector and a loss of competitiveness. The essence of a non-accommodating strategy is that such higher costs will *not* be offset by devaluing the currency.

Rejection of an accommodating strategy does not however imply that exchange rate policy has no role to play in protecting the competitiveness of the internationally trading sectors of the economy. The Council has previously argued that "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 exchange rate". (NESC, 1986, p.177). The distinction here is between, on the one hand, using the exchange rate to accommodate excessive domestic cost increases and, on the other hand, allowing the exchange rate to change in response to changes in *external* cost structures. The Council was opposed to the former but acknowledged that there were circumstances where the latter was justifiable.

Up until 30 January, 1993 the nominal value of the pound was maintained within the EMS, in line with the policy supported by the Council. This policy was associated with a narrowing of the gap between Irish and German interest

8 See NESC No. 83, *A Strategy for Development 1986-1990.*

rates and a reduction in Irish inflation rates to below German levels in the period up to mid-September 1992. However, pressure on the currency in subsequent months, prior to the devaluation of the Irish pound within the ERM, was such that differentials between Irish and German short-term interest rates at times reached very high levels.

On 30 January, 1993 the Irish pound was devalued by 10% against its central ERM rates. This followed a period of extreme instability in international money markets and foreign exchange markets, which had begun to emerge in the Summer of 1992 following the Danish rejection of the Maastricht Referendum. The pressure for devaluation did not arise from excessive growth in domestic costs. It reflected a general problem within the EMS that interest rates, determined largely by German monetary policies, were inappropriate for domestic conditions in most member States. There was a further, particular factor in the Irish context, namely the perception that the effective appreciation of the Irish pound against sterling was not sustainable, because of the continued high dependence of much of indigenous Irish industry on the UK market. The fact that Sterling's fall was so sharp and sudden made it difficult to adjust other economic policies to accommodate the new levels of the Irish pound. From the second quarter of 1992 to January 29, 1993 the nominal effective trade weighted index of the Irish pound appreciated by 7.5% (see Table 2.14). On the week ending February 5, (following the devaluation) the effective trade index had returned to the level of the second quarter of 1992. Since then, the index has depreciated by about 4%, to stand at 64.7 on 1 October, 1993.

TABLE 2.14

Irish Pound Nominal Trade Weighted Effective Index
1971 = 100

Second Quarter 1992	67.63
Week ending January 29, 1993 (pre-devaluation)	77.72
Week ending February 5, 1993 (post-devaluation)	67.40
Week ending October 1, 1993	64.66

Source: Central Bank.

The evolution of the trade-weighted index of the Irish pound in the immediate aftermath of the devaluation suggests that the role of the devaluation was to prevent an appreciation in the nominal effective exchange rate. As such it was not inconsistent with the principles of exchange rate policy developed by the Council in Strategy for Development.

The persistence of tensions within the EMS led to a substantial widening of the ERM bands in August 1993. This development requires a reappraisal of the options for Irish exchange rate strategy, which is provided in Chapter 6.

3.2 Income Developments

The Council in 1990 formulated three principles which it considered should inform income developments:

(i) the evolution of incomes in a way which is consistent with gains in competitiveness;

(ii) resolution of distributional conflicts without disruption to the functioning of the economy; and

(iii) according priority to the task of increasing employment over improving living standards.

The following section examines the evolution of incomes to see to what extent it has been consistent with each of these principles.

(i) Competitiveness

Competitiveness is determined by a range of factors, both cost and non-cost based. In the medium to long-term, sustained competitiveness in the global economy depends increasingly on technological or innovation-based strengths. This trend is discussed in Chapter 4, and again in Chapter 8 where the focus is on the requirements for an improved performance by indigenous manufacturing industry. Both chapters emphasise the crucial importance of non-cost factors such as product and process development, management, marketing and design in providing a sustainable basis for long-term growth. In the short-term, however, conventional cost competitiveness continues to be an important influence on economic performance and it is this which is reviewed here.

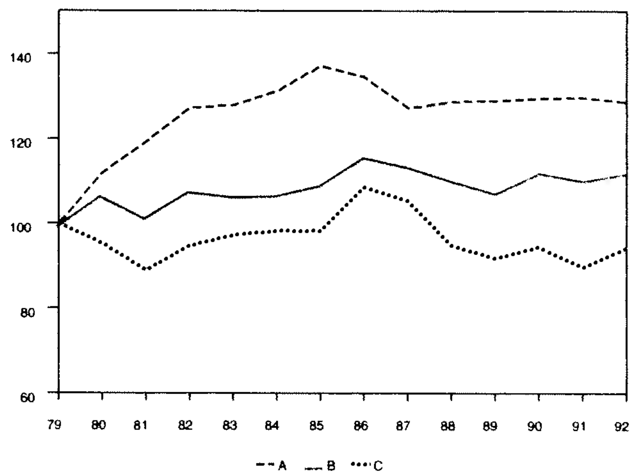
The usual way of measuring cost competitiveness is to measure changes in labour costs in money terms allowing for exchange rate differences, i.e. labour costs in common currency terms. While measuring unit labour costs takes account of productivity gains this is not an appropriate indicator of

competitiveness for Ireland because (i) movements in unit wage costs are dominated by the high productivity multinational sector in Ireland; and (ii) improvements in productivity and hence gains in unit labour costs can be achieved by reductions in employment. A reduction in employment due to a *loss* in competitiveness may not in fact show up as a loss of competitiveness, when measured by unit labour costs.

FIGURE 2.6

Index of Competitiveness (Hourly Earnings in Manufacturing in Common Currency Terms) for Ireland

1979=100



A = Relative to EMS narrow-band
B = Relative to MTP
C = Relative to UK

Note: An increase implies a loss of competitiveness for Ireland, a decrease implies a gain in competitiveness.

Source: OECD and Department of Finance.

Figure 2.6 charts the trend in Ireland's competitiveness from 1979-1992 relative to our main trading partners, the EMS narrow-band economies and the UK. Over the period as a whole, competitiveness *fell* relative to our main trading partners and, in particular, relative to the EMS narrow-band countries. It rose slightly against the UK. Within this long-run picture, a marked difference is apparent between the generalised loss of competitiveness in the first half of the 1980s and the significant improvements in competitiveness after 1986. More recently, 1990 and 1992 saw a renewed loss of competitiveness against Ireland's main trading partners and, among them, against the UK. Although these losses were partially offset by a gain in competitiveness in 1991, the overall picture since 1990 is of a weakening of Ireland's competitive position.

TABLE 2.15

Hourly Earnings in Manufacturing in Ireland and the UK
% Increase

	(i) National Currency		(ii) Common Currency	
	Ireland	**UK**	**Ireland**	**UK**
1986-87	4.9%	8.0%	-1.0%	2.4%
1987-88	4.3%	8.5%	4.2%	15.3%
1988-89	4.1%	8.7%	3.9%	7.2%
1989-90	4.5%	9.4%	5.8%	3.0%
1990-91	5.5%	8.2%	5.5%	10.5%
1991-92	4.1%	6.0%	5.0%	0.6%

Source: OECD and Department of Finance.

It is worth examining the factors contributing to this apparent change in competitiveness behaviour. To do this we need to examine the nature of gains in competitiveness which took place in the late 1980s. Against the EMS narrow-band, the gain in competitiveness took place in just one year, between 1986 and 1987. This gain reflected the 1986 devaluation of the Irish pound. In subsequent years there was some slight loss in competitiveness against the EMS narrow-band countries. By contrast, against our main trading partners there were consistent gains in competitiveness in the years from 1986 to 1989. The main difference between the groupings of main trading partners and the EMS narrow-band are the US and the UK. The competitiveness gains against our main trading partners from 1986 to 1989 reflected competitiveness gains against the UK. These competitiveness gains against the UK were based on the combination of (i) lower cost inflation in Ireland than the UK and (ii) the appreciation of Sterling.

The pattern of competitiveness since 1990 against the EMS narrow-band represents continuity rather than change from the previous period. The loss of competitiveness against our main trading partners since 1990 is due to a

combination of the lowering of the differential between Irish and UK wage inflation (due to somewhat higher wage increases in Ireland than before and a slowing down of wage inflation in the UK) and the depreciation of Sterling. These developments are shown in Table 2.15.

(ii) Resolution of Conflicts

The number of hours lost due to industrial disputes fell sharply in 1991 after increasing in 1990. The number increased again in 1992. Looking at the record since 1980 it is clear that the past number of years have been characterised by relatively greater industrial peace in terms of the number of disputes, hours lost and workers involved than was the case in the early 1980s (See Table 2.16)

TABLE 2.16

Number of Industrial Disputes, Hours Lost, and Workers Involved
1980 - 1992

Year	No. of Disputes	No. of Hours Lost	No. of Workers Involved
1980	130	412,118	30,879
1981	117	433,979	31,958
1982	131	434,253	29,957
1983	184	319,015	30,482
1984	192	386,421	30,992
1985	116	417,726	168,675
1986	102	309,178	50,006
1987	80	264,339	26,221
1988	65	143,393	10,218
1989	38	50,358	3,692
1990	49	222,915	10,309
1991	54	85,513	17,975
1992	38	190,609	13,107

Source: CSO.

(iii) Living Standards and Employment

The Council's view of the appropriate balance to be achieved between growing living standards and increasing employment was, and remains, that priority should be accorded to the task of increasing employment. Changes in living standards can be indicated by changes in real take home pay for workers in manufacturing industry. Over the period 1990-1992 the annual average change in living standards for married workers was 1.7%. This represents a continuation of the rates of increase in living standards which took place in the preceding three years during the Programme for National Recovery.

Income levels in the economy generally may not, of course, mirror the movements in manufacturing earnings. For example, real earnings per head in the public sector have increased at a significantly faster rate than real industrial earnings over recent years. The background to this and the Council's views on income developments generally are set out in Chapter 4.

TABLE 2.17

Annual Changes in Real Take-Home Pay
1980 - 1992
% Change per Annum

	Average Manufacturing Earnings		Average Male Manufacturing Earnings	
	Single	**Married**	**Single**	**Married**
1980-87	-1.0	-0.8	-1.6	-0.7
1987-90	2.6	1.6	3.0	1.9
1990-92	2.2	1.7	2.1	1.7

Source: Department of Finance.

3.3 An Overview of Structural Reform

The third strand of the Council's *A Strategy for the Nineties* was a coherent programme of structural and adjustment policies designed to improve the economy's internal efficiency, enhance international competitiveness and overcome barriers to long-run development. This was seen as the key to increasing the employment creation capacity of the economy, given the limitations on other policy interventions and the greater exposure of the domestic economy to international competition. The Council envisaged the

trade-off between the economic and social implications of structural reform as being determined by the over-riding objective of increasing employment.

The following section briefly reviews the salient features of developments over the past few years. More detailed comments are provided in the individual chapters of this Report.

Tax Reform

The Council's strategy for tax reform recommended: (a) reductions in effective marginal and average tax rates on earned income; (b) the broadening of the tax base to ensure the overall progressivity of the income tax system, in particular through the introduction of a comprehensive property tax[9]; (c) the treatment of PRSI as a tax and the application of employees' PRSI at a lower single rate without exemptions or ceiling; (d) a top VAT rate of 18% and a 3% rate on items then zero-rated, with specific measures to compensate the less well off for the latter change; (e) adjustment of excise duties and DIRT to meet EC harmonisation criteria.

The principal changes in income taxation effected since 1990 include: a reduction in the standard rate of income tax to 27% and the introduction of a single higher rate of 48%. Personal tax allowances have not been fully indexed. The standard rate band has been substantially extended. However, the 1993 Budget introduced a 1% income levy on earnings in excess of £9,000 (excluding social welfare payments). The income levy represents a fifth separate tax on income and is inconsistent with the strategic approach to tax reform developed by the Council. The Council's views on the future direction of tax strategy are set out in Chapter 7.

Measures to broaden the tax base have included the abolition of relief on life assurance premia, the removal of accelerated capital allowances to agriculture (pollution control) and stock relief, and a tightening of the concessionary tax treatment of certain specific forms of income (eg. benefits-in-kind). With regard to the latter, the inclusion of disability benefit in reckonable income in the current year represented a significant move. Measures adopted since 1990 which have had the *opposite* effect (ie. reducing the tax base) include the extension of mortgage interest relief for both new mortgage holders and mortgage holders generally[10], the extension

9 The IFA, ICMSA, ICOS and the CIF did not endorse the Council's recommendations on the introduction of a property tax.

10 This followed the exceptional rise in interest rates associated with the currency crisis of late 1992/early 1993.

of urban renewal tax incentives, and the improvements to the BES. A comprehensive property tax has not been introduced and only minor changes have been made to the residential property tax.

The ceiling for PRSI contributions has been increased, to £20,000 for employees in the current year, but not abolished.

With regard to VAT, the structure has been rationalised in accordance with EC-determined principles to two rates of 12.5% and 21%, with the range of zero-rated items largely unchanged. The principle of targeted compensation for VAT increases was reflected in the 1993 Budget where increased VAT on house building was accompanied by an increase in the grant to first-time house buyers.

Adjustment to excise duties largely in line with structures determined by EC obligations has occurred, while DIRT rates have been reduced on accounts meeting specified conditions in response to the advent of the single market in banking services and the elimination of restrictions on capital movement within the Community.

The overall pattern is significantly less radical than the strategy recommended by the Council in 1990. The role of taxation policy in a strategy for employment growth is discussed in Chapter 7 below.

Industrial Policy

In *A Strategy for the Nineties*, the Council reiterated its long-standing position on the need for industrial policy reform. Among the requirements noted were:

- a need to give greater priority to the development of indigenous industry;
- the need to focus State assistance on specific barriers to growth. In this context, a continued shift in financial support away from fixed asset investment towards areas such as management, marketing, product development and skill development was envisaged;
- the need to develop the innovative capacity of Irish industry as a means of securing a strong and sustainable basis for competitive advantage.

In the period since *Strategy*, a major review of industrial policy has been completed. The subsequent Culliton Report confirmed much of the Council's analysis and conclusions and the broad thrust of the recommendations made

by Culliton have been accepted in principle by the Government. Following reports from a Task Force on the Implementation of the Culliton Report[11], detailed announcements on structural and other changes have been made. Chapter 8 below sets out the Council's views on the policy priorities to be pursued within the new industrial policy framework. A separate chapter (Chapter 12) reviews the specific issues which arise in relation to the *financing* of industrial development and sets out the Council's views on this subject.

Agricultural Policy

The Council's approach to agricultural policy in *A Strategy for the Nineties* was heavily influenced by the extent of the challenge posed by the then proposals for CAP reform and by the GATT negotiations. The essential requirement was that greater progress be made in solving the structural weaknesses of the sector and that structural policy should give priority to achieving effective land use within the context of the development of off-farm employment opportunities and direct income aids. While recognising the impact of the CAP on the nature and volume of primary production available for further processing, the Council emphasised the importance of a vigorous national structural policy in agriculture - complemented by productivity policies focused, in particular, on the development of human resources - for minimising agricultural supply constraints on the development of a profitable, market-driven food industry.

Since *Strategy*, the Council has published a report outlining the principles which it urged should guide the process of CAP reform[12]. These were broadly reflected in the outcome to the CAP negotiations. However, it is clear that the reform outcome, while broadly securing Irish agricultural interests, has major negative implications for certain categories of producer. Furthermore, the proposals for agriculture in the current GATT round raise questions about the viability of aspects of the CAP reform package. The challenges posed in adapting to the emerging Community and global context for agriculture and food prompted the establishment of two development groups, one representing the Department of Agriculture and Food and the farming organisations to prepare a Development Programme for the sector, while another Expert Group on the Food Industry was established following the publication of the Culliton Report. Chapter 9 below sets out the Council's assessment of current priorities and prospects. Through the Leader programme and the integrated rural development projects supported by the

11 Moriarty (1993).

12 NESC (1992). *The Impact of Reform of the Common Agricultural Policy*. Report No. 92.

Department of Agriculture and Food, rural development strategies have emerged as a potentially strong element of structural policy at national level. The Council has commissioned consultants to examine rural development policies and intends to publish a separate report on this issue in the near future.

Manpower Policy

In *A Strategy for the Nineties* the Council argued that education and training policies have an important long-run contribution to make to the creation of employment, since they represent an important potential source of national competitive advantage. The Council argued for the development of education and training policies as part of an active labour market approach. It also argued for a radical approach to the problem of long-term unemployment using targeted special employment measures. This reflected the Council's emphasis on the fact that a general rise in demand for labour would do little to reduce long-term unemployment. The Council therefore advocated measures to target labour demand on areas of high long-term unemployment, in particular through subsidised job creation and temporary direct hiring. This would be done through local area-based strategies, focusing on communities characterised by concentrated incidence of unemployment, low incomes and social deprivation.

Since *Strategy* there have been a number of initiatives in relation to education and training policies and special employment measures broadly consistent with the approach set out by the Council. In particular, an employment subsidy scheme, allied to an Employer PRSI exemption arrangement, was introduced, as was a job training scheme designed to improve work experience opportunities for the unemployed. These were not as tightly focused on the long-term unemployed as the Council's recommendations would have implied. In the event, both schemes had difficulty in the early stages and the rate of take up was less than anticipated.

The contribution of vocational education and training, with appropriate independent certification, has been the subject of considerable analysis and discussion arising from both the Culliton Report and the Green Paper on Education. Progress was also made towards the introduction of a new standard-based apprenticeship system.

The most direct response to the Council's approach, however, was the establishment of the pilot area-based programme for the long-term unemployed under the PESP. These projects cover 14% of the national population but 23% of the unemployed. Bringing together representatives of statutory agencies, the social partners and local community groups, their

focus is on working with the long-term unemployed, co-ordinating and integrating education and training and supporting enterprise, job creation and attitudinal change. They have generally been effective in establishing new working relationships between agencies and community groups, identifying the varying needs of the long-term unemployed and securing substantially increased rates of participation in education and training programmes. They have not had as wide a brief in terms of functional areas as the Council had envisaged for an area-based strategy, but many of the areas in question are covered by parallel programmes such as the Department of Social Welfare's Community Development Programme, the Leader Programme and the disadvantaged schools/home-school linkage programme of the Department of Education. Chapter 3 reviews trends and prospects in the labour market and sets out the Council's priorities for manpower policy, as a core element in a new strategy for employment growth, while Chapter 16 sets out the Council's views on education policy.

Structural Reforms in the Public Sector

With regard to *public enterprises*, the Council advocated that priority be given to increasing competition and improving regulation. Privatisation was regarded as an appropriate option in the case of competitive markets and where necessary equity finance may be unavailable from public funds. The Council also emphasised the potential of state enterprises as development vehicles. The Council advocated clear regulatory rules where competition was not feasible, in particular through transparency of the financial flows between the state and state enterprises. The Council recommended that an audit be undertaken of state companies to establish the appropriate strategy to enhance efficiency given their particular role and market characteristics.

Since the *Strategy* report, some changes have occurred in the environment facing state enterprises. Some - Irish Life and Greencore - have transferred to majority private ownership. Others are facing major challenges due to changes in market conditions, EC regulatory requirements and fiscal pressures. The comprehensive audit advocated by the Council has not occurred. Chapter 4 below sets out the Council's assessment of progress in building competition and efficiency in the non-traded sector, including the role of state bodies.

Structural Reforms in the Social Area

In *A Strategy for the Nineties* the Council's general approach to the social area was to emphasise the importance of (i) links across functionally separate areas of policy to achieve co-ordinated interventions, and (ii) finding the appropriate mix of public and private provisions to prevent inequality while ensuring choice. The reduction of unemployment was emphasised as the principal route to be pursued in achieving overall social policy goals. The Council therefore emphasised (i) the importance of resolving the unemployment trap and, (ii) the potential of area-based policies in addressing unemployment and increasing the effectiveness of existing social provisions.

Chapters 13 to 17 below review the principal developments in relation to social expenditure and set out the Council's views on the strategic priorities to be pursued in the areas of social welfare, education, health and housing. A major challenge to policy in these areas will be to achieve progress on these strategic priorities while adhering to the fiscal constraints which arise inescapably from the requirements for significantly faster employment growth. This would represent an advance on the position which has applied over recent years.

Institutional Issues

The Council argued in *A Strategy for the Nineties* that (i) Ireland should systematically learn policy lessons from the small, open, more successful European economies, (ii) the role and scope of consensus and of consensus-forming arrangements should be broadened and strengthened, and (iii) the system of policy formation should be developed to support a stronger and more analytical approach to public policy and more open, accessible and communicative styles of policy debate and policy change.

The principal development in this area following the publication of *Strategy* was the conclusion of the Programme for Economic and Social Progress which, as recommended by the Council, covered the evolution of pay, taxation, the public finances, exchange rate and monetary policy and the various publicly provided services. The Central Review Committee continued to operate under the PESP to oversee on a consensual basis issues arising under the Programme. The 1993 Programme for Government also identified a number of measures, including the establishment of a National Economic and Social Forum, to develop the basis for a consensus approach to policy and a more open style of policy debate. The Council, meanwhile, has published a study by Dr. Lars Mjøset of the Institute of Social Research in Oslo which examined the long-run nature of Ireland's relative under-development and of the institutional factors underpinning and arising from that historical experience[13]. The Council has reflected the thrust of Dr. Mjøset's analysis in the preparation of this Report and in its approach to the strategic requirements from the rapid expansion of employment.

13 NESC (1992a), *The Irish Economy in a Comparative Institutional Perspective*, Report No. 93.

4. OVERVIEW OF POLICY CHANGE 1990-1993

Having outlined the main policy developments of the past three years, we now wish to assess to what extent policy has been consistent with the three broad, components of the Council's strategy:

(i) consistency of fiscal, monetary and exchange rate policy to achieve economic stability;

(ii) an incomes policy which accords priority to employment; and

(iii) a radical policy programme of structural reform.

The development of fiscal policy has not followed all of the recommendations of the Council. The target of reducing the debt/GNP ratio to 100% was met in 1992, slightly ahead of target, and while there has been an increase in this ratio in 1993 reflecting the effects of the January devaluation, the underlying trend remains downwards. There have, however, been significant real increases in current public expenditure since 1990 which cannot be solely explained in cyclical terms. There has also been some increase in the exchequer borrowing requirement.

There has been considerable pressure in the area of monetary and exchange rate policy. However, from a policy point of view it is important to distinguish between pressures on the exchange rate which arise due to excessive increases in domestic costs on the one hand and, on the other hand, pressures which arise from external forces, including an effective appreciation of the nominal trade weighted exchange rate. The exchange rate difficulties experienced by Ireland in late 1992 and early 1993 were due to the latter cause rather than the former.

Despite the upheaval in currency and financial markets in 1993, the experience of recent years differs fundamentally from that of the early 1980s. At that time, the development of fiscal policy and of incomes were fundamentally inconsistent with the fixed exchange rate policy. We would conclude that in recent years fiscal, monetary and exchange rate policy *have* been broadly consistent.

Turning to the second strand, the development of incomes in the past three years has not secured an overall improvement in competitiveness.

Competitiveness has been maintained against the EMS narrow-band countries, which represents broad continuity with the experience of the late 1980s. The difference between the past three years and preceding years is that there has been no gain in competitiveness against the UK. This reflects a lowering of the differential between Irish and UK wage inflation and a depreciation of Sterling. In this sense the evolution of incomes in the economy has not been consistent with the principle of according priority to increasing employment over improving living standards. The extent to which this has been the case is not uniform across all sectors of the economy.

With regard to structural reform, the pattern is mixed. There has been progress in specific matters identified by the Council, especially in many areas of social policy and in the development of an area-based strategy to combat long-term unemployment and social exclusion. However, there has not been the general programme of radical policy reform envisaged by the Council. The need for such changes is now more widely recognised and the general direction which reforms should take has been identified and accepted as policy goals in a number of key areas. However, the slow pace of change, allied to evidence of increased upward pressure on non-cyclical public expenditure, suggest that the commitment to change has not been sufficient to support the scale of structural reform envisaged by the Council. This is partly a matter of public policy but it is also a responsibility on the social partners and on economic interests generally. A willingness to accept change, including the loss of privileges, is a necessary condition for the achievement of progress in employment development on the scale required to reduce the present corrosive levels of unemployment.

5. MEDIUM-TERM OUTLOOK FOR THE ECONOMY

The context for Irish economic growth is expected to improve slowly over the next year or two, as the world economy moves out of recession. Global economic activity is expected to grow by 2.5% in 1994, up from an expected 1.5% this year and virtual stagnation in 1991[14]. This recovery in world output growth is expected to strengthen and consolidate in the latter half of the 1990s, providing Ireland with a more positive environment for growth than has existed in the first three years of the decade. In the immediate future, however, considerable uncertainties remain about the timing and pace of any international recovery. Moreover, Ireland's ability to capitalise on any upturn in world economic activity will depend critically on the evolution of domestic policies, including wage developments, fiscal, monetary and exchange rate policies, and structural reform. The development of domestic policies which are consistent with maximising output growth and, specifically, employment growth forms the subject of this report.

14 European Economy, No. 6/7, June/July 1993.

(i) Outlook for 1994

The consensus is that there will be some pick up in Irish economic growth next year, but that the scale of recovery will be relatively modest and will be hedged with uncertainties concerning the international environment. Domestic demand is expected to grow by about 3% to $3\frac{1}{2}$%, which would represent an improvement on the stagnation of the early 1990s. The main constraint on growth next year will be the weakness of external demand, particularly in continental European markets. This is likely to keep overall growth rates relatively subdued, with GNP expected to rise by perhaps 3.0% to 3.5% in volume terms, up from an expected 1.75% in 1993.

TABLE 2.18

Short-Term International Outlook

	GDP % change		Emp. % change		Unemp. % labour force		Inflation %		Wages[1] % change	
	1993	1994	1993	1994	1993	1994	1993	1994	1993	1994
UK	1.8	2.9	-1.2	0.4	10.7	10.4	2.4	3.5	4.6	4.4
Germany	-1.9	1.4	-2.4	-0.8	10.1	11.3	4.9	3.1	7.2	5.0
France	-0.7	1.5	-1.0	-0.5	11.2	12.1	2.4	2.0	3.7	3.2
Italy	-0.2	1.7	-1.2	0.3	10.9	11.0	3.4	4.3	3.7	5.2
EC	-0.4	1.3	-1.7	-0.2	11.5	11.9	4.2	3.8	4.0	4.0
US	2.6	3.1	1.1	1.8	7.0	6.5	2.6	2.4	4.6	3.5
Japan	1.0	3.3	0.8	1.1	2.5	2.6	1.6	1.7	1.8	2.7
OECD	1.2	2.7	-0.1	0.9	8.5	8.6	3.0	2.8	3.9	3.5

1 Compensation per employee in the business sector.

Source: OECD Economic Outlook, No. 53, June 1993, except for the average forecasts for the EC which are from European Economy, No. 6/7, June/July 1993.

The international outlook for 1993 and 1994 is set out in Table 2.18. Overall growth rates in the OECD are expected to move from a weak 1.2% this year to a slightly stronger rate of 2.7% in 1994. The EC economies are in deep recession, with most of the main continental economies (including France, Germany and Italy) expecting to record a fall in GDP this year. Some recovery is forecast for the EC in 1994, but the rate of growth is expected to remain very low at around 1.3%, and there are fears that even this prediction may prove overly optimistic. Moreover, many countries have indicated an intention to tighten their fiscal policy stance, which may have a deflationary impact at least in the short-run.

Inflationary pressures in the Irish economy will be subject to a number of conflicting influences in 1994. The rate of inflation fell to an historically low level of around 1.6% in 1993, reflecting in particular the low international growth rate, and the influence of falling nominal interest rates. Both of these factors will be present to some degree in 1994, with the slow growth of the world, and particularly the EC, economies and the prospect of some further reduction in international interest rates continuing to act as moderating influences on inflationary pressures. However, manufacturing output prices have accelerated sharply in 1993, from a very low base. The annual rate of price increase for manufacturing output jumped from 0.3% in the fourth quarter of 1992 to 5.8% by July 1993. A key factor behind this rise has been the depreciation of the Irish pound, especially against the US dollar. Manufacturing output prices for goods destined for domestic markets have risen much less sharply - by 2.7% in the same period. Overall, the expectation is that there will be some increase in the rate of inflation in 1994 from the very low rate which obtained this year[15]. The extent of such an increase will depend among other things on the timing and pace of the international recovery, the extent to which further falls in international (and Irish) interest rates are achieved, the trend in Ireland's effective exchange rate and the evolution of domestic costs, including wages.

Given the lack of growth in the EC economies, prospects for employment and unemployment in the Community remain bleak. The level of employment is expected to fall in most of the main EC economies in 1993 and further declines are predicted for next year. Overall employment in the Community is set to fall by 1.7% this year, with a further 0.2% decline in 1994. The poor employment trend is reflected in a deteriorating trend in unemployment throughout the Community, with unemployment rates high and rising in most countries. Average unemployment in the EC is expected to reach 11.5% this year, rising to 11.9% in 1994. Against this background of low growth and deteriorating labour market performance, inflationary pressures remain subdued. Inflation in the Community is expected to average 4.2% this year, easing back to 3.8% in 1994. These inflation rates are slightly above the wider OECD average, which is hovering around the 3.0% mark.

15 Recent forecasts of the average rate of CPI inflation in 1994 include 2.5% - 3.0% (Davy's, September 1993), 2.5% (ESRI QEC, Summer 1993) and 2.9 (Riada, October 1993).

Ireland's expected growth rates of 1.75% in 1993 and 3.0% to 3.5% in 1994 compare favourably with the international growth rates set out in Table 2.18. Our ability to out-perform the global trend is greatly assisted by the fact that the UK and continental business cycles are out of phase with each other, so that recovery in the important UK market this year and next can help to offset the contraction in continental markets. Economic growth in the UK is expected to rise to about 2.9% in 1994, up from 1.8% this year. While these figures are a good deal lower than one might expect during the recovery phase of a business cycle, they nonetheless offer an important relief from the declining markets on mainland Europe. Despite the difficult external environment therefore, exports from Ireland are expected to grow next year by about 6% in volume terms. This would represent an improvement on the expected 1993 out-turn of 4%, and will contribute towards the overall rise in the growth rate.

In the domestic economy, a number of developments are expected to boost demand in 1994. The improvement in business and consumer confidence which was expected to follow the drop in interest rates this year has so far proved elusive, but some positive feedthrough is expected in 1994. It seems likely at this stage that the growth of personal consumption and investment will follow the US and UK pattern of cautious expansion, and a repeat of the very rapid growth of the late 1980s is not in sight. Despite this, personal consumption should grow by about 3.0% - 3.5% in real terms, with the volume of investment up by perhaps 4.5%. Public sector investment financed by the EC Structural Funds made an important contribution to investment activity in 1993, turning a substantial decline in investment volumes into a small increase. This factor will continue to assist in underpinning investment levels in 1994 and in the years ahead. The final major component of domestic demand is public consumption. Little change is expected in the rate of growth of public consumption, which is set to remain at about 2% in 1994.

The prospects for employment growth in 1994 are slightly better than they have been in the last few years, but remain wholly inadequate relative to our employment needs. The resumption of growth in domestic demand, coupled with a modest increase in the overall rate of economic growth, should allow for a small increase in the numbers at work. This would represent an improvement on the static employment levels of the early 1990s. It will not, however, come anywhere near meeting the potential growth rate of the labour force, which would, in the absence of emigration, increase by an average of 22,000 to 24,000 per annum over the next six years. The prospect therefore is for continued growth in unemployment and/or a return to high levels of involuntary emigration, unless policies can be found which can accelerate the rate of employment growth. There is evidence that the recovery in the UK economy has already resulted in a resumption of emigration in 1993. This trend is likely to accelerate in 1994.

(ii) Prospects Beyond 1994

Looking beyond 1994 to the second half of the decade, the prospects for stronger growth in the world economy generally, and in Ireland in particular, appear brighter. The international economy is currently at or close to a turning point. By 1995, the expectation is that the world economy will be back on a path of sustained growth. It is not anticipated, however, that there will be a period of *above-trend* growth to compensate for the poor growth of recent years. Moreover, the recovery in the European economy could lag behind that in North America, reflecting the present difficulties in Europe and the likelihood that the adjustment in Germany consequent on reunification still has some time to run.

The pace of international growth in the medium-term will be influenced by developments in a number of key areas, among them the negotiation of a successful conclusion to the current round of GATT negotiations and the evolution of policy within the European Community. The environment in the EC is more uncertain than it has been for many years now, and makes projections of future growth patterns more than usually difficult. Among the developments which will impact significantly on EC and Irish growth rates in the years ahead are:

- the consequences of completion of the single market for the EC generally, and for Ireland in particular;
- the enlargement of the EC through the accession of new member States and the expansion of intra-European trade;
- the implementation of CAP Reform;
- the deepening of economic relationships with the central and Eastern European economies in transition, and
- the evolution of future exchange rate policy in the EC, including the prospects for moving back on course for EMU.

Substantial reductions in interest rates are seen as a necessary condition for economic recovery in the EC. If interest rates fail to fall significantly, or if

they are slow to do so, the prospects for EC growth would be significantly weakened. Moreover, any improvement in EC performance will require a substantial increase in consumer and business confidence. Both are at a historically low level in the EC and may not bounce back before the economic climate perks up. Confidence levels in the US remain very low, despite the fact that that economy is now more than two years into recovery. If the same phenomenon were to occur in the EC, the response to any easing of monetary policy would be weaker and slower than expected. The persistence of low levels of business and consumer confidence has inhibited the recovery in world economies over the past number of years. High unemployment and attendant job insecurity are undoubtedly contributing towards these low levels of confidence, as is the hangover from high rates of borrowing in the Anglo-Saxon economies in the 1980s. In addition, the failure of policy to deliver sustained growth in output and jobs has eroded confidence in many countries.

The recently published National Development Plan suggests that, on the assumption that the international economy picks up as expected during 1994 and that it expands steadily over the medium-term, Ireland's rate of economic growth could be upwards of 3.5% per annum over the period 1994-1999. The main contribution to growth will come from private and pubic investment, assisted by the EC Structural and Cohesion Funds, and from industrial exports. Agricultural exports may show only marginal growth as the sector adjusts to CAP reforms. On the other hand, exports of industrial goods and tourism services should show significant expansion. Manufacturing output may expand by around 6% per annum with the leading sectors responding to more buoyant external demand.

Inflation should remain moderate with Ireland among the better performing Community countries in that respect. The current account of the balance of payments should remain in substantial surplus, supported by a strong trade balance and increased transfers under the Structural and Cohesion Funds.

The Plan envisages growth in non-agricultural employment of about 12,000-14,000 per annum to the end of the decade. This increase would be partially offset by a continued decline in agricultural employment, so that the increase in *total* employment in the economy might be of the order of 9,000-11,000 per annum. While such an employment performance would be significantly better than recent years, it would still fall far short of Ireland's employment needs. Given this existing level of unemployment and the strong underlying growth in the labour force, with potential growth of 25,000 per annum to the end of the decade, substantially stronger employment growth will be needed if high levels of involuntary emigration and continued high levels of unemployment are to be avoided.

The 3.5% growth rate envisaged in the National Development Plan for 1994-1999 represents a central projection. Faster growth is possible, if the international environment proves to be more buoyant than expected or if the underlying competitiveness of the economy - in all its aspects - were to improve substantially. With regard to the former, it is possible that the recovery in the international economy could be faster and earlier than expected. This would have significant benefits for the open Irish economy. In addition, international interest rates could fall more significantly than assumed and the positive effect on business and consumer confidence could be stronger than expected. The aspect of economic performance which falls within the realm of *domestic* policy influence, however, is competitiveness.

The need to secure faster economic growth and, in particular, faster *employment* growth than that anticipated in the National Development Plan underlines the importance of measures designed to increase the competitiveness of the economy, in the broad sense discussed in this Report. The strategy outlined in this Report aims to push Irish economic performance *above* current projections in order to achieve an employment outcome more in line with our requirements.

CHAPTER 3

Labour Market Development and Policy

LABOUR MARKET DEVELOPMENTS AND POLICY[16]

1. INTRODUCTION

Historically high levels of unemployment and the prospect of large inflows into the labour market until the end of the decade represent the backdrop to Irish labour market policy in the 1990s. In *A Strategy for the Nineties* the Council forecast, on the basis of the policies then in place and on the assumptions that (i) emigration would continue for the foreseeable future and (ii) unemployment would fall only slowly in subsequent years, a scenario that it viewed as entirely unacceptable. In the period following the publication of *Strategy,* however, stagnant employment levels and the virtual cessation of net emigration, both reflecting in large part the impact of worldwide recession, have combined to push unemployment to unprecedented levels, adding renewed urgency to the task of finding ways to enhance the employment creating potential of the economy. The Council's view is that all aspects of economic policy must be reviewed in the light of the implications for employment and unemployment; within this framework, however, there is a need for active policy intervention in the labour market itself. The implications of this approach are developed in later Chapters of the Report.

The problem of reducing the general stock of unemployment is compounded by the existence of a very substantial core of long-term unemployed persons, many of whom are comparatively young and would therefore reasonably anticipate contributing to society as active members of the labour force for at least a couple of decades. Because of certain characteristics of the long-term unemployed and because of the nature of such unemployment itself, this subset of the labour force is unlikely to gain significantly from any general improvement in labour market opportunities consequent upon, say, the implementation of structural reforms or the emergence of a more positive external environment. Analysis of the educational qualifications of the long-term unemployed, for example, suggests that they are particularly ill-equipped to compete against other labour market participants. For the same reason, even emigration to more buoyant labour markets may not be a realistic option. Moreover, as Section 2 shows, 'escape' probabilities rapidly diminish as the duration of unemployment increases.

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16 This Chapter draws heavily on a paper prepared for the Council by Dr. Philip O'Connell of the ESRI. Copies of the paper may be obtained from the Council Secretariat.

The economic and social costs associated with unemployment hardly need to be restated here. Nevertheless, the Council has emphasised the importance of both the labour market and welfare dimensions of unemployment. Joblessness not only lowers welfare by contributing to poverty and deprivation, thereby necessitating in turn state intervention through cash transfers and social policy generally, but also results in substantial economic costs, in the form of forgone output and erosion of the stock of human capital. If, as in Ireland in the mid-to-late 1980s, the lack of sufficient job opportunities is reflected in high emigration, the welfare problem may be temporarily alleviated, even though the economic cost to the economy in terms of forgone output remains[17]. The same may be partly true if unemployment tends to be concentrated among young people living within families, rather than among heads of households. In Ireland, however, a significant proportion of the unemployed are heads of households, suggesting that the labour market and welfare dimensions of unemployment overlap to a high degree.

Section 2 of this document reviews labour market trends over recent years. The Council's overall strategic approach to employment creation and reducing unemployment is summarised in Section 3 and the role that active labour market or manpower policies may play in this strategy, especially in relation to the problem of long-term unemployment, is explained. The effectiveness of current labour market policies in the sphere of training and employment creation is also considered. The final section considers how the direction and content of manpower policy might be redefined to make it a more effective response to short and long-term unemployment.

2. LABOUR MARKET DEVELOPMENTS

This section begins with a review of trends in population, migration and the labour force and then discusses employment and unemployment. It finishes with a discussion of the composition of unemployment.

(i) Population, Labour Force and Migration

Table 3.1 shows changes in population, migration and the labour force. Changes in population are due both to natural increase and migration. The 1980s was a decade of strong natural increase in population, particularly in

17 Of course the economic loss may be lessened to the extent that returning emigrants have acquired experience and training which increases their productivity.

the first half of the decade, when annual increases were in excess of 1 per cent.

The decade was also characterised by a dramatic resurgence of emigration. Most of the emigration took place in the second half of the decade, and net emigration peaked at 44,000 in 1989. Net emigration between 1986-1991 amounted to 134,000 persons, which exceeded the natural increase of 119,000, with the result that total population declined from 3,541,000 in 1986 to 3,526,000 in 1991. This represented the first intercensal decline in population since the 1956-1961 period. With the deterioration in international labour market conditions since 1991, migration fell substantially, leading to the resumption of population growth in 1991 and 1992.

TABLE 3.1

Changes in Population, Migration and the Labour Force 1980-1992

Year	Natural Increase (000)	Net Migration (000)	Change in Population (000)	Change in Labour Force (000)
1980	41	-8	33	14
1981	40	2	42	25
1982	38	-1	37	21
1983	38	-14	24	14
1984	34	-9	25	0
1985	31	-20	11	-2
1986	28	-28	1	3
1987	29	-23	6	4
1988	26	-42	-16	-2
1989	23	-44	-21	-18
1990	19	-23	-4	13
1991	22	-2	20	29
1992	20	+2	22	16

These countervailing trends in natural increase and migration have resulted in marked fluctuations in the rate of labour force growth. Labour force growth was strong during the early part of the 1980s. Then, when emigration increased through the mid-to late-1980s, growth ceased and the labour force declined in 1988 and 1989. The more recent fall-off in emigration, combined with the entry to the labour force of those born during the fertility boom of the 1970s, have, together, resulted in a strong resurgence of growth in the labour force since 1990.

TABLE 3.2

Population, Labour Force, and Labour Force Participation Rate 1980-1992

Year	Population	Population Aged 15+	Labour Force	Labour Force Participation Rate
	(000)	(000)	(000)	(000)
1980	3401	2366	1247	52.7
1981	3443	2400	1272	53.0
1982	3480	2426	1293	53.3
1983	3504	2462	1307	53.1
1984	3529	2489	1307	52.5
1985	3540	2506	1305	52.1
1986	3541	2516	1308	52.0
1987	3546	2533	1312	51.8
1988	3531	2535	1310	51.7
1989	3510	2535	1292	51.0
1990	3506	2548	1305	51.2
1991	3526	2582	1334	51.7
1992	3548	2621	1350	51.5

Table 3.2 shows the population of working age (aged 15+), labour force and the labour force participation rate for the years 1980-1992. While total population fluctuated over the period, the population of working age increased steadily from 2,366,000 in 1980 to 2,621,000 in 1992, an increase of 255,000. Over the same period, however, the labour force has increased by less than 150,000 people, with the result that the rate of labour force participation declined between the two years. This reflects in particular the significant increase in the numbers in full-time education over that period. Labour force participation peaked at 53.3% of the population aged 15 years or greater in 1982, it subsequently declined to 51% in 1989 and has fluctuated around 51.5% since then.

Table 3.3 shows the total at work and unemployed, the two components of the labour force, and estimated net migration for the period from 1980 to

1992. With the onset of recession in 1980, following the second oil price shock, the labour market situation deteriorated rapidly. Total employment fell by nearly 70,000 between 1981 and 1985 and the level of unemployment escalated, from less than 10 per cent of the labour force to over 17 per cent. The spectre of emigration re-emerged - slowly at first but then more rapidly as relative labour market conditions in Ireland and the United Kingdom diverged. After 1985 the employment level began to stabilise but recovery (at least in terms of net job growth) proved to be slow. There was a modest increase of some 10,000 in employment in 1988 but it was not until 1989/90 that a significant improvement occurred when there was an unexpectedly large increase of some 36,000 in the total numbers at work. Unemployment fell significantly during the later years of the 1980s, from 232,000 in 1987 to 179,000 in 1990, but while some of this was attributable to job gains, most of it was due to rapidly rising emigration.

TABLE 3.3

Annual Estimates of Total Numbers at Work, Unemployed and Net Migration

Year	At Work	Unemployed	Labour Force	Net External[1] Migration
	(000)	(000)	(000)	(000)
1980	1156	91	1247	-8
1981	1146	126	1272	+2
1982	1146	147	1293	-1
1983	1124	183	1307	-14
1984	1103	204	1307	-9
1985	1079	226	1305	-20
1986	1081	227	1308	-28
1987	1080	232	1312	-23
1988	1091	219	1310	-42
1989	1090	202	1292	-44
1990	1126	179	1305	-23
1991	1125	208	1334	-2
1992	1125	225	1350	+2

Source: CSO (1988). *The Trend of Employment and Unemployment 1979-85.*
CSO (1991). *The Trend of Employment and Unemployment 1986-88.*
CSO (1992). *Labour Force Survey, 1991.*
National Economic and Social Council (1991). Report No. 90. *The Economic and Social Implications of Emigration.*

The global recession of recent years arrested the recovery in the Irish economy, as discussed in Chapter 2. However, even though the overall employment level did not fall after 1990 (in fact the numbers employed outside agriculture continued to rise) the pressure of continuing labour force growth caused unemployment to escalate. The numbers rose by 46,000 (to 225,000) in the year to April 1992 and recent trends in the registered unemployed suggest that this figure is at present in the region of nearly 18 per cent of the labour force. A number of parallel factors have combined to bring this situation about, principally the large numbers leaving the educational system combined with the rapid fall in net emigration due to unfavourable conditions in external labour markets (particularly in the United Kingdom).

TABLE 3.4

Distribution of Population Aged 15+ by Principal Economic Status, Selected Years

Year	At Work	Unemployed	Labour Force	Education	Home Duties	Other	Population 15+
				(000)			
1971	1049	61	1110	96	639	203	2047
1981	1146	126	1272	200	663	265	2400
1986	1081	228	1308	248	685	275	2516
1987	1081	232	1312	263	675	281	2531
1988	1091	219	1310	275	682	274	2540
1989	1090	202	1292	277	682	287	2538
1990	1126	179	1305	288	663	291	2546
1991	1125	208	1334	301	648	298	2581
1992	1125	225	1350	322	650	299	2621

Source: CSO: Labour Force Survey and Census of Population, various years.

Table 3.4 shows the distribution of the population of working age by principal economic status for selected years between 1971 and 1992, and reveals some significant changes in the patterns of activity of the population. In 1971 51.2% of the population of working age were at work and 3% were unemployed, giving a labour force participation rate of 54.2%. By 1992 just under 43% of that population were at work, 8.6% were unemployed, and the labour force participation rate had fallen to 51.5% The proportion engaged in full-time education increased from under 5% of the population aged 15

and over in 1971 to over 12% in 1992. The share of population engaged in home duties fell from 31% in 1971 to 25% in 1992 and the share in the 'other' status increased from 10 to 11%.

(ii) Labour Supply and the Age Structure of the Labour Force

The current age structure of the Irish population is such that, in the absence of net emigration, the potential for labour force increase is very substantial. The numbers of births increased rapidly throughout the 1970s (until they peaked in 1980) and the effects of this are now evident in the labour force in the form of a large inflow from the educational system which far exceeds the outflows. In present circumstances the Irish labour force has the capacity to expand by between 20,000 and 25,000 each year (ie., by 1.5 to 2 per cent) and this situation will continue to prevail until the end of the 1990s. More detailed information on this aspect is given in Table 3.5, which shows projected labour force inflows and outflows in different age groups for selected years between 1990 and 2006 on the basis of nil net migration in all age groups. This calculation understates the annual net job creation target necessary even to contain unemployment at its present level, since the long-run decline in the agricultural labour force will increase the necessary rate of growth in non-agricultural employment - a formidable requirement. Without a substantial improvement in labour market performance, the prospects are for a substantially higher rate of unemployment and/or emigration.

TABLE 3.5

Projected Labour Force Flows for Different Age Groups, 1990 to 2006, Assuming Nil Net Migration in all Age Categories

Age	1990/91	1995/96	2000/01	2005/06
		(000)		
15-24	+59	+58	+56	+48
25-34	-12	-13	-14	-14
35-44	-2	-2	-3	-3
46-64	-10	-11	-12	-14
65+	-10	-9	-9	-10
Total	+25	+23	+18	+7

Note: The projections are based on an assumption of labour force participation rates remaining constant at 1986 levels.

Source: National Economic and Social Council. Report No. 90 The Economic and Social Implications of Emigration.

TABLE 3.6

The Irish Labour Force Classified by Age for 1981, 1986 and 1991, with Projected Numbers for 1996

Year	15-24	25-44	45-64	65 and Over	Total
			(000)		
1981	365	540	317	49	1271
1986	342	618	310	38	1308
1991	299	668	333	34	1334
1996	306	675	366	23	1370

Source: (1) Census of Population 1981.
(2) CSO Labour Force Survey Reports for 1986 and 1991.
(3) CSO (1988). Population and Labour Force Projections 1991 and 2021.

Table 3.6 indicates the changing age structure of the workforce. The projections for 1996 are based on an assumption involving medium net emigration of 25,000 per annum over the 1986-1996 period and changing participation rates. Because of the former assumption, the youth labour force is forecast to rise marginally over 1991/96, instead of increasing significantly, as it would do in the absence of a net outflow. The most notable feature to observe is the ageing of the labour force; in particular the number aged 45-64 years is projected to increase by some 33,000 (a rise of 10 per cent) over the period in question. These trends have implications for countering long-term unemployment as they suggest that, in the future, the general body of both employed and unemployed persons will inevitably involve larger numbers of older workers, who face greater problems of re-integration.

(iii) Labour Force Trends for Males and Females

During the 1980s, while male employment underwent almost continuous decline, female employment continued to rise, apart from a brief period in the middle of the decade. The total number of women at work in the Irish labour force stood at an estimated 388,000 in 1992 compared with 337,000 in 1981, a rise of 15 per cent. In contrast, male employment fell by 9 per cent over the same period, from 809,000 to 737,000. These differences are to some extent a reflection of changing employment structures. The 1980s, in particular, saw a large reduction in industrial employment, which was partially offset by an increase in the number of service jobs. The former resulted in job losses of many male workers, while the latter opportunities (a significant proportion of which were part-time) were taken up by women job seekers.

The increase in the number of women at work during the 1980s, did not, however, prevent female unemployment from rising (from 22,000 in 1981 to 55,000 in 1992) because the female labour force also increased in size. The increase in the female labour force resulted both from an increase in the adult population and an increase in the rate of female labour force participation. This is in contrast to the position which prevailed for males, among whom aggregate participation in the labour force continued to fall because of increasing numbers in education and the growing incidence of early retirement. These influences also affected the female labour force, but they were offset by rapidly increasing participation among women aged 25 to 44 years.

(iv) Sectoral Trends

The trend of employment for different economic sectors over the period from 1971 to 1991 is indicated in Table 3.7. Over the entire period the long-standing secular decline in the numbers at work in agriculture continued, the level falling from 272,000 in 1971 to 155,000 in 1991, a decrease of 117,000.

TABLE 3.7

Numbers at Work Classified by Broad Sector for Selected Years 1971-91

Sector	1971	1981	1986	1989	1990	1991
Agriculture	272	196	168	163	167	155
Industry (excl. Building)[1]	236	262	234	236	244	244
High Technology	53	78	70	76	82	82
Food	49	46	38	36	37	37
Other Traditional	135	137	126	124	125	125
Building and Construction	84	101	72	70	76	78
Commerce	147	165	170	170	171	172
Insurance, Finance	24	42	42	52	54	57
Other Market Services	163	187	189	199	208	213
Non-Market Services	123	193	206	200	206	206
Total	**1049**	**1146**	**1081**	**1090**	**1126**	**1125**

Note: (1) Employment series estimated for the ESRI Macro-Model were used to subdivide the totals for the industrial sector.

Source: Derived from various CSO publications.

As may be seen from Table 3.7, there was an overall net job loss of 65,000 during the period 1981-1986. Subsequently, the employment position began to stabilise. The downward spiral in industrial and building employment was arrested and some net job creation began to emerge in market services. During the exceptional 1989/90 period, when total employment increased by an estimated 36,000, there was substantial employment growth in both the industrial and private services areas. In 1990/91, while the downturn in the economy brought employment expansion in manufacturing industry to a halt, the numbers at work in market services continued to increase. After 1986 employment in non-market services began to decline (or at least stabilise) largely because of the necessary effort to restore fiscal balance. Over the decade of the 1980s as a whole, significant job losses in agriculture and construction, and to a lesser extent in industry, were substantially offset by increased employment in services.

(v) Regional Patterns

Aggregate national labour market trends can conceal important regional variations. The labour force, which grew nationally by about 2% between 1986 and 1991, and by 8% in the Eastern region outside Dublin, declined by about 4% in the Midwest and the Midlands and by 3% in the West, and remained static in the North West. The numbers at work, which increased nationally by about 4%, declined in the Midwest, Midlands and North West regions.

The rate of labour force participation is highest in Dublin (54.7%), about 3% above the national average. Unemployment is also high in Dublin (19% in 1986 and 17.1% in 1991) and has been about 1.5% above the national average. In contrast, the North West has the lowest rate of labour force participation, and although it increased from 48.7% in 1986 to 49.3% in 1991, this was almost 2.5% less than the national average in the latter year. Despite its low labour force participation rate, the North West also suffers from the highest rate of unemployment, suggesting that the North West benefited little from the upsurge in employment experienced elsewhere in the country in 1989 and 1990.

(vi) Unemployment

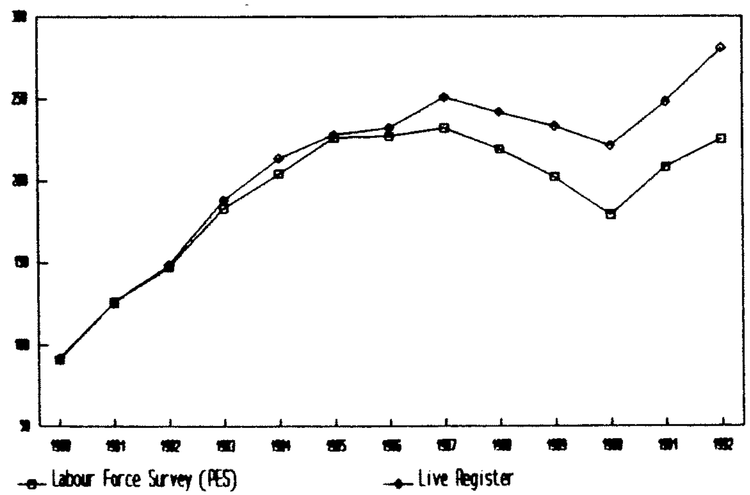
Figure 3.1 shows the trends in unemployment levels between 1980 and 1992 from both Labour Force Survey and Live Register sources. Both measures show similar trends over time, with unemployment climbing steadily from

1980 to 1987, then falling between 1987 and 1990, before increasing again to 1992. We have seen that the Labour Force Survey measure increased from 91,000 (or 7.3% of the labour force) in 1980, to 232,000 (17.7%) in 1987, fell to 179,000 (13.7%) in 1990, and then increased to 225,000 (16.6%) in 1992. The Live register figures are even bleaker, with unemployment increasing from 92,000 (7.4% of the labour force) in April 1980 to 250,700 (19%) in 1987, falling to 221,100 (16.9%) in 1990 and then increasing to the then unprecedented level of 280,900 (20.8% of the labour force) in 1992.

Figure 3.1 also shows that while the two trends are similar over time, they have diverged substantially since the mid-1980s. The use of different definitional methods, deriving in large part from the existence of eligibility criteria for receipt of unemployment benefit/assistance, would automatically imply some variation in the two measures of unemployment. However, the growing divergence since 1986 is more likely to be attributable to the following factors.

FIGURE 3.1

Number Unemployed 1980-1992
Live Register and LFS



1. A substantial part of the difference may be attributed to married females, who are actively seeking work and registering for social insurance benefits or credits, but who identify themselves as engaged in home duties in the Labour Force Survey. Greater numbers of females aged

over 25 years are now signing on the Live Register following the 1985 Social Welfare Act which removed restrictions on married women signing on.

2. Part of the difference is accounted for those who have withdrawn from the labour force, or are only marginally attached to it, but who, nevertheless, are registered for receipt of social welfare payments. This category would include "discouraged workers" who have ceased to search for work after an extended period of unemployment because they do not believe that they have any hope of finding a job. The number of such discouraged workers is likely to have increased over the 1980s with the growth of mass unemployment and the increase in the incidence of long-term unemployment.

3. Many young people who are unemployed and who either have insufficient contributions to qualify for Unemployment Benefit or who, living at home, do not satisfy the means test for Unemployment Assistance, have little incentive to sign on the Live Register. This should result in the Live Register under-estimating the true level of unemployment among young people (and the LFS based measure). In the second half of the 1980s, outward migration was concentrated among younger workers, which may have had the result of reducing the shortfall of the Live Register data.

These considerations reflect the fact that the conceptualisation and measurement of unemployment is far from straightforward. Moreover, it should be recognised that a significant number of those currently regarded as "inactive", particularly married women and some of those engaged in full-time education, have withdrawn from, or delayed their entry to, the labour force because of the difficulties of finding suitable work, and could be expected to enter or re-enter the labour force if labour market conditions were to improve. Ireland has one of the lowest labour force participation rates in the OECD - a characteristic which is probably directly related to its high levels of unemployment. What is manifest is that Ireland suffers from excessively high levels of unemployment, however measured, and shares with Spain the dubious distinction of having the highest level of unemployment in the EC.

(vii) The Age and Sex Composition of the Unemployed

Table 3.8 shows the percentage distribution of males and females by Principal Economic Status in 1991. Almost 40% of young males are at work,

13% are unemployed, and about 48% are inactive - most of the latter being still engaged in full-time education. Given the low labour force participation rate, the 13% of the population aged 15 and over who are unemployed actually represents almost 26% of the young male labour force - the highest rate of unemployment for any age sex category.

Just over 80% of males aged 25-44 are at work, as are 70% of males aged 45-64. Unemployment is higher among 25-44 year-olds: 16% of the age group is unemployed. Inactivity increases among those aged 45-64, about half of whom are retired and half unable to work due to sickness or disability.

The pattern of labour force activity among young females is similar to that of young males, although labour force participation is lower, with smaller proportions of young females either at work or unemployed. However, the 9.4% of the age group unemployed represents an unemployment rate of 21.5% of the labour force. Over 56% of young females are inactive, including about 5% of females already engaged in home duties.

TABLE 3.8

Percentage Distribution of Principal Economic Status by Age for Males and Females 1991

Age	At Work	Unemployed	Inactive	Total	Unemployment Rate
			%		
Male					
15-24	38.9	13.5	47.6	100.0	25.8
25-44	80.2	15.9	4.0	100.0	16.5
45-64	70.1	12.0	17.8	100.0	14.6
65+	15.3	0.5	84.2	100.0	3.0
Total	58.7	12.3	29.1	100.0	17.3
Female					
15-24	34.4	9.4	56.2	100.0	21.5
25-44	42.6	4.0	53.4	100.0	8.6
45-64	22.5	1.6	76.0	100.0	6.6
65+	2.8	0.2	97.0	100.0	5.8
Total	28.9	4.0	67.1	100.0	12.1

Over the age of 25 years, the labour market activities of males and females diverge quite dramatically. Less then 43% of females aged 25-44 were at work in 1991, and this proportion fell to less than 23% of those aged 45-65, the latter figure representing less than a third of the proportion of males at work in the same age group. The proportion of females aged 25-44 classified as inactive (53%) was slightly lower than the proportion of young females so classified (56%). Inactivity has different meanings for the two age groups, however. About 5% of the younger age group were engaged in home duties and almost half were in education. This pattern was reversed for the 25-44 year-olds: almost 52% of the age group were in home duties and less than half of one per cent were in education. The inactivity rates for females aged 25-44 are in stark contrast to the 4% of males in that age group who were inactive. Over three-quarters of all women aged 45-64 were inactive, and about three-quarters of these were engaged in home duties. Less than 18% of males in that age group were inactive.

(viii) The Duration of Unemployment

Ireland suffers from an exceptionally high level of long-term unemployment - the proportions of the labour force, and of those unemployed, who have been out of work for one year or more is the highest in the EC. To examine the issue of unemployment duration and the composition of the long-term unemployed, we make use of Live Register data on duration of unemployment, which is published bi-annually by the Central Statistics Office.

TABLE 3.9

Registered Long-term Unemployed Persons 1980-1992, (October)

	1980	1985	1989	1991	1992
LTU					
Males	28,949	80,570	77,470	79,120	89,704
Females	5,709	18,243	24,184	29,266	34,366
Total	34,658	98,813	101,654	108,286	124,070
TOTAL					
Males	83,743	165,493	151,107	170,593	184,923
Females	25,816	60,142	68,913	85,015	96,161
Total	109,534	225,635	220,020	255,608	281,084
LTU (%)					
Males	34.6	48.7	51.3	46.4	48.5
Females	22.1	30.3	35.1	34.4	35.7
Total	31.6	43.8	46.2	42.4	44.1

Note: LTU refers to Long-term Unemployment

Source: CSO (1991). Live Register. Half Yearly Age by Duration Analysis for the dates indicated.

The most recent figures available relate to the registered unemployed for October 1992. Table 3.9 shows that of the 281,000 persons who were on the unemployment register at that time, more than 44 per cent were unemployed for over a year. The table shows that this proportion was, in fact, higher two years earlier in October 1989 when the proportion was over 46 per cent. However this does not indicate any material improvement in the situation; it simply arose because of the influx of large numbers of recently unemployed persons as economic conditions deteriorated. In fact, in the two years prior to October 1992, the absolute number of long-term unemployed persons rose, from 102,000 to 124,000.

It is necessary to view the phenomenon of long-term unemployment over an extended period in order to see beyond the temporary effects of economic cycles. The pattern which has emerged across many Western economies during the 1980s is that the stock of long-term unemployed persons did not fall when economic conditions improved, it merely stabilised. As a result, the next dip in the economic cycle caused the total to be further augmented, leading to the build-up of a very large body of disadvantaged unemployed who are extremely difficult to re-integrate into employment. Table 3.9 shows that, apart from cyclical variations, the share of long-term unemployment among the total registered unemployed in Ireland rose from 32% in 1980 to 44% in 1992, with the strong likelihood of a further ratchet-type jump when the current recession works itself through.

In 1992, of the 281,000 unemployed, 157,000 (56%) had been unemployed for less than one year, 45,000 (16%) had been unemployed for between 1 and 2 years, 25,000 (9%) had been unemployed for between 2 and 3 years, and nearly 54,400 (over 19%) had been unemployed for 3 years or more. Long-term unemployment is particularly concentrated among those aged between 25 and 44 years.

Table 3.10 presents a detailed breakdown of long-term unemployment, showing substantial variation by age and sex. Of the 124,070 long-term unemployed, almost 90,000, or over 72%, are males. Almost half of all unemployed males had been unemployed for at least one year in 1992. This was true of almost 36% of unemployed females.

The percentage of long-term unemployment in total unemployment increases with age up to age 55 years for both males and females, but the increase is much greater among males, and is particularly sharp for males aged 35 and over: over 61% of unemployed males in the 45-54 year age category were long-term unemployed in 1992. Furthermore, almost 50% of long-term unemployed males are aged between 35 and 54. Among females, on the other hand, over 60% of the long-term unemployed are aged less than 35 years.

TABLE 3.10

Short and Long-term Unemployment by Age and Sex 1992

	Less than 1 year	Long-term	Total	Per cent Long-term	Age distribution
MALES				%	
LT 20	11163	2533	13696	18.5	2.8
20-24	21984	13071	35055	37.3	14.6
25-34	26333	24149	50482	47.8	26.9
35-44	18254	25244	43498	58.0	28.1
45-54	11385	18140	29525	61.4	20.2
GT 55	6100	6567	12667	51.8	7.3
TOTAL	**95219**	**89704**	**184923**	**48.5**	**100.0**
FEMALES					
LT 20	9410	1817	11227	16.2	5.3
20-24	15305	7554	22859	33.0	22.0
25-34	19047	11416	30463	37.5	33.2
35-44	10079	7461	17540	42.5	21.7
45-54	5558	4133	9691	42.6	12.0
GT 55	2396	1985	4381	45.3	5.8
TOTAL	61795	**34366**	**96161**	**35.7**	**100.0**
ALL					
LT 20	20573	4350	24923	17.5	3.5
20-24	37289	20625	57914	35.6	16.6
25-34	45380	35565	80945	43.9	28.7
35-44	28333	32705	61038	53.6	26.4
45-54	16943	22273	39216	56.8	18.0
GT 55	8496	8552	17048	50.2	6.9
TOTAL	**157014**	**124070**	**281084**	**44.1**	**100.0**

Source: CSO, *Live Register: Half Yearly Age Duration Analysis, October issues, 1989-1992.*

Table 3.11 presents data on unemployment survival rates from durations of less than 1 year to 1-2 years, from 1-2 years to 2-3 years and from durations of over 2 years to over 3 years for males and females by age group between October 1991 and October 1992. This table is therefore concerned with transitions into and within long-term unemployment. It is striking that there are very substantial differences in survival rates by duration. Thus, interpreting the survival rate as a probability or risk of remaining unemployed into the next period, we see that in October 1992 those who had been unemployed for less than 1 year had a .31 probability of remaining unemployed one year later, while those who had been unemployed for over 1 but less than 2 years ran a 65% risk of remaining unemployed for an additional year, and those who had been unemployed for over 2 years in October 1991 had a 77% risk of still being unemployed in October 1992.

Both survival into long-term unemployment (from less than 1 year to 1-2 years) and within long-term unemployment (from durations of 1-2 years and more than 2 years) vary significantly by age and gender as well as unemployment duration. Males have substantially higher survival rates and are therefore less likely to escape from unemployment than females, and among males the risk of remaining unemployed rises sharply with duration and age. *Those experiencing the highest risk of remaining unemployed for a further year are males in the 45-54 year age group who have been unemployed for 2 years or more* - in 1991 they had a 90% probability of remaining unemployed through October 1992, and only 10% of them would have exited from unemployment. The risks of remaining long-term unemployed are only slightly lower among males aged 25-44 who have been unemployed for at least 2 years.

TABLE 3.11

Survival Rates from Unemployment Durations of less than 1 Year, 1 to 2 Years and over 2 Years 1990-1991

	LT 1 to 1-2 years	1-2 years to 2-3 years	Over 2 years to over 3 years
MALES			
LT 25	0.27	0.58	0.59
25-34	0.33	0.68	0.80
35-44	0.37	0.74	0.83
45-54	0.41	0.79	0.90
GT 55	0.33	0.62	0.64
TOTAL	**0.33**	**0.68**	**0.79**
FEMALES			
LT 25	0.24	0.54	0.62
25-34	0.28	0.57	0.42
35-44	0.30	0.64	0.39
45-54	0.30	0.67	0.33
GT 55	0.33	0.67	0.31
TOTAL	**0.27**	**0.59**	**0.43**
ALL			
LT 25	0.26	0.57	0.58
25-34	0.31	0.64	0.78
35-44	0.35	0.71	0.83
45-54	0.37	0.76	0.87
GT 55	0.33	0.63	0.65
TOTAL	**0.31**	**0.65**	**0.77**

1 The Pre-Retirement Allowance Scheme and the Pre-Retirement Credits Scheme were introduced in 1990. The numbers aged 60 and over on the Live Register fell by 37% in the twelve months to April 1991.

Source: As for Table 3.10.

Among females the risk of continued unemployment is highest for those who have been unemployed for 1-2 years - 59% of women who had been unemployed for this duration in 1991 were still unemployed in October 1992, and the chances of remaining unemployed increased with age; from 57% among those aged 25-34 to 67% among those aged over 45. The risk of continued unemployment among women who have been unemployed for 2 years or more is lower than among those unemployed for 1-2 years, and the risk declines with age - from 62% among women aged less than 25 to 31% among those aged over 55 years. These patterns of risk of continued unemployment among women must be interpreted with caution; what we know from other sources of information on women's labour force participation (see for example Section 2 (iii) of this chapter), suggests that many women, particularly those aged over 25, who exit from long-term unemployment do so when they withdraw from the labour force to engage in full-time home duties, rather than to take up gainful employment in the labour force.

These survival rates reflect the very severe difficulties in finding employment of those who have been unemployed for an extended period of time and highlight the need for targeted intervention on the part of the State to assist in the reintegration of the long-term unemployed in the labour market. Of particular concern is that survival rates into and within long-term unemployment have increased over time. This is particularly true of those surviving from over 2 to over 3 years duration - for all ages in this group the survival rate increased from .69 in 1989 to .77 in 1991.

3. MANPOWER POLICY

The 1993 *OECD Employment Outlook* concludes that, in order to enable employment patterns to adjust in a rapidly changing technological environment and to deal with the problems posed by growing cyclical and structural unemployment,

> "... policy needs to exploit the complementarity between sound macro-economic policies, aimed at creating the right environment for economic agents to take long-term decisions about saving and investment, and structural policies aimed at making labour and product markets more adaptable. A prime requirement is that labour market policies, social policies and education and training reinforce each other to encourage activity".

These sentiments broadly echo the Council's strategic approach to fostering employment growth and securing reductions in unemployment outlined in

Chapter 1. Stable monetary and exchange rate policy, coupled with prudent management of the public finances, create the conditions for a low-inflation environment and reduce uncertainty about the conduct of policy, boosting private sector confidence and investment. If complemented by a national consensus covering not just the evolution of incomes, but related matters such as taxation and social welfare, such an approach will facilitate the achievement of gains in international competitiveness while reducing the risk of disruption to the economy as a result of distributional conflict. Though necessary, these two strands of policy do not, on their own, represent a sufficient condition for long-run growth and development. Competitive potential can be translated into competitive performance only through the application of structural reforms, for example in taxation, social welfare regulatory and competition policy, which alter the incentive structure of the economy, as well as removing internal constraints to its development. The implications of pursuing the competitive strategy outlined in Chapter 2 are developed by the Council in the later Chapters of this Report. The strategy is designed to address the scale and intensity of the labour market problems described above.

The Council is of the view that human resource development or manpower policies must be an essential ingredient of any plan to tackle unemployment. This conclusion derives from the fact that unemployment in many countries has various structural characteristics, such as a high proportion of long-term and/or youth unemployment, which will not simply be removed as employment opportunities generally increase. Apart from measures to promote employment and diminish the stock of general unemployment, therefore, specific policies must be in place to ensure that

1. The short-term unemployed and new entrants to the labour market (ie. primarily school-leavers) have an effective chance to compete and do not drift into long-term unemployment.

2. The existing long-term unemployed are successfully reintegrated into the workforce.

Because of its concern at the scale of the long-term unemployment problem, and in particular the social class and geographical concentration of long-term unemployment, the Council has chosen to begin its discussion of policy measures with those directly addressing this problem. The following discussion focuses on the role that active labour market policies can play within an overall strategy for expanding employment and reducing unemployment. The rationale for such a policy, which has both micro and macroeconomic underpinnings, is explained first. The discussion then proceeds to a consideration of the current operation of Irish manpower polices in the areas of training, subsidised employment and job creation. Some reference is also made to recent manpower initiatives abroad, to determine whether there are useful policy lessons from which Ireland could benefit.

(i) The Rationale for an Active Labour Market Policy

In recent times there has been a growing belief among policy-makers in many countries that part of the solution to rapidly escalating unemployment lies in a complex array of active labour market instruments centred on training and subsidised job creation. For example, a new framework for labour market policies endorsed by OECD Labour Ministers in 1992 proposed a shift in resources away from passive income support for the unemployed towards active policies aimed at mobilising labour supply, enhancing employment related skills and increasing the efficiency of labour markets. It must be emphasised, however, that active manpower policies are only likely to be successful in situations where unemployment has significant structural characteristics, preventing or inhibiting the integration of large sections of the unemployed into employment. However, the evidence does suggest that structural unemployment is a major problem in many European countries, including Ireland.

While one function of active labour market programmes is to increase the employment probabilities of programme participants, a major part of the rationale for such an approach is based on the generation of various *microeconomic effects* which are likely to produce an expansion of total employment within the economy.

The microeconomic effects may occur via a number of channels. To begin with, active policies in the areas of training and job counselling may improve the efficiency of labour market matching between vacancies and job-seekers, producing a moderating influence on wage pressures and stimulating the demand for labour. Improved labour market matching may be achieved in a number of ways. For example, training programmes may enable redundant workers to be equipped with new skills more relevant to a high-technology economy and may also reduce uncertainty among employers regarding the suitability of potential employees. Participation in training programmes and counselling services may also safeguard against the possibility of job-search incentives becoming blunted.

Apart from their beneficial impact on wage pressures, active labour market policies may also increase the productivity of the workforce and reduce costs

to firms associated with unfilled vacancies, providing a further stimulus to labour demand.

However, perhaps the most important function of active manpower policies is their ability to mobilise the supply of labour by reducing the extent to which groups, such as the long-term unemployed, are excluded from effective labour market competition for available jobs. In general, the higher the proportion of such structural unemployment within the total stock of unemployment, the slower the rate of labour market adjustment is likely to be for a given labour surplus. As indicated in *A Strategy for the Nineties,* structural unemployment is a term that encompasses a wide range of possible underlying faults in the labour market. In its simplest form, such unemployment may reflect a mismatch between the skills possessed by the unemployed and the qualifications required to take up job vacancies. Mismatch unemployment of this type may have a distinct regional character, often being associated with the occupational displacement of workers in traditional industrial areas struggling to adapt to changing patterns of demand and technology. In the case of Ireland, however, *specific skills mismatches are not particularly evident and, if anything, there appears to be a labour surplus at current wage levels at all educational and skill levels.* Even so, this does not invalidate the theory that a more *general* mismatch may exist between the requirements of many jobs and the qualifications and experience levels of a whole category of unemployed individuals. Long-term and youth unemployment are two examples where this is likely to be particularly true. For young job-seekers, the major constraint on effective competition relates either to poor qualifications or to the absence of work experience. In tackling this form of unemployment, the appropriate policy response is early intervention through counselling and training, preferably during the initial period of unemployment, coupled with measures aimed at reducing the extent of early school-leaving. Intervention in relation to the problem of early school leaving is especially important as there is a strong link between educational attainment and labour market success. Table 3.12 shows the education qualifications of those at work and unemployed in 1991. As can be seen, almost three-quarters of these who were unemployed had either no qualifications or an Intermediate/Group Certificate only, whereas this was true of less than half of those at work. Furthermore, the distribution of qualifications is significantly more favourable among the short-term unemployed than it is among the long-term jobless. The Council's recommendations on education policy have been set out in a recent report (NESC, 1993) and are outlined in Chapter 16 below.

TABLE 3.12

Educational Qualifications of Those At-work and Unemployed 1991

Educational Level	At Work	Unemployed	Short-Term Unemployed	Long-Term Unemployed
	%	%	%	%
No Qualifications	22.4	40.1	24.3	47.2
Inter./Group	25.6	34.5	37.7	33.2
Leaving Cert.	30.9	18.6	26.9	14.9
3rd Level	20.8	6.7	11.1	4.8
Total	100.0	100.0	100.0	100.0

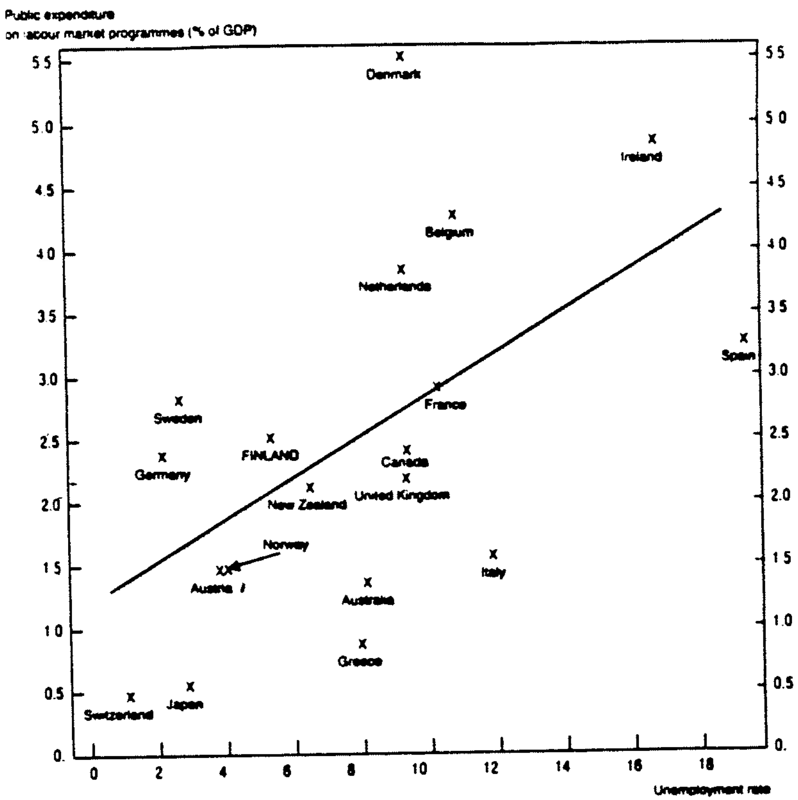
Source: Labour Force Survey, 1991 (Special tabulation).

For the long-term unemployed, constraints on effective labour market participation derive from a number of factors. To begin with, many long-term unemployed are, as indicated above, educationally disadvantaged in comparison with other members of the labour force. Additionally, stigmatisation and the absence of recent work experience create in-built biases on the employer side, leading to the screening-out of the long-term unemployed during the recruitment process in favour of younger, more qualified or more experienced applicants. International survey evidence quoted in the *1993 OECD Employment Outlook*, for example, indicates that many employers refuse to consider employment applications from persons without recent work experience. It has also been suggested by some studies that high turnover costs associated with employment protection and security rules may reduce the demand for labour and militate against the employment chances of long-term unemployed persons. However, the international evidence regarding the net effect of such rules on total employment is ambiguous, while the extent of employment protection measures in Ireland is significantly less onerous than in some of our trading partners. Finally, it is argued that the effectiveness of job search tends to diminish as the duration of unemployment increases, reflecting both the reduced probability of finding employment and the progressive demotivation of the unemployed.

Active labour market policies are well-established in the Irish context and expenditure on such programmes is high relative to other European countries. As shown in Figure 3.2, this is not due simply to the relatively high rate of unemployment. The relatively high proportion of spending reflects in part the significance of Ireland's structural unemployment problem. The following sections outline the principal features of the active labour market programme and the final section sets out the Council's recommendations.

FIGURE 3.2

Public Spending on Labour Market Programmes in Relation to the Unemployment Rate Average 1985-1991



Source: OECD (1993).

(ii) The Role of Education and Training as a Response to Unemployment

If there exists a shortage of skilled labour, then education and training measures will serve to reduce structural unemployment of the type discussed above. On the other hand, if, as appears to be the case in Ireland at present, there is a labour surplus at all levels of skill, then training and education will, *apart from any impact on the demand for labour,* function as a method for the redistribution of job chances among the labour force. This function is in itself important. *As the 1993 OECD Employment Outlook* points out, a challenge for manpower policies across many European countries is to prevent current inflows into unemployment, which reflect in many instances cyclical downturns in economic activity, from turning into long-term structural unemployment. In the case of Ireland, the labour force is expected, in the absence of substantial net migration, to continue growing by approximately 23,000 per annum until the end of the decade. Under conditions of constant excess labour supply, caused primarily by a continual influx of young labour force entrants, a "queuing" system will operate whereby those without appropriate qualifications and experience are pushed down the queue into long-term unemployment. A minimum aim of manpower policy must therefore be to correct this phenomenon through an equalisation of employment chances in the labour market.

Of course, education and training can perform such a role only to the extent that they represent appropriate instruments for countering labour market disadvantages. This leads us into a consideration of the present structure and adequacy of education and training provisions for the unemployed. It should be stressed, however, that for the long-term unemployed even highly relevant training is unlikely to be completely sufficient in offsetting the extent of labour market bias against them, creating a need for further specially tailored measures involving, for example, employment subsidies or direct job creation.

Irish active labour market policies in the area of education and training of the unemployed can be broadly classified into programmes aimed at (1) early school leavers (2) the long-term unemployed (3) specific skills training of the general unemployed. The Early School Leavers programme, administered by the Department of Education and FÁS, consists of four measures, all of which are designed to provide foundation training to young people with poor educational qualifications. These are: Youthreach, Community Youth Training Programme, Community Training Workshops and, related to these, the Skills Foundation Programme, which is run by FÁS. The Early School Leavers measure provides training for about 6,000 young people per annum. However, a number of problems are evident in programmes directed at early school leavers viz. low rates of progression to further education and training and a lack of sufficient integration with the rest of the education and training system (O'Connell and Sexton, 1993). The poor rate of progression to further education and training is a matter for concern, since most participants in these programmes suffer severe educational and occupational disadvantages that are unlikely to be corrected easily.

Another substantial element of training for the unemployed consists of measures aimed at meeting particular skill demands in local labour markets.

The largest such programme is the Specific Skills Training Programme administered by FÁS, involving the training of over 10,000 persons annually and targeted on the unemployed (90%) and those at risk of unemployment (10%). Courses last on average for about 18 weeks and are linked directly to the local market through instructors who monitor skill needs and conduct placement surveys after course completion. If employment placement falls below 65%, the course is reviewed to determine whether it should be substituted or adjusted in the light of local labour market needs. At 66%, the aggregate placement rate in 1990 was only marginally above the required "quality control" threshold, but it must be recognised that SST programmes cater for a wide range of abilities, educational attainments and labour market experiences (FÁS, 1990, "Follow up of FÁS Programme Participants" survey). O'Connell and Sexton (1993) found that there were significant variations in the impact of SST according to personal and background characteristics and that, generally, better qualified and experienced participants tended to benefit more, in placement terms than other participants. Furthermore, a report by the Programme Evaluation Unit of the Department of Labour showed that about 28% of SST courses in 1991 had a placement rate below 50%, a statistic which, given a curriculum centred on medium and high level skills, suggests that the problem may lie more in the relevance or quality of the course itself than with the characteristics of participants.

In the area of training for the long-term unemployed, two major training programmes may be noted: Alternance training and the Vocational Training Opportunity Scheme. In addition, about 1500 long-term unemployed persons participate annually in Specific Skills Training courses. Alternance Training, provided by FÁS, allows trainees to alternate between employment experience and formal vocational training. Women, mainly those seeking to return to the labour force after a prolonged absence, account for about 75% of participants in Alternance. O'Connell and Sexton (1993) found that, one year after completion of the programme, only 30% of participants were in employment, while 9% were undertaking further education or training. Given that the scheme is intended to function as a bridge to more advanced training, the low rates of transfer from Alternance to other training programmes are a cause for concern, suggesting that linkages to the mainstream education and training system need to be strengthened through appropriate certification, counselling, and provision of "follow-on" courses.

The Vocational Training Opportunity Scheme, administered by the Department of Education and implemented by the 38 Vocational Education Committees, provides a mixture of training and mainstream senior cycle secondary education to long-term unemployed people. The programme, which has about 3000 participants, is aimed at the long-term unemployed (at least 12 months) over the age of 21 years and its objective is to provide second-chance vocational education to the unemployed in order that they may compete effectively with other groups in seeking employment and in gaining access to further education or training. The programme is widely regarded as being of high quality. The National Development Plan envisages that provision will remain at this level. Nevertheless, it is relevant to note two problems that would confront any major expansion of the programme, namely a shortage, particularly in rural areas, of instructors in suitable subjects, as well as the relatively unrepresentative nature of the highly motivated and able participants whom the scheme has so far attracted.

At this point it may be useful to consider briefly some aspects of the various training programmes that have been instituted in other countries to counteract problems of structural unemployment. A limited number of microeconomic studies of these programmes have been undertaken. Some of these evaluations are of an experimental or quasi-experimental nature, involving the use of treatment and control groups, whereas the rest are based on alternative methods involving, for example, the study of labour market flows.

A number of general conclusions can be obtained from these studies. First, although much of the research must be regarded as tentative, there is very little evidence to suggest that *broadly-targeted* training schemes have a substantial impact on the post-programme employment rates of participants. In a recent OECD review of nine studies of broadly-targeted programmes, only five indicated the presence of a positive impact on employment but these were all characterised by methodological problems, making interpretation difficult. The remaining four studies found no significant impact on employment.

Second, programmes targeted at particularly disadvantaged sub-sections of the unemployed produced more successful results. Training measures provided for disadvantaged groups under the Job Training Partnership Act in the United States, for example, were found to produce an overall impact on employment of between 2-3% for both male and female participants. However, the employment impact was not significant for those participants classified as highly disadvantaged in terms of characteristics such as work experience and qualifications.

Third, there is some evidence to indicate beneficial effects on employment and earnings from targeted measures combining training and work experience. A General Projects option under the Job Development programme for the long-term unemployed in Canada, providing a mixture of public-sector work experience and formal and on-the-job training, produced an increase in employment probabilities for female, but not male,

participants. Other schemes combining work experience and training for other disadvantaged groups were also found to induce a general improvement in employment chances, working hours and earnings.

Fourth, training schemes may work better when they are directed more towards the requirements of employers than workers. This is one of the conclusions deriving from a study of Canada's Skill Shortages programme, which is intended to help employers fill specific skill vacancies. The relevant study recorded a positive impact on employability and earnings for unemployed participants in two classroom variants of the programme.

Fifth, early intervention through counselling and identification of retraining needs can facilitate the re-entry of redundant or displaced workers into employment. An evaluation of such measures has, for example, been undertaken in the case of displaced workers in Canadian steel and mining enterprises. Compared with their counterparts at unsupported sites, displaced workers at sites where both counselling and retraining options were provided had a 7% higher probability of progressing to further employment elsewhere.

(iii) Special Employment Measures

As the Council pointed out in *A Strategy for the Nineties,* manpower policies centred on human resource development alone may be unsuccessful in removing all labour market impediments to the reintegration of the long-term unemployed into the workforce. Even with suitable training provision, the balance of incentives, from an employer's perspective, is likely to reside with those who possess recent work experience. The correction of these disincentive effects implies a need for a set of complementary policies including, for example, direct or subsidised job creation.

A number of such employment schemes and subsidies are currently in operation. The Social Employment Scheme (SES), the main policy response to the problem of long-term joblessness, provides subsidies for the employment of unemployed adults over the age of 25 years in jobs that would not be viable on commercial grounds but which fulfil certain public or social functions. The measure, which provides funding for an average of 2.5 days per week for up to one year in newly created jobs, is intended to provide work experience but it has attracted some criticisms. Ronayne and Devereaux (1993), for example, concluded that: (1) quality varies greatly, with a minority of quality schemes in existence; (2) the decline in payment rates combined with the routine and menial nature of much of the work make SES participation unattractive; (3) the scheme needs to be accompanied by a demand-side stimulus to increase the employment chances of those who have completed it (hence the Council's concern to give priority within such modest resources are available to this broad area). A number of these deficiencies have been addressed in the design of the Community Employment Development Programme. The latter is currently confined on a pilot basis to residents of areas served by the twelve Partnership Companies established under the PESP. The CEDP is similar in outline to SES, but contains structured training elements and somewhat different payment and eligibility conditions.

Subsidies are also provided to encourage the employment of both short and long-term unemployed persons within the private sector. The Employment Incentive Scheme, directed towards the subsidised employment of long-term unemployed adults, had a subvention rate of £60 per week, with a duration of 39 weeks and an estimated coverage of 4,850 recruits in 1992. The scheme's potential for altering employment is, however, diluted by the existence of a similar job subsidy programme, the Employment Subsidy Scheme, for those signing on the live registrar for eight weeks or more. The ESS, introduced in 1992 and intended to support the creation of 15,000 additional jobs, provided a subsidy to employers of £54 per week for 52 weeks for each additional staff member recruited above the staff complement obtaining in November 1991. The total number of jobs subsidised under the ESS was 5,939 in January 1993, and recruitment has now ceased.

Two smaller schemes under the heading of enterprise development may be briefly mentioned. Introduced to support unemployed people starting up a business, the Enterprise Scheme can be availed of following FÁS training, or directly where no training is needed. The Scheme, covering all sectors of the economy and based on the payment of an allowance during the first year of business, supports more than 2,000 people per annum. Breen and Halpin (1989) estimate a deadweight effect in the range 40-50% and a displacement of 60%. For these reasons, some have argued that the measure distorts competition, providing participants with subsidies not available to their competitors.

The Community Enterprise Scheme is a small and inexpensive programme, assisting community-owned enterprises employing 500 people and catering for about 240 trainees annually. The basic rationale of the programme is to encourage local community development of facilities, job creation and natural resources, and is consistent with the locally based initiatives established under the PESP.

Employment subsidies, direct job creation projects, and enterprise schemes all have the basic objective of altering the market-determined level or

distribution of employment. Research on the performance of these types of schemes internationally has highlighted a number of features that may serve as a guide to project design and implementation. First, employment subsidies often have significant deadweight costs arising from the fact that much of the additional employment would have occurred in any event. These deadweight costs may be reduced, however, by confining subsidies to those groups, such as the long-term unemployed, with particular labour market difficulties. Nevertheless, even with such a targeting, net increases in total employment may be small as a consequence of employment substitution and displacement in product markets, though this may not be a significant policy problem as long as a sufficient redistribution of employment chances is being effected.

Second, one analysis of the Targeted Job Tax Credit in the United States attempted to estimate the wage-cost elasticity of employment for disadvantaged workers (Mangan, 1988). The study found that smaller firms were, in employment terms, generally more sensitive to wage costs, implying that subsidies targeted on such companies are likely to have greater impact.

Third, evidence from the United States indicates that enterprise schemes have a very limited role to play in countering labour market disadvantages, generally being of interest to only a tiny proportion, perhaps in the region of 2-4%, of the unemployed, who are likely to be relatively advantaged in terms of education or technical expertise.

Finally, studies of the impact of large-scale direct job creation schemes have proved inconclusive (OECD, 1993). Again, however, more narrowly-focused schemes appear to perform better in altering post-participation employment rates. The impact of such programmes on wage formation behaviour must be taken into account in assessing their net impact on employment.

Generally, it must be added that the employment impact of active labour market measures must take account of the possible negative impact of their taxation implications for growth in sustainable employment.

(iv) The Role of Counselling in Active Labour Market Policies

A successful active labour market policy must be founded on a number of inter-related and complementary elements, including training in relevant skills, targeted employment subsidy or job creation schemes, and consistency between the social welfare system, on the one hand, and the training system and labour market on the other. The potential of this approach in alleviating structural unemployment in particular can be enhanced through the establishment of effective job counselling procedures. In the case of young entrants to the labour force or workers recently made redundant, the aim should be to avoid the possibility of drift into long-term unemployment by ensuring rapid identification of employment needs and immediate access to training. Where unemployment is the result of redundancy, it may be necessary to determine whether such employment has been caused by the secular decline of a traditional industry, implying a programme of retraining in more relevant skills, or whether it reflects a cyclical economic downturn, suggesting that the particular skills under consideration are still relevant and that more generalised training, for example in job search techniques, is in order.

For the long-term unemployed effective counselling can facilitate a better matching of individual needs and ability levels with training and job placement programmes, as well as helping to prevent labour market marginalisation and reducing the risk of demotivation.

France provides a recent example of a concerted initiative in the area of job counselling and placement. In February 1992 the French Government introduced a new programme whose aim was to evaluate, through an interview process, the employment prospects of long-term unemployed individuals as well as any adjustments that might be required in the design of existing training schemes. Over 1 million interviews were conducted, leading to an actual placement in 17% of the cases. Another 17% of the interviews resulted in the offer of either a job or training place, both under the community work programme. However, early indications are that the counselling initiative has had mixed results. In the ten-month period following its introduction, long-term unemployment fell by around 5%, but this was accompanied by a reduction in placements of other unemployed categories, as well as an increase in overall unemployment. Of course, this is likely to reflect cyclical and other exogenous factors. While the initiative has not improved the overall labour market situation, it has reduced the extent of *structural* unemployment by redistributing job chances in favour of the long-term unemployed.

The French interview and placement programme was a once-off effort to reduce the ranks of the existing long-term unemployed. Studies have been undertaken in some countries, however, concerning the more general contribution to labour market outcomes resulting from the operation of public employment services. A key issue for some of these studies is whether counselling should be pursued in the case of all unemployed persons or whether resources should be channelled towards groups with specific labour market disadvantages.

An evaluation of Canada's National Employment Service, based on questions in national labour force surveys and surveys of workers and employers, attempted to shed light on this issue. Its conclusion was that the employment services improved the job prospects of groups who faced particular labour market disadvantages, but had no measurable impact on those whose employment prospects were generally favourable. The study consequently advocated a more selective approach to provision of public employment services, with procedures in place to allow an early determination of those applicants for unemployment support who were most likely to benefit from job-search assistance. The pivotal role of initial interviews was also underlined in a 1992 study of the Employment Service in Great Britain. In Ireland, the initial contact programme for the long-term unemployed which is operated by the 12 PESP area-based partnerships is applying a similar approach (with some programmes adopting a relatively sophisticated "tailor-made" approach developed in the Netherlands).

In general, public provision of job-search assistance in a number of countries seems to have been beneficial when targeted at certain disadvantaged elements of the labour force. It is possible, however, that improvements in employment prospects for such groups may come at the expense of the unemployed generally. Jackman and Lehmann's (1990) study of the British Restart programme, for example, found that, while the chances of employment for the long-term unemployed were probably increased, this was partly explained by a crowding-out of employment prospects for the short-term unemployed. Thus, the main economic function of employment services may be to secure a more equitable distribution of employment chances among the unemployed, rather than to facilitate the general filling of vacancies. However, as outlined above, *the dynamic effects of such redistribution are likely to result in an increase in the total number employed in the economy*.

4. CONCLUSIONS ON LABOUR MARKET POLICIES

The Irish labour market is characterised by a number of features which pose a fundamental challenge for employment policy in the years leading up to the end of the decade. To begin with, the general stock of unemployment is already at an alarmingly high level. Added to this, and in common with many other countries, Ireland has a very high incidence of structural unemployment resulting from youth and long-term joblessness. Irish unemployment also tends to afflict prime age groups and prime income earners within families, implying substantial economic and welfare costs. Successfully addressing those problems alone would represent a major policy achievement. However, these problems must be also tackled within the context of an expanding labour force, which, in the absence of significant net migration, is expected to continue growing by around 23,000 p.a. until the end of the decade.

The implementation of a programme of structural reforms aimed at improving the economy's internal efficiency and international competitiveness, combined with the likely upturn in external trading conditions, can produce a significant acceleration in employment growth over coming years. It is also likely that any recovery in external economic activity will be accompanied by a resumption of substantial net emigration, although this would in no way represent a satisfactory means of resolving Ireland's unemployment problem. However, even a very significant reduction in general unemployment is likely to have little impact on the high incidence of structural unemployment. It is in tackling the latter problem that a clear role for active labour market policies arises.

In principle, an active labour market policy may encompass not only specific manpower programmes and services but also other policies that can have some impact in mobilising labour supply and dealing with structural unemployment. When comparing the effectiveness of active labour market expenditure across countries, it is also important to bear in mind that unemployment and its structure may be influenced by active labour market policies that do not have an obvious budgetary dimension. Measures to promote greater consistency between the tax and social welfare systems, for example, constitute one example of an active, yet non-direct, labour market policy. It is also a challenge to policy to secure a balance between the protection of the legitimate interests of those currently in work and the stimulation of demand for labour in order to increase the overall numbers in work.

As shown in Figure 3.2 above, Ireland places a very high reliance on active labour market instruments in comparison with many other OECD countries, which is hardly surprising in view of the relative scale of our long-term unemployment problem. It might be asked why Irish manpower policies have so far not proved to be a more effective response to growing unemployment, particularly of a structural kind. Active policies in the manpower area generally comprise five inter-related elements: public employment services, training, job creation, subsidised employment, and youth programmes. In the case of Ireland all of the elements required to pursue an effective active labour market policy appear to be in place. While it may be the case that the

individual components lack development and/or an overall co-ordination and consistency, it must also be recognised that the aggregate demand for labour is too low for our strong labour force growth. The achievement of a higher rate of economic growth, and output growth whose composition supports higher rates of employment growth, is therefore central to the achievement of our employment targets. Nevertheless, the Council is satisfied that there is a need for a radical programme of active manpower measures.

The Council believes that active labour market measures should reflect a strategic approach. The strategy should be to minimise the risk of drift into long-term unemployment, on the one hand, and to counter the hysteresis effect which tends to trap the long-term unemployed on the margins of the labour force. The first requires an active programme of early intervention at the time of redundancy or other job loss, or on entry to the labour force. Counselling, job-search skills and skill development generally should be the focus for such intervention. It has been suggested that participation in such programmes should be a condition of eligibility for income maintenance payments. The Council believes that it is more effective to encourage such participation through the design and delivery of attractive and effective programmes, participation in which should not entail any reduction in effective entitlements. There is a particular need to focus on the needs of young people entering the labour force with low levels of educational attainment and correspondingly poor employment prospects. These needs are currently addressed primarily in the Youthreach Programme and in the FÁS Teamwork and Community Youth Training Programmes. The Council recommends that the effectiveness of these measures should be enhanced, in particular through improving the accreditation arrangements for the training provided and the structural linkages between such programmes and mainstream education and training services. The Council therefore recommends that as an alternative to signing on the Live Register new entrants with low levels of educational attainment should be provided with the possibility of continued education or training leading to an accredited qualification. The Council believes that there is a need to expand provision for a somewhat broader range of disadvantaged young people and more generally to enhance the guidance and placement services available to them at the point of registering for unemployment assistance.

The second element of the strategy, the focus on the long-term unemployed, should aim to increase their active engagement with the labour market through an integrated approach to work experience, training, counselling and placement. Such a strategy is dependent for its effectiveness on the quality of the interventions. Effectiveness is also likely to be enhanced by the operation of financial incentives which consistently favour the recruitment prospects of the long-term unemployed.

In relation to measures in the field of education and training, a number of questions must be asked. First, to what extent do the present schemes for the unemployed provide quality training in skills that are relevant to the requirements of a modern economy? Second, apart from the issue of actual relevance and quality, how are such training measures perceived by employers? The Council notes that 70% of the unemployed who underwent the FÁS Specific Skills Training Programme were in employment in 1991 six months after completion of their training. However, this is only marginally higher than the prospects for employment of all of those unemployed for less than 12 months. Third, do training programmes for those with low educational or skill levels provide a pathway to further education and training which may be necessary to secure employment? These issues are discussed in more detail in Chapter 16 below.

The present operation of employment subsidy and job creation schemes also raises a number of concerns. As noted above, employment subsidy schemes tend to have high deadweight costs. In addition, the effect of employment subsidies intended to introduce a degree of positive discrimination in favour of the long-term unemployed can be substantially offset by the existence of similar subsidies for the short-term unemployed. Given the high deadweight costs of schemes available in respect of the unemployed generally, and given the need to deal with the extent of structural unemployment, the Council recommends that employment subsidy schemes be focused on the most disadvantaged groups, namely the long-term unemployed.

The principal specific policy response to the problem of long-term unemployment has been the Social Employment Scheme, which did not fulfil any of the criteria for a successful active labour market measure. No formal training was provided and progression to employment or formal training was low. The Council therefore supports the proposal in the National Plan that the SES be replaced through the extension nationally of the Community Employment Development Programme. That programme, which takes specific account of the training and developmental needs of the long-term unemployed participants, should be integrated with the rest of the education and training system through appropriate certification, counselling and placement elements. An econometric study of the wage-moderating effects of active labour market programmes concluded that a key variable was average expenditure per participant, a proxy for programme quality, rather

than the actual number of participants (as a proportion of the labour force) (OECD, 1993). This result suggests that the objective of securing effective labour market participation, and hence dynamic effects leading to employment growth, is more likely to be achieved with high quality programmes. Low cost schemes with large numbers of participants are therefore likely to have only a marginal impact on open labour market outcomes. The impact of labour market programmes is, of course, mediated by the degree of competitiveness of the labour market.

The Council is deeply conscious of the scale of the unemployment problem and in particular the extent of long-term unemployment. The challenge which this poses to social solidarity, as well as the affront to the dignity of the individuals concerned demand action from all economic agents. The headlines for such action are set out in the Council's recommendations throughout this Report. However, the Council believes that, even were all of its recommendations to be applied comprehensively and the external economic environment to prove benign, the labour market prospects of many of the 120,000 long-term unemployed will remain bleak. For example, if the most optimistic projection for net employment growth contained in the National Development Plan were doubled, with a net increase of 200,000 jobs in 1999, in the absence of emigration unemployment would fall by only 50,000. Given the likely increase in female labour force participation and return migration which such employment growth would induce, the decline in unemployment would probably be significantly less. Given the likelihood of a continuing cumulative process of labour market marginalisation and social exclusion across generations, the Council believes that a more direct response is required.

There can be no return to irresponsible fiscal expansion designed to stimulate inevitably unsustainable employment. The Council's analysis of the requirements for growth and employment rule that out. There is, however, a case for public resources to be used within prudent fiscal limits to provide meaningful work, social purpose and a basis for progression through the labour market for those who otherwise would face the grim prospect of decades of enforced idleness. The geographical concentration of unemployment in certain neighbourhoods and districts gives rise to particular forces which are likely to deepen stigma and exclusion. In such areas, important work needs to be done to build up the physical, social and cultural infrastructure. Much is already achieved on a voluntary basis. The recognition of the importance of such activities through the resourcing of voluntary and community groups and other agencies to enable the long-term unemployed to be employed in such work would represent an additional and effective response to the labour market realities. This would be additional to the range of education and training measures targeted on the unemployed which, excluding initial education and training measures for young people, are likely to provide approximately 50,000 places annually under the terms of the National Development Plan.

On the basis that the net additional cost would be modest, relative to the transfer payments which would arise in any event, as the basis for employment in meeting community needs. In all cases, participants would receive counselling and guidance on the educational and skill development opportunities available, but the primary objective would not be progression in a short time to open employment. The Council's approach to fiscal policy provides for a modest real increase in public spending within its overall strategy, given its projection for growth. The Council believes that a targeted programme of job creation of this kind should have priority in the allocation of those resources.

The alternative would be to apply this modest level of resources to the reduction of the tax burden, augmenting the tax reform measures set out in Chapter 7. The Council believes that the supply-side effects of such an approach would have a very much more limited impact on unemployment - and probably none at all on the long-term unemployed - than the targeted approach put forward here. This proposal is directed at addressing the very specific needs of the long-term unemployed and is not to be seen as taking from the Council's overall strategy for tax reform and competitiveness in the interests of boosting sustainable employment.

5. CONCLUSIONS

The Council believes that transfer payments to support many of the long-term unemployed will require to be funded in any event. This expenditure could be applied so as to generate the resources required to create opportunities for meaningful work in areas such as community services, care of the elderly, environmental improvement and other necessary activity, which would provide a basis for satisfying work for those who may not be otherwise likely to enter gainful employment. The provision of this work opportunity will require innovation and flexibility in support of the community sector and the voluntary organisations who may be best placed to structure this activity. It would complement the education and training measures focused on the long-term unemployed, catering for those for whom such measures are

inappropriate or providing, as necessary, an outlet for those who participate in such education and training programmes but find it impossible to secure open employment.

The Council is satisfied that the scale of the problem of long-term unemployment and its intractability make this a more satisfactory option, on both economic and social grounds, than the alternatives. For example, allocating the modest resources implicit in this recommendation to reducing tax levels would have a very limited impact on the demand for labour and that demand would not, in any event, improve the prospects for the long-term unemployed. The Council considers that it is a matter of great urgency that the needs of the long-term unemployed be addressed directly, in tandem with measures to improve job opportunities for those entering the labour force and those employed in occupations which are vulnerable to competitive pressures. Concentration on the latter to the exclusion of the needs of the long-term unemployed would be alien to the values which the Council believes are widely shared in Irish society and on which its approach to the development of this strategy report has been based.

CHAPTER 4

Competitiveness

COMPETITIVENESS

In this Chapter the Council outlines its views on the central importance of competitiveness as a basis for maintaining and expanding sustainable employment in Ireland. The first section outlines the role of competitiveness in sustaining economic growth. The second section discusses the different dimensions of competitiveness to be reflected in public policy. The third section discusses innovation as a central element in the process of building competitiveness. The fourth section discusses the role of competition policy. The final section discusses income development in the context of a strategy to develop the competitiveness of the economy.

Given the high rates of productivity growth which have applied in Ireland and the likely continuation of present trends, significant employment growth will require the sustained achievement of very high rates of output growth. To clarify what policies are likely to support a high rate of economic growth, a model of the determination of growth is needed. The neoclassical model of economic growth (outlined in the Appendix) provides important policy guidelines. It indicates the importance for economic growth of reducing the debt/GNP ratio, of achieving appropriate factor costs and of increasing competition in the non-traded sector of the economy.

The neoclassical growth model is subject to a number of limitations which are particularly significant in an Irish context. This arises from the fact that Ireland's industrial structure has two distinct sectors: one which is concentrated in high productivity, high-tech and largely foreign-owned firms, and the other which is based on low productivity, low-tech and largely indigenous firms. Hence, while following the recommendations provided by the model is *necessary* to achieve economic growth, this is unlikely to be *sufficient* to achieve the optimum development of the economy, in particular of the indigenous sector.

Endogenous growth theory (discussed in the Appendix) suggests the types of additional factors which are likely to be relevant. The policies most likely to foster growth, derived from endogenous growth models and associated empirical work have been listed by Barro and Romer (1990) as follows: "Support for education; incentives for investment in physical capital; protection of intellectual property rights; support for R&D; international trade policies that encourage the production and worldwide transmission of ideas; and the avoidance of large Government induced distortions in the market." Endogenous growth theory points to the importance for growth performance of factors such as increasing returns to scale, imperfect competition and the cumulative effects of learning by doing. Development policy needs to pay attention to these factors, rather than assuming that the economic environment is characterised by perfect competition and freedom of entry. This points to the need to broaden our understanding of the nature of competitiveness. The Council's approach to competitiveness is outlined in the rest of the Chapter and the implications of this approach inform the analysis throughout the rest of the Report.

1. DIMENSIONS OF COMPETITIVENESS

For an open economy like Ireland, growth and employment are dependent upon competitiveness. Competitiveness has been defined as "the degree to which (a nation) can, under free and fair market conditions, produce goods and services that meet the test of international markets while simultaneously maintaining and expanding the real income of its citizens" (US Commission on Industrial Competitiveness, 1985). In an Irish context, the achievement of a much higher employment rate would be required to achieve a significantly higher rate of real income per head.

At one level it can be argued that Ireland has been competitive at the national level: our rate of output growth over the period 1960-90 was very close to the EC average, while non-agricultural employment over the same period grew at a rate which was more than 40% above the EC average. Furthermore, both output and total employment growth rates in Ireland since 1986 have substantially exceeded the EC average. However, the rate of growth achieved has not been sufficient to generate employment on the scale required in Irish circumstances. Furthermore, the composition of growth, reliant as it has been to an exceptional degree on foreign-based manufacturing industry, has not been the most appropriate for a country with a substantial labour surplus. Demographic conditions are such that, in the absence of net emigration, employment will have to grow at the rate of 2% per annum for the rest of this decade to avoid further increases in unemployment. This would represent a dramatic improvement over long-run performance in the Irish economy.

Given that the degree of integration of Ireland into the international economy will intensify, employment growth of a sustainable kind on the scale required can only be achieved by increasing the competitiveness of Irish firms and of Irish labour.

Competitiveness is a *relative* measure - by definition it describes a state which is better or worse than that of others. There is controversy over the extent to which the source of competitive advantage lies with the

performance of *countries*, or particular *industries*, or individual *firms*. It is also necessary to distinguish between short-run and long-run competitiveness, since short-term cost advantages can be rapidly eroded. Furthermore, competitiveness is related to technological change and the capacity to innovate and to adopt new technologies. It is, therefore, probably easier to recognise competitive performance than to specify its causes. It is, however, important to recognise explicitly the various dimensions of competitiveness as a prelude to devising strategies to enhance competitiveness. Following Buckley *et al* (1988), this involves distinguishing between *competitive performance*, which is a measure of the comparative success of an economy; *competitive potential,* which is a measure of the possibilities which are present in the economy but which require development to sustain a competitive performance; and *competitive process,* which is a measure of the policy and behaviour which will translate a competitive potential into competitive performance.

With regard to competitive *potential*, the principal indicators relate to price and cost competitiveness (including relative costs and prices and labour productivity) and technological developments (including process and product development). It is clear that a competitive potential which is based solely on costs may prove unsustainable in the medium to long- run, especially as the progress of globalisation induces the transfer of economic activity to low cost developing countries. Equally, however, a lack of price or cost competitiveness can rapidly translate into a loss of market share and therefore of employment. Technological and quality competitiveness, on the other hand, represents a basis for sustained performance, especially when it reflects the mastery of new technologies or successful participation in the emergent stages of new product or service markets. Successful technological competitiveness (covering qualities such as design and consumer service) eases the pressure on cost and price competitiveness in the long-run.

The translation of a competitive *potential* into competitive *performance* requires appropriate policy and action, both on the part of government and on the part of firms and industries. These include necessary innovation in products and processes, strategies to improve the quality and motivation of the workforce, strengthening of the commitment to and capacity for international trade, building of strategic capacity in design and market positioning, and an appropriately balanced approach to regulation, investment and R&D. There is a general agreement that the degree of competition *within* an economy contributes to the effectiveness of the competitive process as defined here. Therefore, indicators such as the rate of business start-up and the rate of growth of companies with appropriate potential are important signs of this dimension of competitiveness.

2. INNOVATION

The Council believes that the pace of change - in technology, in markets, in products and in the efficient organisation of work - make it imperative to focus on ways of strengthening flexibility and adaptability as the key to long-run competitiveness. This competitive strength is best expressed as *innovation*, and the test of a country's competitiveness as its capacity to promote and sustain innovation. While innovative performance, being both a response to and the basis for enhanced profitability/viability of business, is fundamentally a matter for individual firms and those who manage and work in them, the capacity for innovation can be stimulated or inhibited by the institutional and policy framework within countries.

The implications of applying this approach to the Irish experience were suggested by a recent study carried out for the Council by Dr. Lars Møjset of the Institute of Social Research in Oslo.[18] The study identified a number of structural features of the Irish economy which, over a very long period, contributed to a vicious circle of underdevelopment at a time when the contrast countries in the study[19] were enjoying the benefits of a virtuous circle, leading to growth and development. These structural features include a long-run reliance on Britain and the relatively weak British economy; the central importance of an extensive (grass-based) type of agriculture; the absence of an indigenous industrial base at independence, largely as a result of the deindustrialisation of Ireland in the last century; and a unique demographic pattern characterised by high natural increase and high emigration. The strength of Mjøset's analysis lies in tracing the interaction of these various factors in the Irish economy and society and their influence on the way in which Ireland in turn interacted with the external economy, ways which were quite different from those of the contrast countries.

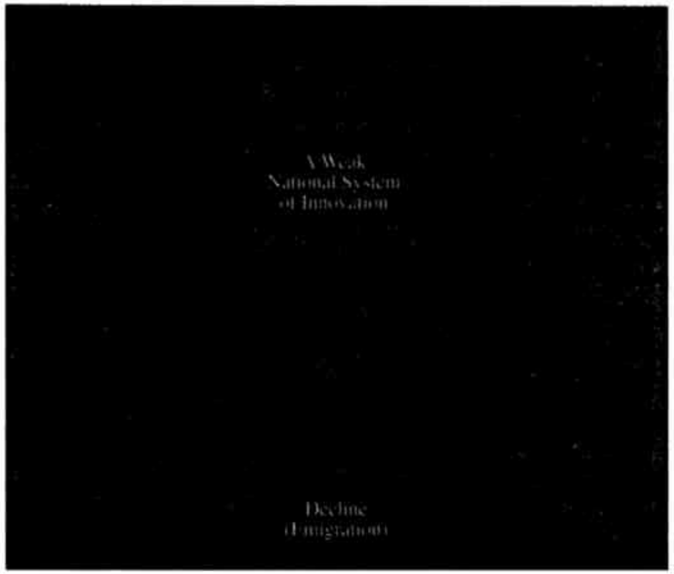
The basic vicious circle which characterised Ireland's long-run development is shown in Figure 4.1. The processes summarised in that figure reflect the fact that Irish agricultural systems effectively precluded the development of close industry/agriculture linkages, such as developed in many other agricultural exporting countries, such as Denmark. This, allied to proximity to and dependence on Britain inhibited an Irish industrialisation process which could match that of the contrast countries. After independence, the dominant export activity remained the same as before, namely the export of live cattle to Britain. Clearly this was a very unpromising context for the development of industrial activities.

18 Report No. 93. *The Irish Economy in a Comparative Institutional Perspective*, 1992.

19 The countries examined were Austria, Denmark, Finland, Sweden and Switzerland.

FIGURE 4.1

Ireland's Basic Vicious Circle



A similar process of interaction leading to cumulative developmental problems can be seen in connection with Ireland's industrialisation programme. A key limitation of the programme in the past was that a strategy which broadly relied on the importation of entrepreneurship from abroad, or rather on importing the fruits of foreign entrepreneurship, of itself did little to challenge the factors which contributed to long-run underdevelopment.

It is, of course, possible to break out of a vicious circle. Ireland's experience in the late 1980s shows that when internal conditions are appropriate, rapid benefits can flow from a benign international environment. However, the nature of Ireland's development needs is such that policies directly focused on the structural constraints to building international competitiveness, and therefore growth, are also needed. Mjøset argues that entering and sustaining a virtuous circle of development requires a strong *national system of innovation*. The dimensions of this will be outlined below. Fundamentally, it implies a capacity at national level to succeed in the international economy based on successful adaptation to prevailing technologies and market characteristics.

Mjøset shows that the development of the world economy can be divided into distinct periods, characterised by the prevailing core technologies. In the past these core technologies have related successively to textiles, the railways, electricity and chemicals, durable consumer goods and, since the 1970s micro-electronics and bio-technology. The mastery of these core technologies, which are characterised by their impact on products and processes in all economic sectors, is crucial for competitiveness. Small countries face particular difficulties in this regard. They rarely develop the technologies themselves, but unless they master and apply them they may be caught in a classic "small country squeeze", between large countries, on the one hand, which have mastered the core technologies and, on the other hand, newly industrialising countries which are capable of producing simple goods very cheaply. This small country squeeze has become increasingly acute as a result of the intensification of international competition, the differentiation of product markets and the ever shorter life cycle of products. "The new 'haves' are those who master high technology and can therefore achieve high standards of living, while the new 'have-nots' are those who have to be content with the simpler products or technology, where price competition and therefore pressure on wages is the dominant regime" (Braun and Polt, 1988).

Central to this approach to defining the basis for competitiveness is the notion of innovation. The term is applied with three different meanings:

(a) To denote a specific stage in the process of technological change - when an invention is introduced to the market;

(b) To denote all kinds of non-technical novelties of an organisational, social, institutional nature;

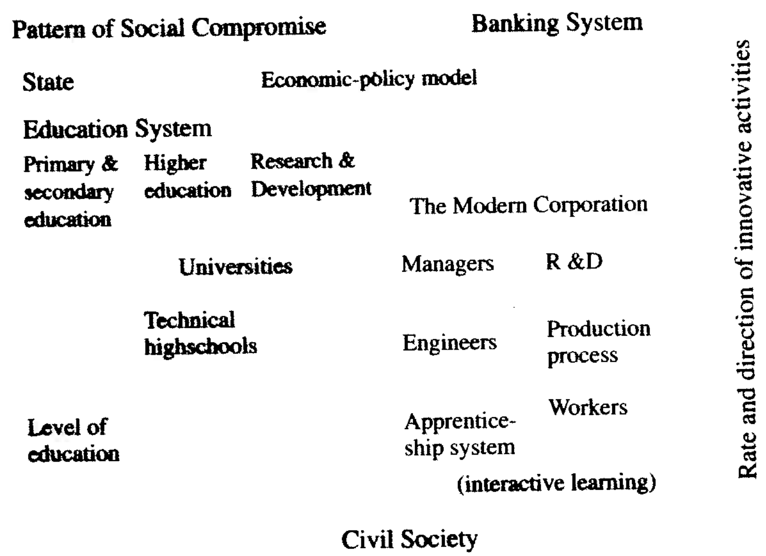
(c) To denote the process of creating, diffusing or using these various changes' (McKelvey, 1991, p.118).

While traditionally the emphasis has been on radical technological breakthrough, innovation in reality is ubiquitous, gradual and cumulative. Innovation is fundamentally grounded in learning: learning by doing, by using and by interacting. Given the central importance of knowledge to the modern economy, learning is arguably the most important social process. To understand how it occurs and therefore how it can be strengthened and developed, it is essential to recognise that "learning is predominantly an interactive and therefore a socially embedded process which cannot be understood without taking into consideration its institutional and cultural context" (Lundvall, 1992, p.1). The wide range of institutional factors which

impact on innovation include: communication and interaction *within* firms; interaction *between* firms (through forward, backward and horizontal linkages); user-producer relations; the institutional infrastructure (including education and training and incentive systems); norms about conflict, co-operation and consensus; demand side factors (dealing with the appropriation of the benefits of innovation); and formal institutions concerned with searching and exploring (such as universities and R&D departments). (Johnson, 1992)

FIGURE 4.2

A Sketch of the National Innovation System



It follows that innovation is not just about technology, but rather about the context in which technology is developed and applied. Mjøset points out that technological change proceeds much faster than institutional change. A disjunction between the two has often been invoked as an explanation for the surprisingly low rate of productivity increase internationally, given the scale of technological change over the past 20 years.

The importance of these institutional factors and the cumulative impact of their interaction has led to growing interest in the concept of a "national system of innovation" which has been defined as "the institutions and economic structures which affect the rate and direction of innovative activities in the economy" (Edquist and Lundvall, 1992). The wide-ranging elements of a national innovation system are outlined in Figure 4.2 on the previous page. While policy and procedures at the national level are under pressure from the divergent trends towards globalisation and regionalisation, it remains the case that many of the institutional, cultural and policy variables which constitute a system of innovation are shaped and intelligible only at a national level.

The focus on the institutional framework can help to illuminate contemporary growth experience. For example, a recent World Bank analysis of rapidly growing economies in East Asia placed particular emphasis on their strong outward orientation, their commitment to capital accumulation and human resource development and their very effective institutional frameworks. This institutional perspective is not to the exclusion of the role of individual enterprise and risk-taking. On the contrary, the institutional perspective helps to identify the circumstances in which such enterprise is likely to prove most effective. This is reflected in the fact that much of the dynamic which constitutes the national system of innovation comprises the activity of firms and individuals in inter-action with the formal institutional system.

There is, however, a strong cumulative character to the national system of innovation, since it primarily reflects established structures of production and institutional frameworks. It follows that systems of innovation can be stronger or weaker and they certainly differ substantially from place to place. For example, it has been observed that "the institutional differences between national systems of innovation as close in terms of geography, historical experience and culture as Denmark and Sweden are considerable. Sweden tends to base its innovative processes on systemic R&D while Danish firms tend to build much more upon practical skills and upon interaction with users. The focus of innovative activities differs also; in Sweden the focus is upon process technology while it is more upon incremental product innovations in Denmark" (Johnson and Lundvall, 1992, p.48). A strong national system of innovation will be built around networks of related innovations which, following Dahmen, have come to be called 'development blocks'. These development blocks are characterised by clusters of innovative investment projects. The weakness of the Irish national system of innovation is fundamentally the absence or underdevelopment of such development blocks, and the difficulty of establishing effective indigenous linkages to those parts of *global* development blocks which, through mobile foreign investment, have been located in Ireland.

There are strong grounds for caution in approaching the task of strengthening the national system of innovation. Rapid institutional change is difficult, while copying institutional arrangements in other countries is futile. What is necessary is to identify mechanisms to strengthen the learning process at the level of the firm, the industry and society as a whole. In particular, it is clear that, learning can be affected by policy making and deliberately institutionalised in more or less efficient ways. Also in policy making itself, learning may be more or less efficiently institutionalised' (Dalum *et al*, 1992, p.302). Dalum *et al* have argued that the appropriate role of the state in strengthening the national system of innovation is through concerning itself with:

(a) *The means to learn*, including the form and content of the education and training system;

(b) *The incentives to learn*, including income determination, tax and patent systems;

(c) *The capability to learn*, through restructuring of firms and training of the labour force;

(d) *Access to relevant knowledge*, through universities, technical institutes and promotion of IT;

(e) *'Remembering and forgetting'*, that is facilitating structural change by easing the winding down of obsolete industries and processes while preserving accumulated skills or market links, in particular through effective redistribution and active labour market policies;

(f) *Utilising knowledge*, by leading sophisticated demand.

Such a role for the State must be exercised within the limits of the capacity of the institutions of State, as well as within the limits created by fiscal policy.

For small countries there is a particular need to focus on the capacity for technology transfer. This implies a focus on ways to stimulate awareness of and openness to developments abroad, through network relationships with users, producers and technical institutes as well as the stimulation of such 'innovative networks at home. This involves measures to strengthen the 'innovation triangle', comprising sophisticated consumers, competent producers and R&D specialists. In this context, participation in EC-wide development programmes may be particularly important, although a substantial risk exists that such programmes will tend to reinforce the advantages and interests of the larger, established multinational enterprises in the relevant fields, rather than the needs of developing small and medium-sized businesses. In any event the issue of strengthening the position of SMEs with regard to technology transfer will continue to be of central concern for development policy (See O'Doherty, 1990).

The need for innovation has increased as the global division of labour proceeds. Reich has argued that work is now divided between occupations which can be categorised as "routine producers", "in-person servers" or "symbolic analysts", employed within global webs "whose high-volume standardised activities are undertaken whenever labour is cheapest worldwide, and whose most profitable activities are carried out wherever skilled and talented people can best conceptualise new problems and solutions" (Reich, 1991, p.304).

The implications of a strategy to build competitiveness through strengthening the national system of innovation are addressed by the Council throughout this report. Chapter 8 emphasises the priority to be given to developing the capacity of the indigenous sector in the conduct of industrial policy. Chapter 9 identifies the importance of measures to strengthen human capital in agriculture, while pursuing options for on-and-off farm diversification and new approaches to rural development. Chapter 16 deals with the priorities which should inform the development of education policies, especially the need to cater more effectively for the full range of abilities of students from the widest range of social backgrounds in the senior cycle of second-level education, while strengthening links between educational provision and the labour market.

A particular focus for policies to strengthen innovative capacity should be the public sector, which is a relatively large element in national economic activity. The primary contribution of the public sector to innovation is to secure macroeconomic stability and the other ingredients of competitive potential and to discharge their specific functions efficiently and effectively. The Council notes the difficulties which are being experienced in this regard in many cases. Chapter 5 discusses the need for developing greater capacity to ensure the effectiveness and relevance of public spending programmes. However, the potential role of the public sector in promoting innovation is far wider than the management of public spending. Because of its relative size in aggregate, because state and semi-state bodies are among the largest organisations in the corporate sector, and because of the range and sophistication of the functions discharged and the personnel employed, the public sector should exemplify the characteristics of an innovative society. In the approach taken to the application of new technology, in the systematic assessment of emerging international trends and the identification of good

practice, in the conduct of human resource development policies, in the strengthening of management capacity, and in the encouragement of enterprise, both at personal and corporate levels, the public sector should set an example of good practice and display an approach to change which would strengthen the capacity of Irish society to innovate and compete. The Council believes that this is not generally the case at present and that there is considerable room for development in this direction. This is not to suggest that the private sector, both traded and non-traded, has not an equally strong obligation to develop the practice of innovation. The Council believes, however, that the public sector, in Irish conditions, has a particular duty to develop a leading role in promoting a more strongly innovative society, which in turn would facilitate more effective performance of core functions.

3. COMPETITION POLICY

One other important area of structural reform leading to enhanced competitiveness, by dealing with the effective functioning of the market system itself, is that of competition policy. The basic welfare effects of monopoly power and collusive business practices are well-known: economic theory predicts higher prices and output losses compared with a more competitive situation. Many countries, including Ireland, have instituted various forms of legal regulation to counter excessive market concentration and prevent distortionary effects of this kind. However, it is clear that in the case of a country such as Ireland, with outward-looking industrial policies and crucially dependent on exports for economic growth, an effective competition policy is doubly important because the prices of inputs produced by the sheltered or non-traded sector must not be allowed to hinder the development and competitiveness of the traded sector. Other benefits may accrue from an appropriately - structured competition policy. Porter (1990), for example, argues that the presence or absence of vigorous *domestic* competition is an important determinant of the degree of innovation undertaken in an economy. A failure to innovate or, more precisely, to establish a 'national system of innovation' is, as noted above, a significant barrier to the long-run competitiveness of the Irish economy.

This section considers the appropriate role of competition policy in an Irish context, reviewing in the process a number of different views on the subject. It briefly describes the current operation of competition policy in Ireland, including the implications of the recently-enacted Competition Act and the increasing influence of the EC in this area. The current extent of monopoly power and anti-competitive practices in the Irish non-traded sector are described and a number of recommendations to facilitate a more effective Irish competition policy are presented.

(i) The Functions of Competition Policy

Competition policies tend to be of a somewhat amorphous nature, often lacking, outside the sphere of formal economic analysis at least, a rigorous definition. Some countries have sought to regulate market structure and conduct by means of policies based on fairly narrow economic efficiency criteria, whereas elsewhere the scope of anti-trust and restrictive practices legislation is of a broader nature, often incorporating a number of additional public-interest objectives (Williams, 1993; White, 1993). Hay (1993) sees three main schools of thought on the objectives of competition policy, although there are undoubtedly a number of other views on the subject.[20]

(i) One perspective, which is gradually gaining in dominance, is that competition policy should be pursued solely on the basis of economic efficiency. This definition encompasses both productive efficiency - the production of goods and services at minimum cost - as well as its allocative counterpart viz. the provision of desired goods and services at prices that reflect the cost of their provision. It also recognises that the relationship between market structure and economic efficiency is often complex, implying that increased competition may not always serve to enhance efficiency. A number of factors account for this conclusion. First, the short and long-run welfare effects of particular forms of market behaviour may not be identical. For example, a merger or take-over bid may appear to represent a sizeable increase in market concentration or economic power, yet in the long-run may yield significant improvements in productive efficiency (due to scale economies) or innovative activity. At the other extreme, predatory pricing, a situation where an incumbent firm uses accumulated funds to finance below-cost selling designed to deter further market entry, may produce initial benefits for consumers in the form of lower prices but create on unassailable monopoly position in the long-run. Second, some forms of non-price competition appear to be wasteful, suggesting that agreements to limit competition in these areas may be beneficial. Included under this heading might be activities such as brand proliferation and duplication of advertising/R&D expenditures, whose function is often simply the maintenance of market share.

20 For a description of the range of views in existence, see OECD Note, 1992, The Objectives of Competition Policy.

(ii) Other economists assert that the primary focus of policy should be on encouraging the *process* of competition itself. Competition, it is argued, provides a spur to innovation. Within this school, an extreme group contends that monopoly rents are a reward to innovation and not a cause for concern, being eroded as soon as other firms begin to innovate and enter the market. Others argue that competition can be assured only if there is some form of public intervention or regulation.

(iii) A third approach, while recognising the importance of considerations such as efficiency and innovation, maintains that attempts to regulate market structure should also be guided by various social and public-interest objectives. Among these subsidiary objectives are issues such as the encouragement of start-up and small businesses, the pursuit of balanced regional development, and the protection of industries experiencing the effects of recession or structural change. The problem here, however, is that a multiplicity of objectives may result in a competition policy lacking in transparency, leading to confusion among firms and market participants about what constitutes acceptable market behaviour. Moreover, difficulties arising out of regional or industrial decline are best tackled with appropriate, targeted policies. In addition, it may be inappropriate to use competition policy as an instrument to prevent what could be viewed in many instances as necessary structural change (Williams, 1993).

In the context of a small open economy, the operation of competition policy raises somewhat different concerns from those of a large semi-closed economy such as that of the United States. Problems of monopoly power are unlikely to arise within the Irish traded sector. Indigenous firms in the traded sector are likely to be small in scale and subject to strong competition in export and import-substitution markets. Multinationals with branch plants located in Ireland may, of course, have significant market power in a European or worldwide context, but any resultant difficulties obviously cannot be tackled at a domestic level. (Cartels and abuses of market power can, however, be addressed at an EC level, under Articles 85 and 86 of the Treaty of Rome; see following section.) It is for these reasons that attention has focused on the extent to which monopolies and anti-competitive agreements prevail in the non-traded sector.

It has been observed that competition policy may assume increased relevance in small peripheral economies because of the effect high access and transport costs can have in enlarging the size of the non-traded sector. In addition, the small size of the market can result in increased industry concentration due to the existence of economies of scale, thereby lowering communication costs among the small number of producers and providing more scope for collusive action (Fingleton, 1993; Sutton, 1991).

The restrictions on competition in the non-traded sector flow from a number of sources. First, there is the case of monopoly provision in certain industries. Such monopoly power derives in the main from legal impediments to market entry, as in the postal services, telecommunications, transport (though not to the same extent as previously), and public utilities such as electricity and natural gas. The rationale for the ban on competition was in many instances based on natural monopoly arguments, as well as a desire by government to use these organisations as vehicles for fulfilling various non-commercial, socio-economic goals, such as employment provision or regional development. Second, there are many services provided within the public sector itself that could conceivably be opened up to competition. This notion forms the basis for the policy of 'contracting-out', as in refuse collection or provision of school meals, increasingly observed in the United Kingdom in recent years. Third, the Irish services sector has tended to be marked by numerous forms of collusive behaviour and anti-competitive agreements among providers. This has been sustained or even caused by regulatory measures. Legal services, advertising, retail banking (to some extent), petrol retailing, taxi and pub licensing, for example, have all been characterised as areas with significant restraints on competition.

Higher input prices have generally been viewed as the main conduit through which inefficiencies in the non-traded sector affect traded-sector competitiveness. This applies not only to direct industrial inputs such as telecommunications or energy, but also in a less obvious sense to restrictions on competition in services such as taxi and public house licensing, which can serve to drive up prices and affect tourism demand. However, it has been observed that the effects of non-traded sector inefficiencies may operate through a number of indirect channels as well (DKM Consultants, 1992). First, public monopolies, because of lack of incentives or the type of legal or social obligations they are required to discharge, may become inefficient and require subsidisation, which can in turn imply increased taxation and associated distortionary effects on the rest of the economy. Second, in the absence of competition, pay levels may be relatively high and spill over to more exposed sectors, reducing their competitiveness. Third, insufficient

competition in the provision of certain domestically-consumed services may reduce consumer welfare through higher prices and restrictions of output. To the extent that workers attempt to compensate for these welfare losses in the wage-bargaining process, there may be further adverse implications for an economy's international competitiveness.

The above comments illustrate how inefficiencies in the non-traded sector can, via their effect on traded sector firms, impose output losses on the economy. Additional losses may occur, however, if these inefficiencies hamper a country's ability to attract foreign direct investment projects.

Indeed, it has been argued by one commentator that a country's international competitiveness depends exclusively on the competitiveness of the *non-traded* sector (O'Rourke, 1991). This conclusion, however, relies on the assumption that international trade and factor mobility will result in the equalisation of traded goods and factor prices across countries (adjusted for exchange rates and transport costs). If the prices of traded goods and factors of production, such as labour, do not diverge internationally, then it is true by definition that a country cannot gain in competitiveness except by having higher productivity or by reducing the costs of inputs from its non-traded sector. In practice, however, factor price equalisation does not occur, particularly in the case of labour, leading to the conclusion that one cannot focus on competitiveness solely in terms of issues specific to the non-traded sector. Nevertheless, this view does indicate that development policies that focus on the traded to the neglect of the non-traded sector may ultimately be counterproductive.

(ii) The Operation of Competition Policy in Ireland

Competition policy is generally concerned with two broad issues: collusive agreements between firms or service providers and abuses of economic power derived from the existence of a monopoly position in a market. However, within these two categories many different types of restraints on competition are possible. Collusive behaviour may, for example, involve agreement to limit price competition, keep new products off-market, restrict market entry, or in extreme cases to operate a cartel. In the case of oligopolistic markets, higher prices and restrictions of output may be accompanied by what are known as *vertical restraints* on competition. The latter have been defined as "the restrictions that one firm (usually, but not always, the supplier) tries to place on the actions of other firms (or consumers) in the vertical chain that links production with final sales to consumers" (White, 1993). Examples of vertical restraints include full-line forcing,[21] exclusive dealing, loyalty bonuses or contracts,[22] and resale price maintenance. Competition policy also needs to be concerned with the processes whereby producers may *gain* monopoly power, i.e., take-overs, mergers or predatory pricing.

Following the 1991 Competition Act, the investigation of possible anti-competitive market behaviour is now the responsibility of the Competition Authority, which replaces the earlier Fair Trade Commission. The 1991 Act is modelled largely on Articles 85 and 86 of the Treaty of Rome, which refer to anti-competitive agreements between firms and the abuse of a dominant market position, respectively. As in the case of Article 85 of the Treaty of Rome, provision is made in the Irish legislation for exempting certain types of agreements between firms where it can be demonstrated that these yield benefits (for example in R&D, etc.), at least some of which must accrue to consumers, and where the exemption is necessary for the benefits to occur.

It has been observed that a potential weakness of the 1991 Act is that it envisages private actions by aggrieved persons as the main enforcement mechanism for competition policy, although the Minister for Enterprise and Employment may also bring actions (OECD, 1993a). The Competition Authority is not empowered to instigate examinations of market structure on its own initiative, but may do so at the request of the Minister. The role of the Competition Authority is mainly one of investigation. The 1991 legislation also indicates that public interest considerations will play some part in the operation of competition policy. There are, for example, the block exemptions noted above in respect of agreements between firms. In addition, the Minister may, in extreme situations and with the approval of the Dáil, dissolve a firm's dominant position if such action is judged to be in the interests of the common good. The latter appears to include issues such as the implications for employment, regional development, etc.

The preceding discussion points to the influence of the EC on the design of Irish competition policy. Apart from attempts to regulate market structure, EC competition rules also apply in respect of commercial state monopolies (Articles 37 and 90), dumping (Article 91) and state aids (Articles 92-94). While these rules have the same purpose of preventing distortions in competition, dumping and state aids to industry are generally regarded as

21 A situation where, in order to obtain a specified product from a supplier, the retailer must take the seller's full line of products.

22 These create switching costs for retailers, thereby tying-up distribution systems and acting as a deterrent to producers contemplating entry into the market.

issues in industrial and trade policy. With respect to state aids, Ireland has been granted a derogation from the competition rules because of its below-average per capita income levels. Apart from this exemption, the rules on state aids should benefit Ireland indirectly by allowing fairer competition in international markets and by reducing the costs of attracting mobile investment projects.

The impact of completion of the EC internal market on domestic competition is likely to become increasingly evident in the years ahead. Public procurement contracts, traditionally reserved for domestic firms, will be open to tender from firms anywhere in the EC. State monopolies may also be required to operate in a more competitive environment. The EC Commission has, for example, signalled its intention to introduce a greater degree of private competition in European postal services. Similar EC requirements exist in the energy sector, particularly the generation of electricity.

(iii) The Irish Non-Traded Sector: An Overview

This section reviews recent evidence on market structure and performance, beginning with some general data on price structures.

Some idea of the effect of inadequate competition in creating price distortions in the Irish non-traded sector can be obtained by comparing suitably adjusted Irish and average European price levels.[23] Following what has been said earlier, it is clear that even in domestically-consumed services a lack of competition can impact on a country's competitiveness. Figure 4.3 shows, for the years 1985 and 1990, OECD purchasing power parity comparisons for household consumption and for 11 individual categories of consumption. As can be seen, the aggregate 1990 price level for overall consumption in Ireland was just below the EC average, a slight improvement over the 1985 outcome. Nevertheless, marked differences are evident in the relative price levels of different types of consumption. Only three individual consumption categories had dollar price levels below the EC average - clothing and footwear; rent; and education, recreation and culture. Major price distortions stand out, however, in the case of beverages, tobacco, and communications. The above-average cost of beverages may reflect not only the effects of taxes but also monopoly rents arising from restrictive public-house licensing. Fuel and power price levels in Ireland are just above the EC average and have

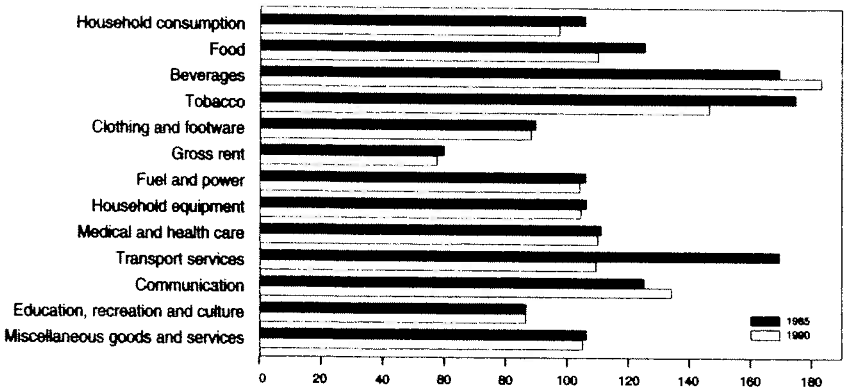
23 It should be stressed, of course, that price distortions may arise for reasons other than an absence of effective competition, such as differing taxation arrangements or, in the case of Irish insurance markets, the high cost of claims.

shown little change since 1985. One notable feature of Figure 4.3 relates to the average price of transport services, which in 1985 was clearly out-of-line compared with the rest of the EC. A significant degree of deregulation of transport markets is the primary factor explaining the sharp fall in transport costs for Irish consumers between 1985 and 1990. However, the cost of Irish transport services is still high when compared internationally, due in part to the relatively high cost of public transport and the high costs of private motoring, the latter deriving from the imposition of various taxes and high vehicle insurance premia.

Regulations governing market entry and activity are an important dimension of anti-competitive markets. Table 4.1 provides a summary of the main entry and operational regulations in force in various sectors of the Irish economy.

FIGURE 4.3

Comparative Dollar Price Levels of Individual Household Consumption EC=100



Source: OECD Economic Surveys, Ireland, 1993.

An important area for the development of competition policy is the issue of monopoly provision of public utilities. It is inevitable that the future environment for the operation of those services will be shaped by EC regulatory provisions which are currently at an advanced stage of preparation.

For example, An Post possesses a monopoly in the delivery of postal packets to the domestic market and, in principle, to overseas. In recent years, however, it has come under increasing competitive pressure from two sources. First, there is the emergence of intensified competition from private operators in the area of express mail, parcel and courier deliveries. Second, mail volumes are being affected by an increasing use of technological forms of communication such as faxes and electronic mail. It would therefore appear that whatever legislative changes are introduced in this sector in the coming years, increased competition is inevitable.

However, the EC Commission published a Green Paper on the Development of the Single Market for postal services, a discussion document intended to initiate debate on the development of a community postal policy, containing proposals to facilitate increased private-sector participation while at the same time ensuring the provision of a universal service throughout the Community. Adequate competition in the postal sector is seen as essential for the effective functioning of the single market generally. As an illustration of this, it may be noted that 80-85% of all mail in the Community is generated by business and other non-household organisations. Most of this mail, 93%, is domestic, while 4% is intra-Community. Ireland's mail structure, however, appears quite different from the rest of the EC, with 51% domestic and 49% international. It is estimated that 60% of intra-Community mail has a delivery time of over three working days. There are also wide disparities across Community countries in terms of cost and average delivery times (Economic and Social Committee, 1993). Clearly, varying standards of price and quality place firms in those countries with less efficient services at a disadvantage in business terms, a situation that is likely to be exacerbated as competition gradually intensifies within the single market.

The EC Commission is at present undertaking a further examination of the whole subject of competition in the postal sector in light of the various views expressed on the ideas contained in the Green Paper. It has summarised the various views received to date and has produced guidelines on the further work which will be needed to resolve many of the complex issues under evaluation.

Telecommunications is another area where the EC Commission has indicated its desire to introduce a greater element of competition. The Community has already achieved some liberalisation of the telecommunications market, notably in the sale of terminal equipment and provision of leased line services. A commitment has been made to full liberalisation of the EC telephone service before 1 January 1998. However, the four cohesion countries - Ireland, Spain, Greece and Portugal - have an additional five-year exemption from the liberalisation requirements. The Community has adopted a number of principles to govern the liberalisation process, including the maintenance of universal services, the independence of telecommunications organisations, and the establishment of cost-related tariffs.

TABLE 4.1

Entry and Operational Regulations[1] in Irish Non-Traded Sector

	Entry Regulations			Operational Regulations			
Activity:	**Legal Monopoly**	**Licensing**	**Vocational Certs**	**Prices**	**Quality**	**Quantity**	**Guidelines for Business Execution**
Licensed Professions	-	P	+	-	P	P	+
Liberal Professions	-	P	+	-	P	P	+
Sector:							
Energy:							
Oil	-	-	-	-	-	P	-
Electricity	+	-	-	+	-	-	-
Trade, distribution:							
Alcohol	-	+	-	-	-	-	-
Transport:							
Road, Freight	-	+	-	-	+	-	-
Road, Passengers	P	+	+	+	+	P	-
Rail	P	-	-	+	+	-	-
Air	-	+	-	-	-	-	-
Telecommunications	P	P	-	P	P	-	-
Insurance	-	+	-	-	+	-	+
Banking	-	+	-	+	-	-	+

1 +/- denotes presence/absence of type of regulation under consideration. P signifies that regulations are partly of the type indicated.

Source: OECD Economic Surveys, Ireland, 1993.

Transport is of importance not only from an industrial perspective but also in terms of its effect on tourism demand and it has been one of the most heavily-regulated areas of the Irish economy. A move towards greater liberalisation, however, has been evident in recent years.

Air transport has been subject to deregulation at both domestic and European level. The entry of new operators on the Dublin-London route in 1986 and following years produced more than a 60% increase in passenger numbers between 1985 and 1987, as well as reductions in average fares. In addition, air traffic between Ireland and Britain in the 1986-90 period almost doubled,

growing at an average rate of 18.6% per annum (see Table 4.2). However, the impact on airlines has clearly not been beneficial, with a number of them withdrawing from the Dublin-London route, one airline liquidation, and financial difficulties for others (O'Reilly, 1993). This may be due either to the world recession or overly rapid liberalisation, or possibly a combination of both. Deregulatory steps have also been taken by the European Community. The 1987 liberalisation measures included agreement on permitting some degree of low-fare competition to national airlines, changes in capacity-sharing arrangements, and an extension of fifth-freedom rights (Barrett, 1991). Another liberalisation package, which took effect on 1 January 1993, will allow airlines from one member state to set up subsidiaries in another, thus promising significantly higher levels of competition (O'Reilly, 1993).

TABLE 4.2

Air Traffic Statistics

Type of Journey	Passenger No.s ('000)	
	1986	**1990**
Transatlantic	535.1	663.0
Great Britain	2114.6	4178.3
Europe	921.9	1490.2
Domestic	323.7	773.1
Transit	528.7	741.8

Source: OECD Economic Surveys, Ireland, 1993.

The road passenger transport industry has been strongly regulated since the Road Transport Act, 1932. The practice has generally been to refuse a licence to private operators if a route is already being served by public transport, creating an effective ban on competition. The rationale for restrictions on public road transport lay, at least in the early days, in a desire to protect the railways. However, private firms have been able to exploit loopholes in the existing legislation to provide services on long-distance bus routes (Barrett, 1991; OECD, 1993a). City services, however, remain tightly controlled. Since 1984, the EC Commission has been pressing to have the provision of essential public railway services of a social nature organised on a formal contractual basis between the railway company and the State. A regulation concerning the issue of public service obligation in transport has recently been adopted by the Council, though most EC countries have yet to determine the manner of its implementation. The proposed Bus Competition Bill should bring Ireland into line with some of the requirements of the Regulation. As far as rail services are concerned, the question of whether and to what extent a public service contract regime might replace the current subvention system is still being examined.

In the area of road freight transport, a new EC draft regulation, agreed in principle at the Council of (transport) Ministers meeting in June 1993, provides for an increased quota of cabotage authorisations, with further increases annually, culminating in complete liberalisation from 1 July 1998.

Finally, in the shipping sector, recent developments include the sale of Irish Ferries to private investors in 1987 and the privatisation of the B&I company in 1992. The management of Irish ports has also come under scrutiny in recent years. The majority of ports are publicly-owned and run by harbour authorities with a local-government form of administrative structure. This structure has proved unwieldy in coping with changes in shipping and cargo handling and the general requirements of port users. The *Report of the Review Group on Commercial Harbours and Pilotage Policy and Legislation*, published in June 1992, observed that Irish ports are hampered in their efforts to make commercial decisions as a consequence of restrictive legislation. This applied to "such matters as setting rates and charges, borrowing money, carrying out harbour improvements, and acquiring and disposing of property". As a consequence of the lack of modernisation and other factors, direct shipping services from the Republic to non-EC markets in particular have been steadily eroded. The Review Group proposed the establishment of 12 commercial state companies to undertake the management of various ports. These companies would be free to compete against each other for business, having discretion to set their own charges, borrow money and seek private-sector investment participation. These recommendations have been accepted.

(iv) Conclusions on Competition Policy

In a general sense, competition policy is directed at curbing abuses of market power which adversely affect consumer welfare through restrictions of output and higher prices. For a small open economy, competition measures assume an added importance because of the extent to which high input prices, direct and indirect, may impinge upon the competitive-ness of the traded sector. It is also suggested by some economists that the process of

competition itself contributes to output and employment by providing incentives for innovative production. Whether the formulation of competition policy should also take into account more broadly-based public-interest considerations remains open to debate, although such an extension of its scope is likely to hamper efforts to achieve more competitive market structures, with consequently fewer efficiency gains.

Where public-interest objectives can be achieved through other appropriate policies, it seems preferable to exclude them from the general scope of competition policy. This applies in particular to goals such as the preservation of rural communities and regional development. As indicated earlier, state-sponsored bodies have often been compelled to forgo commercial decision-making in some areas of their activities in order to fulfil certain social or regional development obligations. This has been true to some extent in the postal and energy sectors. In order to avoid the imposition of competitive distortions on the economy, it would seem appropriate to eschew *ad hoc* measures aimed at maintaining regional balance in favour of more direct, concerted initiatives.

Privatisation has often been advocated as a competition-policy response to inefficiencies associated with state monopoly provision of services, particularly in the case of commercial state-sponsored bodies (CSSBs)[24]. As discussed in *A Strategy for the Nineties*, privatisation may, by exposing companies to the threat of bankruptcy and to the market for corporate control, create significantly sharper incentives for productive efficiency than those present in CSSBs. Other benefits may flow from the elimination of various forms of government control. For example, CSSBs may be required to function under restrictive legislation and cumbersome administrative procedures that limit their capability to respond swiftly to market signals regarding investment and pricing decisions. Privatisation can also have a developmental aspect, providing increased access to equity capital which allows an organisation to expand its range of operations and undertake investments in new technology.

Nevertheless, as explained in *A Strategy for the Nineties*, changes in ownership will not necessarily equate with improvements in allocative efficiency if there is market failure or an uncompetitive market structure. A privatised monopoly has few incentives to pass on productive efficiency gains in the form of lower prices to industrial and private customers, and,

24 It should however be noted that decisions concerning recent privatisations in Ireland were influenced mainly by the companies' requirements for additional equity and the Exchequer's desire to reduce borrowing.

furthermore, it arguably has more incentive than a state monopoly to use its dominant market position to prevent - by predatory pricing, vertical restraints or other means - the emergence of a contestable market. In addition, where there is some element of market failure in an industry, complete privatisation of an enterprise, in the absence of compensating arrangements, is unjustified on allocative efficiency grounds.

Policy towards the commercial state sponsored sector needs to reflect these considerations. Where a CSSB is providing a market-based service which is not significantly affected by market failure, one route to securing efficiency gains is through a policy of deregulation and liberalisation. The question of privatisation is a separate issue, which the Council discussed in detail in *A Strategy for the Nineties*. Deregulation involves permitting new entrants to the industry, while liberalisation implies taking measures that lower barriers to entry. There may be scope for introducing competition into the parts of an industry not characterised by natural monopoly or public good features, for example electricity generation (as opposed to transmission), value-added services in telecommunications (as opposed to network provision), the importation of natural gas through inter-connectors (as has recently occurred), and so on. Again, privatisation (of some functions of a CSSB) is not likely to be a central issue here. Most of the efficiency gains should flow simply from the introduction of competitive pressures into the particular areas of the industry under consideration.

The inadequacy of competition policies is also illustrated by the existence of many restraints to competition in the *private*, non-traded sector. It is these that are the focus of the 1991 Competition Act. However, it is not clear that the Act provides sufficient powers to police effectively anti-competitive behaviour, with the reliance on private legal actions appearing to be a particular weakness. What is really required is that the present Competition Authority by given additional powers to initiate investigations and pursue actions through the courts if necessary.

An effective competition policy, however, must be pursued along other lines as well. In particular, all forms of public regulatory constraints, especially those governing conditions of market entry or price setting, should be carefully evaluated to ensure that unreasonable constraints on competition are not being imposed. Where there is some social rationale for restrictions on market entry, as in city bus services or in the postal sector, consideration should be given as to whether the desired objective can be achieved in some other manner, such as subsidy or contracting, that does not result in the creation of monopolistic markets. Any subsidies provided as compensation for the performance of specific social duties should, however, be

proportionate to the cost involved and be strictly monitored to ensure that they are not being used to fund unfair competition in other, strictly commercial, services. Similarly, the Council is concerned that efficiency should be enhanced in areas of the public service other than the CSSBs. The question of harnessing competitive forces to this end is relevant to this objective.

Public subsidies and supports, especially in the industrial development arena, raise complex issues in terms of their implications for competition. One important issue relates to the principle of selectivity in the provision of support for industrial development. While justified on the basis of limiting exchequer costs and enabling firms to achieve scale economies that will increase their market shares abroad, a selective approach to industrial development may tend to benefit the initial entrants to an industry as the expense of latecomers, thus inadvertently raising barriers to entry. In addition, focusing support on a limited number of enterprises may make industrial policy a less flexible instrument in responding to changing patterns of international demand and production methods. Possible conflicts, therefore, between a policy of selectivity, on the one hand, and encouraging vigorous competition and maintaining flexibility, on the other, point to the need for a very careful and considered approach to industrial policy formulation.

It must be stressed, however, that the Council's position is not that all competition is inherently beneficial. As outlined earlier, the welfare effects of certain forms of competition, especially of a non-price kind, may not always be unequivocal. This may be particularly true in the case of innovation. Given the large investment expenditures often associated with developing an innovative capacity in a particular product area, there may be benefits from encouraging a certain amount of inter-firm collaboration to enhance research in product design, marketing, etc. While it might be argued that R&D grants or tax breaks to individual firms could serve the same objectives, inter-firm collaboration has a number of specific advantages, in terms both of sharing know-how and of internalising spill-overs that often make individual R&D investment less rewarding (Hay, 1993). Of course, such agreements need to be monitored to ensure that collaboration in technical matters does not flow into other aspects of competition, such as pricing or output decisions. Inter-firm collaboration is likely to work best when there are a large number of firms in an industry, when the focus is on developing complementary rather than substitute products, and when co-operative agreements each involve only a small number of enterprises.[25]

25 The wider role of innovation in industrial development is discussed in Chapter 8 on industrial policy.

4. INCOMES POLICY FOR GROWTH AND EMPLOYMENT

(i) Introduction

The preceding discussion demonstrates that the Council's view of the basis for long-term competitiveness requires a broad-ranging improvement in the quality of performance across the whole economy, in both the public and private sectors. To complement this strategic approach there must be an evolution of incomes which ensures continued improvements in competitiveness, and an income determination system which handles distributional conflicts in a way which does not disrupt the functioning of the economy. In outlining its recommendations for incomes policy for the period ahead as part of a strategy to deepen competitiveness, the Council is drawing on the experience of recent years. It is with a brief review of those developments that this section begins.

The Programme for National Recovery (1987-1990) represented a major development in Irish incomes policy, partly because it reintroduced national bargaining but also because it set the parameters for wage growth over a period of three years. It was also significant in that it linked agreement on wages to agreement on the evolution of taxation and social security within a budgetary framework conducive to economic and employment progress. As the Council has previously pointed out, the Programme had a significant influence on the rate of growth of wages and earnings. This effect was small in the first year of the Programme - when rising unemployment and a very poor domestic economic climate would have implied low wage settlements, even without a national wage bargain. However, by 1989 the economy had been growing rapidly for some time and the associated revival of labour demand and fall in unemployment could have been expected to increase the rate of wage settlements. In this context, adherence to the wage growth elements of the PNR right to the end of the three years arrested the decline in wage competitiveness and this was a major factor in enabling Irish employment to expand rapidly in response to favourable international conditions between 1987 and 1990.

The Council, in *A Strategy for the Nineties*, formulated three principles which it considered should inform income developments on the expiry of the PNR:

(i) incomes should evolve in a way which is consistent with gains in competitiveness;

(ii) distributional conflicts should be resolved without disruption to the functioning of the economy; and

(iii) priority should be given to increasing employment levels over improvements in living standards.

Subsequently, the Programme for Economic and Social Progress was agreed between the Government and the social partners and this has provided the framework within which wage levels have evolved in the period from 1990 to date. The principal features of the performance of incomes in the recent past have been outlined in Chapter 2. They are reviewed briefly here.

With regard to **cost competitiveness**, the general approach is to measure changes in labour costs in money terms allowing for exchange rate differences, i.e., labour costs in common currency terms. While this approach has the disadvantage that it ignores productivity gains, it is appropriate to Irish circumstances because (i) movements in *unit* wage costs are dominated by the high productivity multi-national sector in Ireland; and (ii) improvements in productivity and hence gains in unit labour costs can result from labour-shedding in response to uncompetitive cost developments. Hence a reduction in employment due to a *loss* in real competitiveness in the market may be reflected as an *improvement* in competitiveness when measured by unit labour costs.

A number of measures of relative movements in earnings, and therefore in competitiveness, are available. Average earnings per employee in national currency terms have increased somewhat faster in Ireland than in the EC since 1987. Average earnings have increased in real terms by 8% since 1990, which is two and one half times the EC average (3.1%). However, this measure ignores changes in hours worked, as well as differences in the occupational structure. Furthermore, the significance of relative wage movements is dependent upon the pattern of trade. Standardised hourly earnings data for manufacturing show that, since 1990, Irish earnings in national currency terms have been increasing marginally faster than in our main trading partners, reversing the pattern between 1987 and 1990.

As shown in Chapter 2, when earnings are measured in *common* currency terms there has been no gain in competitiveness against our main trading partners in the past two years: there was a gain in 1991 but this was reversed in 1992. In the previous three years Ireland experienced gains in cost competitiveness against the UK which offset losses against our other main trading partners, leaving the overall position for the PNR period virtually unchanged. These competitiveness gains against the UK primarily reflected lower cost inflation in Ireland than in the UK. The lack of competitiveness gain against our main trading partners is due to a combination of the lowering of the differential between Irish and UK wage inflation (due to somewhat higher wage increases in Ireland than before and a slowing down of wage inflation in the UK) and the depreciation of Sterling.

With regard to the **resolution of conflicts**, Chapter 2 demonstrated that the number of hours lost due to industrial disputes fell sharply in 1991 after increasing in 1990, but increased again in 1992. Recent years have continued the pattern of relatively greater industrial peace in terms of the number of disputes, hours lost and workers involved than was the case in the early 1980s (although recent years have not been without significant disputes).

Changes in **living standards** can be measured by changes in real take home pay for workers in manufacturing industry. Over the past two years the annual average increase in living standards for married workers has been 1.9%, which represents a continuation of the type of increase in the preceding three years under the PNR.

(ii) Income Competitiveness

This section focuses on the Council's primary concern, the growth of employment, and considers the impact of the evolution of income on employment levels. Since wage costs are the principal, but not the only component of labour costs, it is to be expected that income levels will affect the demand for labour both in existing firms and in those contemplating establishing or investing in Ireland. The demand for labour is, of course, influenced by a variety of factors in addition to wage levels:

"The determinants of the demand for labour may be summarised as follows. Firstly, there are the markets for output, which depend on domestic and world economic conditions as well as on the characteristics of the goods and services provided. Secondly, there is the cost of labour. This includes wages, employment taxes and other non-wage costs. It also includes costs associated with changing employment, such as hiring costs and costs of training new employees, and firing costs, such as severance and redundancy payments. The nature of some of these costs emphasises the extent to which hiring decisions are investment decisions. They also influence the decision whether to change the numbers of employees or to change hours worked by existing employees. Thirdly, there are the costs of other productive inputs. These include costs of energy and materials and, of particular relevance in the Irish context, the cost of capital, which has been strongly influenced by government taxation policies and by IDA and other incentive schemes. Fourthly, the financial position of the firm affects its vulnerability to shocks and thus may influence labour demand. Finally, there is technology, the state of knowledge about production methods." (NESC, Report No. 86, p.7).

Analysis of variations in the employment and unemployment experience of countries has, in recent years, tended to focus on the degree of labour flexibility including adaptability based on skill levels, quality management and efficient work practices, as well as on wage rigidities, to explain greater persistence in both unemployment and inflation. The argument that has been made is that countries with a high degree of wage rigidity must respond to increased foreign competitiveness through changes in employment levels which, having risen, prove extremely difficult to reduce.

Econometric evidence for Ireland suggests that the wage level *is* a significant influence on the demand for labour. This is seen firstly in terms of the traded sector, whose output is primarily driven by the level of real industrial output in the world but also by competitiveness expectations, measured by Irish unit labour costs relative to world costs (Bradley, Whelan and Wright, 1993). In the non-traded sector, output is strongly determined by domestic demand, but in this instance there is a significantly lower possibility of capital-labour substitution. Demand for labour in the agricultural and public sectors is driven by more specific factors, including policy factors. Geary has reported studies which indicate that, in the long-run, a 1% increase in labour costs in Ireland is associated with a fall in employment of between 0.8 and 1% (NESC, Report No. 86).

Given the significance of cost competitiveness in the traded sector (within the overall framework created by external demand conditions), it is important to note that the price level set primarily as a mark up on unit labour costs in the non-traded sector, is experienced as an input cost to the traded sector. Similarly, increases in the cost of financing the public service, through taxes and otherwise, impinge on the competitiveness of the traded sector.

It is necessary, however, to distinguish between different elements of the traded sector. The foreign-owned high productivity industries experience labour costs as a significantly lower proportion of turnover than their indigenous counterparts in both manufacturing and services. However, evidence suggests that expectations about relative wage costs form a significant part of the competitiveness profile which influences the share of foreign direct investment attracted to the Irish economy. It would, therefore, be wrong to conclude that wage costs are irrelevant to the foreign sector, especially in respect of those production activities which are now highly mobile globally and also having regard to the increased competition to attract such activities and the investment which support them.

A more significant competitiveness issue arises in the case of the indigenous companies in the traded sectors. In manufacturing, these are typically in the low and medium technology categories with correspondingly lower levels of productivity. Evidence discussed in Chapter 8 on Industrial Policy shows that four of the eight sub-sectors in low-tech industry have productivity levels below the EC average, as do three of the six in the medium-tech sub-sector. It follows that labour costs represent a relatively higher proportion of turnover for such firms. Given both the generally low rate of profitability and the scope for substituting capital for labour in these sectors, reduced competitiveness as a result of relatively high rates of increase in wages could prompt reduced employment, either through capital deepening or through closure of companies. The scale of the potential employment impact of loss of competitiveness is indicated by the fact that approximately 80% of manufacturing employment is in the low-tech sector. The key to the long-term survival and development of such firms lies in improvements in the non-wage dimensions of competitiveness, including product and process design and marketing. Such improvements would boost productivity and lessen the pressure on relative wage rates. This must be a central focus for industrial policy, as discussed in Chapter 8 below.

Concern with the contribution to be made by appropriate incomes policies in the short-term to the preservation of jobs and to employment growth is not, of course, confined to Ireland. Similar concerns can be found in policy and practice in other countries. For example, the ***Belgian*** equivalent of the NESC, the Central Economic Council, is required to issue a twice-yearly report on Belgian competitiveness on the basis of export performance, wage costs, financial costs, energy and structural determinants. Earlier this year, the CEC reported that Belgian competitiveness, in terms of wage costs, was deteriorating, and this report triggered legal mechanisms requiring trade unions and employers to reach agreement on ways of dealing with the competitiveness problem. Wage settlements of approximately 1% more than the rate of inflation have emerged for both 1993 and 1994.

Similarly, the NESC's ***Dutch*** equivalent, the SER, in its report on the requirements for EMU, has pointed out that wage costs are having an ever greater impact on growth and employment as the Dutch economy becomes increasingly open. Accordingly, the SER recommended that moderate wage costs be a central part of a strategy to increase employment and maintain long-established social protection measures. Concern at recent rapid rates of increase in unemployment and a much more substantial concealed unemployment problem (much of it recorded in the form of disability claims) prompted a new central wage agreement in November 1992. This is based on the agreed principle that keeping increases in labour costs below those of trading partners is essential to boost market share and employment.

Similar trends are evident in the Nordic countries. In ***Norway***, a rise unemployment to 6%, while still significantly below the European averaį represented a very substantial increase compared to past performance. Tl prompted the establishment of the Norwegian Employment Commissic The Commission recommended that for the five years 1993-97, the rate increase in nominal wages should be significantly below that of its tradi partners. The recommendation was for an annual increase of 3% compaı to a forecast rise of 4 - 5% on the part of competitors. After 1997, Commission recommended that the forecast improvement in c competitiveness of about 10% thus achieved should be maintained. Th recommendations were accepted and the annual growth of average earnir is currently estimated at approximately 3%. Similarly, in ***Sweden*** the rise unemployment from previously very low levels prompted Governm action to seek wage moderation as a means of improving wa competitiveness. This initiative, allied to the effects of lower expec inflation and falling employment resulted in settlements generally of order of 3% for 1991 and 1992, compared to wage inflation which had b running at close to double-digit figures in the previous two years. response to high rates of increase in prices and unemployment in ***Icel*** prompted agreement on nominal wage increases in 1992 of only 1. despite the relatively high inflation rate (7%) which had prevailed until th This was crucial in effecting a rapid reduction in the rate of inflation. Equa in ***Finland***, rapid increases in unemployment to 19% of the labour fc prompted agreement between the social partners on the central importa of price and wage competitiveness both in terms of preservation of jobs more immediately, in terms of reinforcing the credibility of exchange policies. This has resulted in agreement on a freeze or contractual w increases in 1992 and 1993. Similar forces are reflected in the current ro of wage bargaining in **Denmark** where settlements of between 0.2% 2.5% have emerged.

A similar trend towards wage moderation is evident in ***Spain***, where w increases are expected to average approximately 5% in the current y declining to about 4% next year. However, it is expected that this is unlil to halt the trend towards labour shedding on the part of Spanish compa seeking to improve productivity and competitiveness levels. Against background, policy in ***Portugal*** emphasises wage flexibility in the inteı of competitiveness. This has been a major contributor to the very impres Portuguese record with regard to employment (although questions have raised about the quality and viability of some of that employment). Ceı agreements involving Government have, since 1986, sought to inflationary pressures while enhancing wage flexibility. This is reflect relatively high rates of responsiveness to changes in unemployment: an increase of 1% in the unemployment rate is estimated to reduce real wages by between 1-1.4% in the long-run. Furthermore, productivity increases are transmitted rather slowly to wages. Significantly, Portugal displays a high degree of wage dispersion across sectors, reflecting trend productivity growth and the financial position of enterprises. This has enabled employment levels in low productivity industries to be maintained against the European trend. However, the continued inflationary pressures in the Portuguese economy are such that rates of nominal wage increase have been substantially higher than envisaged in the social agreements of recent years.

(iii) Trends in Public Service Pay

Public service pay represents a significant component of total pay. From 1988 to 1993 the Exchequer pay-bill increased by 41.8%, to just over £4 billion. From 1988 to 1992 the average pay for government sector employees increased at an annual rate of 8.2% in nominal terms, compared to an annual increase of 5.3% in average earnings of all employees. This does not take account of relative trends in non-pay labour costs.

TABLE 4.3

Total Percentage Change in Nominal Pay for Selected Periods

	Average Government Sector Employee	Average Earnings (all employees)
1982-1988	5.6	8.2
1988-1992	8.2	5.3
1975-1992	11.5	11.3

Source: Average Government Sector Employee: OECD Economic Surveys, Ireland, 1993. Average Earnings: European Economy, No. 54.

The Council recognises that evaluation of trends in public service pay is sensitive to the time period examined. In particular, it can be pointed out: (i) the increases in recent years reflect the payment of previously deferred increases; and (ii) government sector pay lagged behind the private sector for much of the 1980s. Table 4.3 above shows that, from 1982 to 1988, average government sector pay increased in nominal terms at an annual rate of 5.6%, while average earnings per employee increased at an annual rate of 8.2%. However, this in turn was preceded by changes at the end of the 1970s in which government sector employees achieved a major relative improvement. Taking 1975 as a starting point, government sector pay has

increased at an annual rate fractionally higher than average earnings. This suggests that, in the long-run, wage determination mechanisms produce broadly comparable pay movements across public and private sector employment. However, such comparisons do not take account of relative productivity trends. Furthermore, the short to medium-term divergence of pay trends may give rise to competitiveness pressures, as well as inhibiting the achievement of fiscal policy goals.

There is of course a huge variation in pay within the government sector. Evidence received in the OECD Economic Survey of Ireland, 1993, suggests that, as in the private sector, changes in the mix of skills and occupations within the government sector may be a significant factor in determining the rate of increase of average pay levels. However determined, it is the growth of average government sector pay levels which is significant from the point of view of budgetary policy.

It is important to emphasise that the mechanisms by which public service pay impacts on competitiveness are equally applicable to the non-traded sector as a whole. Where providers operate under conditions of monopoly or low competition, whether in the public or private sector, there is likely to be lower resistance to wage pressure than in the competitive environment of the traded sector. Where wage levels rise as a result, there is a negative outcome for employment both directly and indirectly, through the costs transmitted to the exposed sector.

The Council demonstrates in Chapter 5 that it will be necessary to maintain strong control on public expenditure, including the total public service wage bill, in the years ahead. The growth of the total wage bill is determined by growth in numbers employed, pay levels for the different categories of employment and the composition of employment. The fiscal constraints carry implications for the manner in which these factors are managed.

The level of government sector pay has important implications for the level of employment. This effect is partly indirect, through the impact on competitiveness of the cost of providing public services. However, there is also a direct effect on the numbers employed in the government sector itself. While the size of the public sector should be determined by the most efficient means of delivering the volume of public services deemed appropriate, within any given government budget constraint the feasible level of employment is determined by average pay levels. The very low growth of government sector employment in the 1980s was a major factor in explaining why Ireland had the lowest growth of services employment in the OECD in that decade. *There is therefore a clear link between government pay levels and the level of employment* as there is between private sector pay levels and employment.

It is not the role of the Council to advise on the specific approach to be taken to developing the system of public sector pay determination. The challenge for those directly concerned is to devise systems which better promote, both in the short and in the long-run, a balance between the wage movements in the public and private sectors. However, government sector pay cannot be considered in isolation from the rest of the economy. The interaction of pay levels between different sectors of the economy points to the importance of taking an integrated approach to pay determination in the economy. The prospects for a public sector pay performance which is in harmony with the Council's objective of maximising employment growth will be greater if pay movements *generally* reflect the requirements for maintaining and *improving* competitiveness and thus for promoting employment. In the following section we turn to a consideration of the pay determination system which is most likely to yield this result.

5. WAGE FORMATION SYSTEMS

Given the significance of wage levels for competitiveness and therefore for employment, and given the structure of the Irish labour market, it is necessary to consider what type of wage determination system is most likely to contribute to a higher rate of employment growth. In the short-term this would appear to be a system (a) which delivered moderate wage increases relative to our trading partners, especially the UK (b) which reduced the incentive to substitute capital for labour, and (c) which, insofar as it influenced wage dispersion, flexible work patterns and work-sharing, facilitated the active labour market participation of the unemployed, including the long-term unemployed. For the medium to long-run, it would be desirable that the wage determination system would support measures to strengthen competitiveness through increased productivity and innovation by, for example, supporting efforts to upgrade skill levels and enhance functional flexibility within the labour force in order to maximise the potential of new technologies and their associated optimum work organisation patterns.

In summary, *the priority is to identify an approach to wage determination which sustains the competitiveness potential of the economy in the short-term, while strengthening the more dynamic aspects of competitiveness for the medium to long-term.*

In *A Strategy for the Nineties*, the Council argued that a continuation of centralised wage bargaining, associated with consensus building on the related areas of taxation, social welfare and development policy within a stable macroeconomic framework, represented the best way of securing appropriate income development. The Council also argued that this was the mechanism most likely to secure good industrial relations performance and minimise the risk of disruptive conflict over distributive questions. In taking this approach the Council had regard to the experience of the Programme for National Recovery.

It is appropriate to review the arguments concerning the appropriate structure for wage bargaining given the objectives set out above. There is now a substantial literature analysing the relationship between the institutional structure of the labour market and economic performance.[26] This approach recognises that wages and prices are determined in a bargaining process. In a fully decentralised or plant-level system, it is argued that unions treat wages and prices in the rest of the economy as given. The approach to wage bargaining is therefore largely unaffected by the impact of wage increases on prices. However, it is substantially inhibited by the potential effects on employment and job losses. The more competitive the industry, the more likely this employment effect is to inhibit wage pressure. However, if wage bargaining moves to an intermediate level, at an industry or sectoral level, it is argued that the job effect of wage increases is perceived to be lessened (since competitor firms are equally affected), while the perceived price effect is only slightly increased. The net effect is that the overall level of wage pressure is likely to increase when wage-setting moves from the firm to the industry level, resulting in lower overall employment.

If, however, wage bargaining is further centralised to the national level, it is argued that the external effects of wage increases on both price levels and employment are internalised by the negotiating bodies. It is argued that this tends to reduce wage pressure and thus to increase economic performance and employment. As a result, it is argued that the most competitive results are achieved by highly centralised pay bargaining structures. Intermediate structures are likely to yield less desirable results.

Dowrick (1993) has argued that the links between the degree of centralisation and economic performance reflect the level of organisation or degree of co-ordination of the bargaining bodies, rather than the specific locus of formal bargaining procedures. The categorisation of Japan and Switzerland as centralised bargaining countries in *this* sense reinforces the empirical evidence suggesting a long-run association between the degree of centralisation and economic performance.

It follows that *partial* decentralisation of bargaining is likely to produce maximal wage pressure and inhibit productivity growth. Even where formal

26 This is particularly associated with the work of Calmfors and Driffill.

bargaining is decentralised to the firm level, co-ordination of strategy at industry level by employers and by industry and craft unions would, in effect, amount to partial decentralisation, with the possible negative consequences predicted by labour market theory.

The question which arises in the light of this review of theoretical considerations is which approach to income determination is most likely to enhance economic performance in Ireland, with particular reference to employment growth? One approach would be to pursue a policy of radically decentralised bargaining, with income levels determined at firm or enterprise level. This is the approach which has been pursued, for example, in New Zealand where, under the Employment Contracts Act, 1991, the nature and structure of employment contracts are entirely matters for employers and employees to determine. A similar emphasis on decentralisation can be found in labour market policies in Britain over the course of the 1980s. This has undoubtedly led to a drastic reduction in the number of industry-wide and multi-employer wage contracts. However, it has been pointed out by Browne and Walsh (1991) that this has largely been unsuccessful in terms of competitiveness. Real income growth has outpaced productivity growth through the 1980s and, while the number of multi-employer contracts has radically declined, the move to enterprise-based bargaining is more apparent than real, with significant control of pay developments exercised centrally by large corporations. Furthermore, despite corporatisation in the public sector, strong central control of pay levels remains. Significantly, industries characterised by large numbers of small companies have been active in maintaining or developing collective bargaining procedures even where former statutory controls have been abolished.

Given the structure of the Irish economy and the competitive position of firms in both the traded and non-traded sectors, there are strong grounds for believing that decentralised bargaining would produce strong wage pressures, with higher settlements in high productivity or low competition sectors rapidly transmitted to the rest of the economy. The plausibility of such an outcome would appear to be increased in a situation of international recovery where (given the presence of hysteresis) labour markets may begin to tighten even in the presence of large numbers of unemployed.

The risk of disruption of the economy - in the absence of a negotiated consensus on the evolution of incomes - is high, given that Irish wage bargaining is not conducted by individuals or thousands of local unions. Absence of consensus would not matter so much in a large and highly decentralised economy. But in the Irish context wage conflict, which has sufficient spread effects to feed on itself, is entirely possible - and has, indeed, been experienced in the past, as shown in Table 4.3. If there is conflict over

incomes and international competitiveness is damaged, then the structure of the Irish economy is such that it will quickly result in reduced output and employment.

The effect of an agreement which provides a framework which underpins fiscal and monetary policy, taxation and incomes, is to suspend distributional conflict.[27] This encourages employment growth in a direct way by enhancing cost competitiveness (assuming competitive wage settlements). However, agreements which suspend distributional conflict can enhance competitiveness in a more general, but less tangible, way. Such agreements free industrial relations energies to address other issues - such as corporate strategy, technical change, training and working practices which, as indicated earlier, also influence international competitiveness.

A major argument for the continuation of a negotiated national consensus is that, once a macro-policy centred on exchange rate stability is in place, consensus on a competitive evolution of incomes prevents conflicts over incomes disrupting the economy, and thus facilitates employment growth. Adherence to the EMS puts an externally-determined limit on inflation into the domestic political and industrial relations arena. With limits on cost developments determined externally, conflicts over incomes will either be highly contentious, and therefore disruptive, or affect competitiveness and profitability in a direct and immediate way. In either case, the ability to create jobs and reduce unemployment would be impaired.

Given the importance of the link between exchange rate strategy and incomes policy, it is appropriate to consider what system of wage determination is likely to sustain income developments which are compatible with the exchange rate. Lofgren (1993) has analysed this issue and concluded that, given a devaluation risk, decentralised wage setting is likely, in general, to result in higher wages than centralised wage bargaining. This is because the risk of devaluation is underestimated with decentralised bargaining. However, the credibility of the overall exchange rate strategy, including the performance of fiscal policy, has a significant effect on wage restraint under both centralised and decentralised wage setting procedures.

While the empirical evidence suggests that strongly centralised wage bargaining is conducive to strong economic performance in the long-run, it is not a sufficient basis, on its own, to secure such performance. In reviewing the employment experience of Sweden, Calmfors (1993) emphasises that strong employment performance was as much due to the general

27 This is not to suggest that recent Programmes have been completely successful in this regard.

macroeconomic stance and to micro-level policies including the operation of active labour market policies as to the operation of decentralised wage bargaining. It follows that, in the Irish context, the continuation of centralised pay determination must be allied to a coherent overall strategy covering the exchange rate, fiscal policy, labour market policies and development policies, as outlined elsewhere in this report.

6 CONCLUSIONS ON INCOMES POLICY

A number of specific features of the evolution of incomes over recent years must be noted. Firstly, there has been a real increase in wages and in take-home pay. Secondly, the rate of pay increase in the public service over recent years has been higher than in the economy generally, reflecting factors outlined above, and has contributed to increased real public expenditure and higher government deficits. However, the strong record of industrial harmony associated with the centralised bargaining of the late 1980s has been continued in recent years. The extent to which income developments may have diverged from the priorities set out by the Council in *A Strategy for the Nineties* reflects in part the downturn in international economic conditions following negotiation of the PESP. This in turn points to the need for flexibility in pay arrangements to enable appropriate responses to be made to external conditions.

The Council is strongly of the view that income levels must be shaped by the need to preserve and deepen competitiveness against our main trading partners. Cost competitiveness is especially important in the medium and low-tech sectors of manufacturing and in the expanding category of traded services. Particular reference to trends in UK earnings is necessary. Such an incomes policy is a major ingredient in reinforcing the credibility of the non-accommodating exchange rate strategy, and therefore maintaining a low inflation and low interest rate environment, essential to growth. Cost competitiveness alone is not, however, a sufficient basis for the long-run survival of firms: the strengthening of their competitiveness in the wider sense outlined earlier in this Chapter must be pursued with equal vigour.

To achieve the desired results it is not essential that all formal bargaining over incomes and wages should be confined to the national level. There is, however, a strong risk in moving away from centralised bargaining that the potentially negative impact of partial decentralisation on wage levels, productivity and overall performance would quickly emerge. Such effects, manifested in particular in strong wage drift, is evident for example from the experience of centralised bargaining in Finland (OECD, 1993).

Having regard to the over-riding priority of measures to promote employment, it would be desirable to review the extent to which productivity increases are fully reflected in prevailing wage levels. It is, of course, necessary that income levels per head should increase in order to achieve real convergence with the European Community as a whole. However, it is desirable on grounds of both social and economic policy that this be achieved by *increasing the proportion of the population at work*. Therefore, consideration of mechanisms to translate productivity gains into opportunities for greater employment should be considered. Similarly, insofar as firm-level bargaining features as part of the system of income determination, it would be appropriate that opportunities for job creation would be a central focus. An example would be the pattern emerging in Danish wage bargaining in the current year where, for example, the leading metalwork sector agreement provided for the establishment of firm-level vocational training funds to support two weeks of training annually per worker. Similarly, it was agreed that the maximum period of paid overtime would be reduced from 12 to 8 hours per 4 week period, with overtime above this compensated with time off. These, and other arrangements to stimulate employment creation at the enterprise level, would be a more effective way of stimulating employment creation than assigning all payroll increases to existing employees in the form of disposable income.

On balance, the Council is of the view that a negotiated consensus between the social partners on a wide range of issues - covering the evolution of public expenditure and taxation, the maintenance and implications of Ireland's exchange rate strategy, specific policies to promote the growth and employment performance of the economy, including specific initiatives to increase employment opportunities for the long-term unemployed, *and* the evolution of incomes is likely to represent the most effective mechanism for securing improved employment performance over the next few years. For this to happen, the terms of such an agreement must be internally consistent and consistent with the external conditions facing the Irish economy - including the pressures for cost competitiveness. It is by no means assured that every agreement entered into between the social partners will be optimal in terms of the objective needs of the economy. It is, however, more likely that this will be the result than were we to revert to a partially decentralised system of pay determination.

7. CONCLUSIONS ON COMPETITIVENESS

It will be recalled that the approach to the dimension of competitiveness outlined earlier in this Chapter showed that established competitive potential, combined with the appropriate policy process, makes for successful competitive performance. Using this framework it is possible to classify the elements of the strategic approach to economic and social policy which the Council advocates in this Report. The objective of the Council's Strategy is to achieve and sustain competitive *performance*, as manifested in a higher rate of employment growth. Coherent and consistent macroeconomic strategy and the appropriate evolution of incomes constitute the core elements of competitive *potential*: without them there will not be competitive performance and Ireland will not benefit from the positive stimulus of growth in the international economy or weather the effects of international stagnation. However, a competitive *process* requires the type of structural changes advocated by the Council to boost innovation and productivity growth. The major benefit of a strategic approach is that it brings these complementary elements together: an appropriate macroeconomic stance and moderation in incomes make possible the effective development of competitive processes; the pursuit of competitiveness through structural reform provides results which justify the short-term sacrifices entailed in securing macroeconomic balance and moderation in income growth. A focus on only one dimension of competitiveness - such as wage competitiveness - would be insufficient to build the type of competitive strengths needed for the Irish economy. On the other hand, a lack of cost -including wage competitiveness - would undermine the pursuit of a higher rate of sustainable employment growth, as well as jeopardising in the short-run the employment of those for whom cost competitiveness is currently the key to survival. The rest of the Report is concerned with the development of the strategic overview which should inform the policies and negotiations which are central to building competitiveness, growth and employment.

CHAPTER 5

Fiscal Policyfiscal Policy

FISCAL POLICY

1. INTRODUCTION

A fundamental task of government is to find the appropriate balance between public spending (the demand for which is potentially unlimited) and public revenue (which is strictly limited). Finding this balance comes under the domain of fiscal policy. The Council's over-riding policy objective, which is to enhance employment growth, should be the essential criterion in deciding what balance is appropriate for the years ahead.

Fiscal policy is one component of macroeconomic policy. As outlined in the previous Chapter, the Council emphasises the importance of achieving consistency between fiscal, monetary and exchange rate, and income policies, each of which is the subject of a separate Chapter. The purpose of this chapter is to identify the appropriate direction of fiscal policy in the medium-term. The first section reviews the Council's targets for fiscal policy set out in *A Strategy for the Nineties*. Section 2 reviews trends in fiscal policy since 1990 to see to what extent policy has been consistent with the broad targets of the Council. In Section 3 policy targets for the future and the associated taxation and expenditure implications are examined. Section 4 addresses broader issues concerning the management of public expenditure.

2. PREVIOUS TARGETS OF FISCAL POLICY

The Council was centrally involved in the adoption of the debt/GNP ratio as a target of fiscal policy. In *A Strategy for Development* the Council was so concerned about the evolution of the public finances that it pronounced:

> "that the stabilisation of the national debt/GNP ratio is a minimal requirement of fiscal policy [is] because such a course is the only one that is viable. Accordingly this objective is an imperative ... In effect the authorities have no option but to stabilise the ratio."

This statement was based on the fact that at the time the public finances were on an *unsustainable* course. The evolution of the debt/GNP ratio depends on the relationship between the nominal rate of growth of GNP, the nominal interest rate and the primary (non-interest) budget surplus. When *A Strategy for Development* was being prepared the relationship between these variables was such that the condition for sustainability was not satisfied. In the absence of corrective action the debt/GNP ratio could in principle have continued rising indefinitely. In practice at some point the financial markets would no longer have been willing to finance the ever rising deficits, thus forcing corrective action.

Corrective action was taken and from 1988 the debt/GNP ratio began to fall. When the Council considered fiscal policy in *A Strategy for the Nineties*, the debt/GNP ratio was falling so that the issue was no longer the minimal requirement of technical sustainability. The Council noted that the debt/GNP ratio in Ireland was the highest in the OECD and that Ireland was a clear outlier in this respect by international standards. The Council identified the primary problem of the continued high level of the debt/GNP ratio as lack of *flexibility*: the servicing of the debt still placed a very high burden on exchequer resources, pre-empting resources from the pursuit of other policy objectives. In order to enhance the flexibility of the budgetary system, to reduce its vulnerability to external shocks and to protect the medium-term growth potential of the economy, the Council recommended a target debt/GNP ratio of around 100% by 1993 as the minimum target consistent with these objectives.

A global objective of this nature can be achieved with different taxation and expenditure policies. In the taxation area, the Council recommended reductions in high average and marginal rates on earned income and endorsed changes in indirect and DIRT tax rates to accommodate the single market. Against this background the Council recommended that a target debt/GNP ratio of around 100% be achieved by restraint on current public expenditure. Specifically the Council recommended that current public expenditure (non-capital supply services) should not increase in real terms in the period up to 1993. Real increases in individual areas were to be offset by real reductions in other areas. In particular, within this constraint of no real increase in current public expenditure, the Council recommended a reallocation of resources to address the problem of long-term unemployment through special employment measures. The Council's view was that the very high priority which it attached to long-term unemployment should be operationalised by directing resources to it.

3. RECENT TRENDS IN FISCAL POLICY

Having outlined the fiscal policy objectives of the Council and their rationale as developed in *A Strategy for the Nineties* we now turn to review recent trends in fiscal policy.

(i) Debt/GNP Ratio

The evolution of the debt/GNP ratio is shown below. The debt/GNP ratio fell from 106% in 1990 to 100% in 1992.[28] Hence, the Council's target of reducing the ratio to around 100% by 1993 was reached before the target date. The devaluation of January 1993 led to an increase in the debt/GNP ratio to an estimated value of around 104% for 1993. This reflects the increase in the Irish pound value of the national debt. This is a once-off adjustment and is not necessarily a cause of major concern. It can be anticipated that the devaluation will lead in time to GNP being higher than it would otherwise be.

TABLE 5.1

Debt/GNP Ratio

1986	123.5
1987	126.2
1988	124.4
1989	114.1
1990	106.0
1991	102.0
1992	100.0
1993 (E)	104.0

Source: Finance Accounts, based on revised GNP figures.

(ii) Current Public Expenditure

While some progress was made in reducing the debt/GNP ratio, *how* this was achieved is also relevant to the attainment of policy objectives. The Council recommended that the reduction was to be achieved by no real increase in current public expenditure. The average increase in real gross current government expenditure from 1990 to 1993 was 4.9% per annum (using CPI deflator), while net current expenditure grew by 4.8% in real terms.[29] The somewhat faster growth of gross expenditure reflects the growth

28 At the time of writing *A Strategy for the Nineties*, the debt/GNP ratio understood to be in the region of 111%. Subsequent revisions to the national accounts by the CSO brought the ratio down to 106%.

29 Net current expenditure is defined as Gross expenditure minus PRSI receipts and Appropriations-in-Aid. The latter include CSF receipts.

inappropriations-in-aid.[30] Net current public expenditure has also risen as a percentage of GNP, increasing from 36.8% of GNP in 1990 to an estimated 39.3% in 1993.

Current government expenditure is made up of spending on Central Fund Services (mainly interest payments on the national debt) and Non-Capital Supply Services (which includes public sector pay and pensions, SW transfers, etc). Central Fund Services will absorb an estimated 27% of current expenditure in 1993 (£2.9 billion); the balance will go to fund Supply Services.

Net expenditure on Supply Services grew by 6.7% per annum in real terms during 1990-1992, compared to a drop of 2.1% per annum in 1986-1990. The growth in expenditure has been very broadly-based, with all categories of spending registering an increase. Public sector pay and pensions grew by 5.5% per annum in 1990-1992, up from 1.6% per annum in the late 1980s. This increase reflected the resumption of growth in public sector employment, as well as increases in the level of per capita pay. Social Welfare transfers grew by 8.2% per annum in 1990-1992, after falling by 3.1% per annum in the preceding period. Part of the increase reflected cyclical factors (notably the upturn in unemployment after 1990), but increases in the level of per capita payments also contributed to the rise.[31] Some real increase in welfare benefits was recommended by the Council. Even when social welfare transfers are excluded from the figures, the data still point to a strong underlying growth in current public spending: total current spending net of SW transfers rose by an average of 5.7% per annum in 1990-92, compared to growth of 1.6% in 1986-1990.

30 Note all the changes described in this section refer to real changes (i.e., nominal changes deflated by the CPI). Technically, the appropriate deflator for calculating real changes in public expenditure would be a weighted average of the PANCE deflator (public authorities net current expenditure on goods and services) and the CPI. The PANCE deflator has been rising faster than the CPI in recent years and a real increase in public spending based on the PANCE deflator would thus be lower than that calculated using the CPI. However, the faster rise in the PANCE deflator itself reflects the fact that the unit cost of public expenditure has been rising faster than the CPI in recent years. Since the policy objective was to control expenditure, the Council considers it appropriate to use the CPI deflator in assessing the *real* (i.e. inflation-adjusted) trend in public expenditure.

31 See Chapter 14 on Social Welfare.

TABLE 5.2

Real Changes in Non-Capital Supply Services
% Change per Annum

	1986-90	1990-92
Pay and Pensions	1.6	5.5
Social Welfare — Transfer Payments	-3.1	8.2
Other Non-Pay	1.8	5.7
Gross Supply — Services Expenditure	-0.3	6.6
Appropriations in Aid, PRSI Receipts	6.5	6.4
Net Supply Services Expenditure	-2.1	6.7
Gross Supply less — Social Welfare Transfer	1.6	5.7

Notes: To achieve comparability between the various categories the CPI has been used to deflate all expenditure.
Social welfare transfer payments include some transfer payments which are classified under the Department of Health's note.

Source: Estimates for the Public Services.The residual 'other non-pay' category has also increased, with annual growth of 5.7% in real terms between 1990 and 1992. In the 1993 budget however, this residual category is projected to fall in real terms. If achieved, this would be reminiscent of the type of control which existed in the late 1980s.

(iii) Capital Expenditure

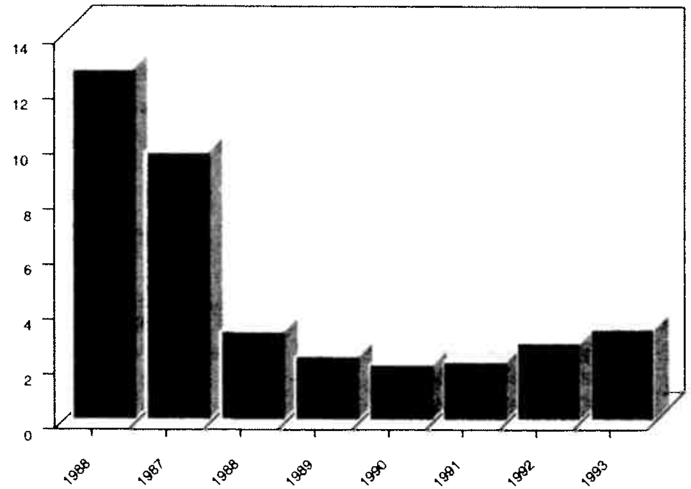
Since 1990 exchequer borrowing for capital purposes has fallen from £310 million to £241 million in 1993. Capital expenditure has however not been curtailed. This reflects the influence of the Community Support Framework (CSF). In macroeconomic terms the CSF is highly significant. In 1992 and 1993, the inflow of funds under these programmes amounted to roughly 3.5% of GNP. This expenditure has benefited a wide range of areas but the most significant beneficiaries have been agriculture, human resources and transport. The Council emphasises that the need for efficiency applies equally to resources provided under the Community Support Framework (CSF) as to other forms of public expenditure. The Council recommends that sufficient resources are allocated within the renewed Framework to ensure ongoing effective evaluation of the results achieved.

(iv) Exchequer Borrowing Requirement

After declining sharply during the late 1980s, the Exchequer Borrowing Requirement (EBR) has increased slightly in the past year. In 1992 the EBR was 2.7% of GNP, up from 2.0% in 1991. The budget target is for an EBR of 2.8% of GNP in 1993. However, if privatisation receipts are excluded the underlying target EBR for 1993 is 3.3%.

FIGURE 5.1

Exchequer Borrowing Requirement
% of GNP



Note: 1988 EBR includes once-off tax receipts from tax amnesty.
1991 figure is exclusive of Irish Life floatation receipts (£270 million).
1993 figure is exclusive of privatisation receipts.

Source: Budget Booklets.

Regarding the computation of the budgetary balance, the Council has emphasised that receipts from privatisation do not alter the fundamental budgetary position. Consequently the Council recommended that such receipts should not form part of the budgetary arithmetic, i.e., they should be kept off budget (NESC, 1990). This principle was followed with respect to the receipts from the flotation of Irish Life. It has not been followed for the other privatisation receipts. In particular the 1993 budget arithmetic includes £150 million from the sale of state assets. These receipts have been used to reduce the recorded EBR. If the EBR is adjusted to reflect this, the target EBR becomes 3.3% in 1993.

If state equity sales are excluded from the EBR, it can be argued that state equity injections should be likewise excluded. This would reduce the recorded EBR. However, the Council would have some reservations about excluding state equity injections: when such an injection is made it cannot be known *a priori* if the state has acquired a profitable and marketable asset.

The General Government Deficit (GGD) measure, which was introduced in an Irish context in the 1993 Budget and is used by the EC in connection with the Maastricht criteria, adjusts for a number of factors (such as privatisation receipts) which affect the EBR. The official 1993 forecast of the GGD is £1033m or 3.4% of GDP.

It is evident that there has been some increase in the EBR in recent years. However, other European countries have also experienced increases in Government borrowing as shown in Table 5.3. The deterioration in the budgetary position in 1993 in EC member states is largely due to the adverse cyclical effects of the slow-down in economic activity in three of the bigger member countries, the UK, Germany and France. The Government deficit in Ireland is likely to prove lower in 1993 than in all EC countries, excluding Luxembourg.

TABLE 5.3

General Government Budget Balances
(% of GDP, 1990-1994)

	1990	1991	1992	1993	1994
Belgium	-5.8	-6.6	-6.9	-7.0	-6.1
Denmark	-1.5	-2.2	-2.4	-4.4	-4.9
Germany	-2.0	-3.6	-2.4	-3.6	-3.7
Greece	-18.6	-16.3	-13.8	-13.1	-11.1
Spain	-3.9	-5.0	-4.5	-4.7	-4.6
France	-1.5	-2.1	-3.9	-5.9	-5.9
Ireland	-2.5	-2.3	-2.4	-3.4	-3.9
Italy	-10.9	-10.2	-9.5	-10.4	-9.1
Luxembourg	0.0	-1.3	-1.6	-2.0	-1.7
Netherlands	-4.9	-2.5	-3.3	-3.8	-3.0
Portugal	-5.5	-6.4	-5.4	-5.7	-4.7
UK	-1.3	-2.8	-6.2	-7.7	-6.9
EC 12	-4.0	-4.7	-5.1	-6.3	-5.8

Source: European Economy, Supplement A, Recent Economic Trends, No. 6/7, June/July, 1993.

(v) Conclusions on Recent Trends

It can be concluded that progress was made in reducing the debt/GNP ratio. The Council's target of a debt/GNP ratio of 100% was achieved by 1992, although the January 1993 devaluation resulted in a once-off increase in the debt/GNP ratio.[32] There has been some increase in borrowing and an increase in taxation as a percentage of GNP associated with significant real increases in current public expenditure. However, government borrowing has been lower than in most other European countries. The Council has concerns about the rate of increase in expenditure and the pattern of resource allocation, insofar as these have not been in line with the priority of reducing unemployment.

4. APPROPRIATE FUTURE TARGETS

Having outlined recent trends it is necessary to consider whether the debt/GNP ratio is still an appropriate policy target; and if so, at what debt/GNP ratio policy should be aimed.

To address these questions we begin by making an international comparison of Ireland's debt ratio. We then examine two criteria which have relevance for determining the desired debt ratio: sustainability and flexibility. The implications of the Maastricht Treaty for fiscal policy are then discussed. Based on these considerations appropriate future targets are then outlined.

(i) International Comparisons

In *A Strategy for the Nineties* it was noted that, despite a fall in the debt/GNP ratio, Ireland remained at the top of the OECD table. This is no longer the case. Table 5.4 compares the debt/GDP ratio in Ireland to that in other OECD countries. We can see that Belgium and Italy now have higher levels of Government debt in relation to national output than Ireland. Belgium has replaced Ireland as the country with the highest debt ratio.

The current international comparisons do not provide any basis for complacency. Ireland's debt ratio is still the third highest in the OECD and very much higher than both the OECD and EC averages.

32 Revisions to GNP estimates contributed to reducing the recorded debt/GNP ratio.

TABLE 5.4

Gross General Government Debt as a Percentage of GDP

	1993
United States	65.1
Japan	66.0
Germany	46.6
France	56.7
Italy	114.5
United Kingdom	47.8
Canada	86.2
Average of above countries	**65.9**
Australia	34.4
Austria	56.2
Belgium	140.0
Denmark	65.7
Finland	41.1
Greece	90.9
Ireland (General Government debt/GDP)	95.1
Ireland (Exchequer debt/GNP)	104.0
Netherlands	79.7
Norway	47.1
Spain	55.7
Sweden	65.8
Average of above smaller countries	66.6
Average of above European countries	66.3
Average of above OECD countries	65.9

Note: The *General Government* debt/GDP ratio is the criterion used in the Maastricht guidelines. General Government debt is wider than Exchequer debt because it includes local authorities and grant-aided bodies. The Council's medium-term domestic policy recommendations are based on the Exchequer debt/GNP ratio. GNP is generally regarded as a more meaningful measure of economic activity in Ireland than GDP. The Exchequer debt/GNP ratio is the measure generally used in domestic budgetary aggregates. The Exchequer component is by far the largest element of General Government debt.

Source: OECD Economic Outlook, June 1993.
Irish data from national sources.

(ii) Sustainability

The technical condition for sustainability of the debt/GNP ratio is that if the nominal interest rate exceeds the nominal rate of growth of GNP, there must be a sufficiently large non-interest surplus. If this is not satisfied the debt/GNP ratio will rise indefinitely. We can see from Table 5.5 that in recent years this condition has been satisfied. There have been substantial non-interest surpluses which substantially exceeded the gap between the nominal growth rate and the nominal interest rate. Therefore the debt/GNP ratio has been falling.

TABLE 5.5

Factors Governing Sustainability of Public Finances

	Nominal GNP Growth %	Nominal Interest Rate %	Non-Interest EBR % of GNP
1986	6.9	9.1	1.9
1987	8.3	8.5	-0.8
1988	5.3	8.1	-7.0
1989	10.1	7.9	-7.0
1990 (e)	7.8	8.4	-7.2
1991	5.8	8.5	-6.8
1992	6.0	8.1	-5.4

If the 1993 budget targets are met then the non-interest surplus should be around 5.6% of GNP. For plausible estimates of nominal GNP and nominal interest rates for 1993 this safely covers the condition for sustainability.

A reasonably conservative growth forecast for the medium-term would be 6% nominal GNP growth comprising 3% real growth and 3% inflation. This would be somewhat below the long-run real growth rate (3.2%). The average interest rate on the national debt averaged 8.4% between 1986 and 1992. If we project a continuation of this average interest rate combined with a 6% nominal growth rate then the required non-interest surplus for sustainability would be 2.5% of GNP to stabilise the debt/GNP ratio at the estimated 1993 level of 104.0.[33] If the type of non-interest surplus which has been achieved in recent years can be continued then the public finances are firmly on a sustainable course.

33 The non-interest budget surplus required to stabilise the debt/GNP ratio is calculated by multiplying this ratio by the difference between the nominal interest rate and the nominal growth rate.

(iii) Flexibility

While the public finances are sustainable it must be borne in mind that sustainability is a minimal requirement. The fact that the current budgetary situation is sustainable does not say anything about its optimality. One of the benefits of reducing the debt/GNP ratio is flexibility. A high debt/GNP ratio means that a large share of tax revenue is pre-empted merely to service the debt.

The benefit of the increased flexibility gained from the adjustments in the public finances in recent years can be seen in Table 5.6. Debt service has fallen from 32.6% of total tax revenue in 1986 to 26.4% in 1992. As a proportion of income tax, debt service has fallen from 83.3% in 1986 to 69% in 1992.

TABLE 5.6

Costs of Servicing the National Debt 1986-1992

	1986	1987	1988*	1989	1990	1991	1992
Debt Service:							
- as % of GNP	11.4%	11.3%	9.5%	9.8%	9.7%	9.5%	9.0%
- as % of Total Tax Receipts	32.6%	32.6%	31.2%	28.8%	29.1%	28.2%	26.4%
- as % of Income Tax	83.3%	78.1%	76.8%	76.2%	76.1%	72.8%	69.0%

* Excluding the once-off effects of the tax incentive scheme.

The exchequer revenue pre-empted by debt service still represents a very large share of taxation. These resources are not available to satisfy other priorities of policy. The high share of taxation pre-empted by debt service makes the exchequer vulnerable to unfavourable interest and exchange rate movements, as was experienced in recent months. The criterion of flexibility therefore points to the need to achieve further significant reductions in the debt/GNP ratio rather than merely sustaining the current level.

(iv) The Treaty on European Union and Fiscal Policy

The Treaty on European Union specifies a number of principles for fiscal discipline for would-be EMU members. These conditions are as follows:

(i) Member states shall avoid excessive deficits. The principle of excessive deficits is based on two criteria:

(a) A government deficit is excessive if it exceeds 3% of GDP at market prices. There is some flexibility with respect to this condition. First, a deficit above 3% might be allowed if it "is only exceptional and temporary and the ratio remains close to the reference value". Second, other factors specific to a country such as "whether the government deficit exceeds government investment expenditures", will be taken into account. Third, the deficit might not be deemed excessive if it "has declined substantially and continuously and reached a level that comes close to the reference value".

(b) The debt/GDP ratio may not exceed 60%. However, a debt/GDP ratio above 60% will not be deemed excessive if it is "sufficiently diminishing and approaching the reference value at a satisfactory rate".

(ii) The "no bail out" clause: Each member state is alone responsible for servicing its own public debt, even in a fiscal crisis.

(iii) Central Bank financing and access to favourable financing of public deficits is banned.

Ireland did satisfy the condition that the general government deficit not exceed 3% of GDP in 1992 but the projected deficit of 3.4% in 1993 is in excess of the required level. However, at present only Denmark satisfies this government deficit condition and the situation in Ireland could reasonably be regarded as "exceptional and temporary" in the words of the Treaty.

Ireland[34] along with Belgium, Denmark, Greece, Italy, The Netherlands and Portugal has a debt/GDP ratio in excess of 60% of GDP at present. While a debt/GDP ratio in excess of 60% is not in itself contrary to the Maastricht Treaty (provided it is sufficiently diminishing and approaching the reference value at a satisfactory rate) the aforementioned countries need to achieve significant reductions in their debt ratios over time.

Buiter, Corsetti and Roubini (1993) have modelled the effect of reaching the debt/GDP target of 60% by the end of 1996 and alternatively by the end of 1998. The authors assume that EMU is characterised by 2% inflation. They assume a 3% real growth rate, which implies a target nominal GDP growth

34 The General Government debt/GDP ratio in Ireland at end 1992 was 95%.

rate of 5%. Scenario A in their analysis involves a gradual adjustment to a 5% GDP growth rate and a debt/GDP ratio of 60% by the end of 1996. Under scenario B the target is reached by the end of 1998 instead of 1996. The authors calculate what deficit would be necessary to reach these debt/GDP targets.

The results are presented in Table 5.7. In the case of Ireland the required surplus ranges from 2.1% of GDP to 4.5% of GDP. These represent total budget surpluses and not merely non-interest surpluses (which are already achieved by Ireland). To achieve these budget surpluses it would be necessary to implement severe budgetary restraint.

TABLE 5.7

Constant Deficit-GDP Ratio (%) to reach the Maastricht Debt Target

	1991 Nominal GDP Growth	1991 Government Deficit	Constant % deficit-GDP to cut debt-GDP to 60% in scenario:	
			(A)	(B)
Belgium	4.7	6.2	-9.2	-5.4
Denmark	4.0	2.0	1.5	1.8
Greece	21.3	16.5	-0.2	1.9
Ireland	5.1	2.3	-4.5	-2.1
Italy	8.8	10.2	-3.2	-0.9
Netherlands	5.4	3.9	-0.2	0.8
Portugal	16.1	6.4	1.5	1.8

Scenario (A) : If the 1991 value for nominal-GDP growth exceeds 5%, it falls at a constant exponential rate to reach 5% by end-1996; it stays constant at its 1991 value otherwise.

Scenario (B): Same as (A) but taking 1998 rather than 1996 as the target date.

Source: Buiter, Corsetti and Roubini (1993).

It must be emphasised that this analysis is based on an assumed real growth rate of 3%. The debt/GDP ratio is very sensitive to the growth rate achieved. De Buitleir and Thornhill (1993) have estimated that each 1 percentage point of growth would reduce the debt ratio by about 7 percentage points by 1997 if the revenue buoyancy from growth is applied to debt reduction. There is a prospect of achieving more rapid economic growth than 3% per annum in Ireland in the second half of the nineties in the context of a favourable external environment and substantial investment of structural funds.[35] Stronger growth would facilitate more rapid progress in reducing the debt/GDP ratio. Even if Ireland has not reached the debt/GDP target of 60% by the target date, continued budgetary discipline should ensure that Ireland's debt/GDP ratio should be "sufficiently diminishing and approaching the reference value at a satisfactory rate", thereby satisfying the Maastricht criteria.

(v) Privatisation Receipts

The one disadvantage with the debt/GNP ratio as a target is that it is generally measured in terms of *gross* liabilities, while in principle the *net* liabilities of government and the Central Bank are a more relevant measure. One of the differences between gross and net debt is equity in profitable public enterprises. Sales of such equity reduce *gross* debt, but leave *net* debt unchanged. One limitation to focusing on gross debt is that *gross* debt can be changed by a balance sheet adjustment (such as selling a profitable state enterprise) which does not change the underlying *net* financial position of the Exchequer.

In the context of Maastricht this point concerning gross and net debt is made by Buiter, Corsetti and Roubini (1993):

> "Privatisation receipts, which should be counted as financing, instead under the Maastricht rules can be used to reduce government debt, thus relaxing the fiscal constraints. Selling an asset for the right price has no effect on government solvency (though threats of privatisation may change effort and behaviour and hence asset values)".

The incentive to privatise state assets to take advantage of the impact on the debt ratio is undesirable because it creates the impression that the real financial constraints of government can be altered merely by making balance sheet adjustments, rather than by making real changes. The point is that if privatisation receipts are realised this would not justify loosening of the fiscal stance. The Council reiterates its general view on privatisation:

> "It is very important to resist the conclusion that because the weaknesses arising from Government as shareholder (i.e., Government failure) are so serious and so pervasive that a general presumption in favour of private ownership is justified. Government failure must be set against market failures and conclusions reached on the particular circumstances of each case." (NESC, 1990).

35 See discussion of Medium-Term Outlook for the Economy in Chapter 2 of this Report. This suggests that the growth rate could increase to between 4.5% and 5.0% p.a. in the period 1995-2000.

(vi) Appropriate Targets

Based on the above considerations the debt/GNP ratio is still an appropriate target for policy. While the Maastricht guidelines use the concept of the General Government debt/GDP ratio, the Council's medium-term recommendations refer to the Exchequer debt/GNP ratio as in previous Strategy reports.[36] The Maastricht Treaty requires satisfactory progress towards a debt/GDP target of 60% to participate in EMU. As discussed in the Chapter 6, monetary union is the preferred exchange rate regime for Ireland. Quite apart from EMU requirements, the target of reducing the debt/GDP ratio to 60% is desirable on its own merits. Further reductions in the debt ratio are necessary to improve flexibility in the budgetary system and to reduce vulnerability to external shocks. Greater flexibility can be expected to enhance investment and consumer confidence. A lower debt ratio also means that, for a given level of public expenditure, the level of taxation which is required for budgetary balance is permanently lower. Put another way, a lower debt ratio means that, for a given level of taxation, expenditure on public services can be permanently higher.

However, there is a need to be flexible with regard to the timetable for meeting the Maastricht criteria. Attempting to reach the target of a debt/GDP ratio of 60% by 1999 would, in the event of economic growth being moderate (say 3%), result in fiscal overkill. On the other hand, if economic growth is buoyant (which is quite plausible for the second half of the 1990s) then it would be highly desirable to take advantage of this growth to make more rapid progress towards the debt target by 1999.

The Maastricht Treaty provides an appropriate long-term debt objective but at this point the Council wishes to propose an appropriate medium-term objective, i.e., to be achieved by 1996. The evolution of the debt/GNP ratio is influenced by a variety of factors, not least exchange rate movements. Therefore while the trend in the debt/GNP ratio is important it is unwise to over-react to fluctuations in the debt/GNP ratio caused by exchange rate movements. For example, if exchange rate movements reduce the debt/GNP ratio this would *not* justify any loosening of fiscal policy.

A major influence on the debt/GNP ratio is the rate of economic growth. A modest baseline assumption for economic growth over the next three years would be volume growth of 3% per annum. In this scenario the Council recommends a *minimum* target of a debt/GNP ratio around 95% by 1996.

36 The difference between these concepts and the rationale for focusing on the Exchequer debt/GNP ratio is explained in the note to Table 5.4.

This target is deliberately recommended as one which allows some small degree of flexibility in relation to public expenditure - allowing direct action to be taken in tackling other priorities, specifically in respect of long-term unemployment[37] - while at the same time ensuring that continued progress is made towards reducing Ireland's debt ratio.[38] In the event of faster growth being achieved the Council recommends that the proceeds be allocated to achieving a faster reduction in the debt burden.

The most important variable which influences the debt/GNP ratio and which is under the direct influence of policy makers is the EBR. This is a key variable in the annual budgetary process. While it is inappropriate for the Council to make specific recommendations about individual budgets, the Council recommends that the EBR should be placed on downward path from its 1993 level. The implications of this recommednation can be expressed in two ways. The nominal EBR target for 1993 was 2.8% of GNP. The budgeted EBR exclusive of privatisation receipts was 3.3% of GNP in 1993. The Council has outlined above its views on the approach which should be taken to calculating the budgetary arithmetic.

(vii) Implications for Expenditure and Taxation

The aims of reducing the EBR and the debt/GNP ratio have implications for taxation and expenditure, since these variables can be reduced by adjusting either taxation or expenditure. The Council's view is that it would not be desirable to increase further the burden of taxation. This derives from the priority which the Council attaches to improving competitiveness in order to promote the growth of sustainable employment. The impact of taxation on the efficiency of the economy depends on the structure, as well as the level of taxation. Revenue neutral changes to the structure of taxation are discussed in Chapter 7. While the Council does not favour increasing the tax burden, the need to reduce the debt/GNP ratio also means that there is little if any scope to reduce the overall level of taxation. However, there is scope for tax reform on a revenue neutral basis (see Chapter 7).

The Council considers that the reduction in the debt/GNP ratio should be achieved by restraint on expenditure, in particular current public expenditure.

37 The Council's analysis of the problem of long-term unemployment in Ireland and its proposals to alleviate it are set out in Chapter 3.

38 In this regard any headroom which may exist should not be eroded by a lack of expenditure control in other areas.

Capital spending projects which are rigorously evaluated and yield an appropriate rate of return should be accommodated within the recommended fiscal parameters. In the late 1980s net current spending (NCSS) was reduced in relation to GNP, falling to 25.5% of GNP in 1990. This reduction has since been reversed. In 1993, the budget estimate was that current spending would rise to 28.3% of GNP. There are structural pressures which place upward pressure on spending. Pay accounts for 53% of NCSS in 1993. while social welfare (non-pay) accounts for 27%. Therefore 80% of current spending is likely to be subject to pressures for increases in the medium-term. In 1993, these two areas increased at an average of 8.1%, well above the increase in NCSS as a whole of 7.6%. Clearly if such a large proportion of current spending continues to increase at this rate, it becomes more difficult to reduce the remaining programmes (i.e., non-pay social and economic expenditure) to ensure that the total NCSS remains at a level consistent with general budgetary targets. The Council's views on the approach to be taken to income developments as part of a strategy for employment were set out in Chapter 4. If these guidelines are followed, the evolution of pay generally, including public service pay, will facilitate the achievement of the Council's fiscal policy objectives.

In the coming years there will be a high level of expenditure under the Structural Funds and the Cohesion Fund. The Council emphasises that such expenditure needs to be subject to the same degree of rigorous control as exchequer expenditure, since the Structural Funds require considerable matching exchequer expenditure. However, such expenditure is already taking place under the current National Development Plan, so the requirement for matching exchequer expenditure will not be a significant source of additional expenditure growth in the years ahead.The Council's budgetary targets are consistent with *modest* real growth in expenditure. The Council emphasises that the modest expenditure growth it envisages will represent a considerable *tightening* of expenditure control, compared to relaxation in recent years. The Council recommends that priority in allocating this modest increase should be accorded to measures to provide work opportunities for the long-term unemployed, as set out in Chapter 3. Increases in other areas, including areas identified as deserving of priority attention in this Report, will therefore require to be accommodated by offsetting reductions in expenditure in other areas.

The Council's medium-term approach to budgetary policy can be summarised as follows:

Under a baseline assumption of 3%[39] growth per annum, a minimum target would be to reduce the debt/GNP ratio to around 95% by 1996 from the 104% anticipated at end-1993. If faster growth is realised the proceeds should be allocated to further reductions in the debt burden. This requires reducing the EBR from its 1993 level (the budgeted level of which is 3.3% of GNP when privatisation receipts are excluded). These budgetary targets can only be achieved by a significantly greater restraint on public expenditure than has existed for the past three years, particularly in relation to current expenditure. The Council's budgetary targets permit of a very modest real increase in public expenditure, at a rate significantly lower than in the recent past. On the basis that effective restraint will be applied to public spending generally, the Council believes that priority within this modest increase should be given to direct resources targeted on the long-term unemployed. The scope for reducing the tax burden is very limited. However, over and above the targeted increase in expenditure discussed above, savings resulting from the more efficient management of public expenditure and reform of its strategic control should be targeted towards reducing the total tax burden. This should be carried out within the context of the Council's strategy of tax reform aimed at reducing the negative impact of certain aspects of taxation on employment.

5. THE MANAGEMENT OF PUBLIC EXPENDITURE

So far we have been concerned with one aspect of fiscal policy, the overall control of the public finances to reduce the debt/GNP ratio. This is an important aspect of public policy, but an effective fiscal policy requires more than a reduction in the debt/GNP ratio. Fiscal policy is or should be concerned with the overall management of public expenditure and taxation to achieve society's objectives. This section will address the management of public expenditure. Taxation is discussed in detail in Chapter 7 and so will not be examined here, although the taxation implications of public expenditure must always be borne in mind.

(i) Characteristics of the Current System

In the 1970s and 1980s there were major difficulties with the control of total expenditure and borrowing. In the 1980s efforts were made to implement fiscal restraint, but serious obstacles were encountered. Automatic stabilisers

39 The medium-term outlook for the economy is discussed in Chapter 2. It notes the central projection in the Government's National Development Plan, which envisages average growth of around 3.5% per annum over the period 1994-1999. The Council notes that faster growth is possible if growth in the world economy is more buoyant than expected and/or if the underlying competitiveness of the Irish economy, in *all* its aspects, is increased.

such as unemployment compensation and institutional rigidities imparted a "flexible upwards - rigid downwards" appearance to the public expenditure system. To counteract these rigidities the Council recommended a strong top-down element to be introduced into the budgetary process.

Considerable progress was made in achieving narrow financial control in the late 1980s although there has been some slippage since 1990. However, there was less progress in reforming the *composition* of expenditure. The traditional budgeting system used in Ireland and many other countries is characterised by: incrementalism (most of the time is spent examining increases in expenditure); it is annual; it is conducted on a cash basis (as distinct from a volume basis); it is a budget based on *inputs* (as distinct from *outputs*).

In the annual budget cycle, the Government is collectively responsible for the fiscal estimates. Within this bargaining process economic and financial calculus may play a secondary role, compared to the importance of political bargaining and judgement. Even when expenditure limits are observed, this process does not contain in-built mechanisms to ensure that resources are allocated to those areas where they are most productive in terms of achieving society's objectives.

(ii) International Experience

A number of countries have addressed some of the problems associated with traditional budgeting:

> emphasis on the annual budget formulation cycle as a mechanism for integrating programme and policy choices is changing somewhat. A number of countries are shifting emphasis to formulation of a total financial frame or block budget for a given Ministry or spending Department, within which the responsible Minister and officials have greater freedom to reallocate funds and adjust programme priorities. This decentralisation ... can be seen as an extension and reinforcement of "top-down" budgeting; in return for greater policy or managerial flexibility, departments are expected to live within the previously approved budgets (OECD, 1987, p.26).

The most radical reform of the budgetary system has been introduced in New Zealand in recent years. The reformed New Zealand management system starts from the perspective that the government wishes to achieve certain objectives or *outcomes*. These outcomes include such objectives as safe streets and clean air. The government cannot purchase these outcomes directly, but it can use a variety of means to achieve the desired outcomes, including tax incentives and regulations. Public expenditure involves the government purchasing *outputs* to achieve these outcomes. The government purchases these outputs from government departments who produce these outputs using various inputs.

The New Zealand system distinguishes two interests of the government: its interest as a *purchaser* and its interest as an *owner*. As a purchaser, the government is interested in purchasing services from its departments at the lowest possible cost. Costs are measured using accruals accounting to avoid distortion caused by manipulating cash flow at the end of the year. The costs of using capital employed by government departments are explicitly included. While the government as purchaser wants to buy services at the lowest cost, the government's interest as owner is not served if departments charge artificially low prices by, for example, not including an appropriate charge for capital.

In general, the government can be satisfied that its interests as purchaser are met if it pays the same price as would be charged by the best alternative supplier. Given this price, the ownership interest can be assessed by applying normal accounting ratios, such as return on funds employed, to measure the efficiency of management of the department.

(iii) Implications for Ireland

Some tentative observations are now offered on the Irish system in the light of the above observations on budgetary systems and on recent international developments. *Firstly*, a system of public expenditure management involving the formulation of a total financial frame, or a resource envelope, within which freedom is given to identify priorities and allocate resources, appears superior to a system where decisions are taken centrally on individual programmes and inputs. A number of other advantages could be claimed for the system but a more detailed evaluation of alternative systems would be necessary before confident conclusions could be drawn. The suggested advantages include, *secondly*, that it could institute a system of competitive dialogue between programmes. This is in contrast to the situation described earlier where programmes tend to compete against the resource constraint rather than with one another for additional resources. This competitive dialogue might also be much more effective in eliciting information on programme objectives, costs and achievements than the existing system. *Thirdly*, the system could possibly spread the burden of fiscal restraint across the public sector, reducing the need for one central department to act as

guardian of the resource constraint, as sole provider of retrenchment options, as priority setter, and as resource allocator in specific areas. *Fourthly*, such a system would be very comprehensive, incorporating all the means at the disposal of the policy maker and ensuring that all the resources deployed for the achievement of particular policy objectives are considered. The issue of tax expenditures is very important in this regard. Their management will be considered in a later section.

The Council does not wish to recommend that any particular system of management of public expenditure be introduced to Ireland. While it is possible to construct systems which are conceptually very attractive, there is no perfect system of expenditure management. The failure of programme budgeting to contribute to effective decision-making in Ireland still leaves resistance to making very radical changes in management systems.

However, the Council is *not* satisfied that the current system achieves a sufficient degree of *strategic* control in public expenditure. The Council acknowledges that economic and financial calculus cannot eliminate the role of political bargaining and judgement in the allocation of public expenditure, but the Council *does* consider that there is a need for reform to achieve greater efficiency in the allocation of public expenditure.

(iv) Enhancing Efficiency and Effectiveness

This section examines a number of measures taken in a variety of countries to improve the efficiency and effectiveness of public expenditure and reviews recent Irish developments. The measures taken in a variety of countries range from campaigns to improve financial management, including management reforms and improved incentive structures, to strengthened external monitoring and tighter controls on expenditure and inputs, to increased competition in the provision of Government services. We now examine each of these in turn.

(a) Direct Input Controls
Constraints on the principal input - manpower - have featured prominently in Government attempts to restrain public expenditure in Ireland in the 1980s. Employment in the public service fell from around 218,000 in 1986 to around 195,500 in 1989. Since 1990 there has been a modest increase in public service employment; in January 1993 public service employment was around 205,000. While such measures are effective in terms of restraining public expenditure, a number of problems can arise. By definition, such measures fall most heavily on

the manpower intensive parts of the public service. In addition, recruitment embargoes impact most severely on high turnover segments of the public service. As a result of these features, the budgetary retrenchment may not be in line with policy priorities. Another criticism frequently levelled at such measures is that the brunt of adjustment is borne by the front-line staff, with the support services escaping retrenchment. This implies that measures such as these need to be accompanied by determined managerial efforts to redeploy overall resources in line with policy priorities.

(b) Improving Financial Management

Efficient resource management in the public sector had traditionally been rendered difficult by the nature of management objectives, by rigidities in the budget system and by lack of information about resource use. To counteract some of these weaknesses, many countries have launched specific campaigns or initiatives to promote better financial management in individual departments and executive agencies. Some of the key features of these initiatives are more decentralised procedures for taking executive decisions and more delegation of such decision-taking. For this, individual managers need clear objectives (and, at lower levels, clear tasks) coupled with responsibility for good use of resources provided to each in a delegated budget. Because of the difficulties of constructing measures of final output, attention has tended to focus on intermediate or activity indicators. The most common use of such indicators to improve efficiency is to set performance targets for management and to compare efficiency over time and between comparable units. The scope for the latter would appear to be quite widespread in areas such as health (between hospitals and health boards), education (between different institutions) and local authorities.

Ireland has been no exception in the introduction of such initiatives in the 1980s and the 1990s. Measures include:

(i) publication of the "Comprehensive Public Expenditure Programmes";

(ii) publication in September 1985 of a Government White Paper on the reform of the public service, *Serving the Country Better*.

(iii) the introduction of a formal system of reporting to Government on the financial performance of the Commercial state bodies based on corporate plans;

(iv) the fixing of administrative budgets on a three-year cycle with delegated managerial flexibility;

(v) the issue to departments of "Guidelines for Financial Management";

(vi) prescription of systematic procedures for the appraisal of capital projects.

(vii) at present, a working group is examining Government accounting procedures with a view to securing greater accountability and transparency in the use of resources in all areas of the civil service.

Many of the weaknesses of the management system cited earlier were identified in the 1985 White Paper and some of the solutions proposed earlier were put forward. While events, particularly since 1987, have cast something of a shadow over general reform of the public service, the improvement of management systems as recommended in that paper would, if applied, greatly assist the overall control of public expenditure. However, little progress has been made in implementing these proposals (Dooney and O'Toole, 1992).

Considerable progress has, however, been made with the introduction of administrative budgets. The aim of administrative budgets is to achieve greater efficiency in administrative expenditure (i.e., programme expenditure, which accounts for most expenditure, is not included). Under administrative budgeting individual departments have more control over their own administrative expenditure. The return for this greater control is that departments agree to reduce their administrative expenditure in real terms over a three year period.

Boyle (1992) has reviewed recent experience of administrative budgeting. He found that it has led to an increase in cost consciousness among department managers, more flexibility to respond to changing circumstances and an encouragement of longer-term thinking on investment priorities. However, progress has been hampered to some degree by uncertainty over the ability to carry forward savings from one year to the next. The 1993 Estimates indicate a carrying forward of savings under administrative savings for a number of departments and offices ranging from £7,000 in the Department of the Environment to £776,000 for the Department of Social Welfare.

(c) External Monitoring

External monitoring of the efficiency and effectiveness of government expenditure has been increased during the 1980s. In many countries use is made of direct private sector input to efficiency and effectiveness reviews. The Irish Government has followed this route with the appointment in 1988 of an Efficiency Audit Group with a brief to examine, in conjunction with Departmental managements, the workings and practices of each Government Department with a view to recommending improved or alternative practices and methods which would reduce costs and improve efficiency.

In addition to these arrangements, most countries have external monitoring through the Government's auditor. There has been a distinct shift in the functions of this auditor in many countries over the 1980s. In terms of the three levels at which control operates: (i) financial regularity; (ii) efficiency and effectiveness; and (iii) strategic control, Government auditors have traditionally operated at level (i), i.e., financial probity. However, many countries have entrusted the Government auditor with a 'comprehensive' auditing function. In Ireland, the Comptroller and Auditor General[40] has traditionally exercised a non-statutory function in relation to administrative efficiency. The Comptroller and Auditor General (Amendment) Act 1993 provides for the extension of this function on a statutory basis. It empowers the C&AG to examine the economy and efficiency of the Departments and other public service bodies which he audits and the adequacy of the management systems they have in place to appraise the effectiveness of their own operations.

(d) Exposure to Competitive Forces

Testing the cost-efficiency of government activity has increased over the last decade by making in-house production units compete with external producers in a competitive tender for specified tasks. In considering this issue it is important to note that governments are involved in the production and provision of goods and services in a variety of ways. A useful distinction in this regard is that between 'who is the producer?' and 'who pays?' There are publicly produced private goods, like electricity and railways; there are publicly produced goods that are publicly provided, free of charge, like education; and there are privately produced goods that are publicly funded, such as parts of the health services.

40 In the case of Ireland it should be noted that the C & AG is the Parliament's auditor and not the Government's auditor.

It is important to ask why differences in performance might be expected between services that are tendered and those that are provided in-house.[41] One argument is that in-house provision removes, to a significant extent, the incentives and constraints that apply to firms operating under competitive market conditions, such that there is not a strong incentive to maximise productive efficiency. It is sometimes argued that the answer to this is to regulate performance directly. However, those attempting to do so may not easily determine whether the service is being provided at a higher cost than necessary because the relevant information about efficiency may not be readily available to them.

Advocates of competitive tendering argue that it largely overcomes the problems both of incentives and information. The tendering process itself generates information about the relative efficiency of the operators who bid for the contract, provided that the level of service is specified correctly and with precision. In regard to incentives, once a fixed-price contract for the service has been granted it is in the operator's interest to minimise costs.

A number of problems arise with this scenario. Firstly, effective competition in the tendering process may not emerge. There are a number of reasons why this might happen, for example, sunk costs incurred in bidding, or differences in information between incumbents and potential entrants. Secondly, once a contract is awarded, the operator may try to increase profits by failing to meet his obligations or, by trying to reduce costs through reducing service levels. It is possible to guard against this by having tightly specified contracts and close monitoring and enforcement. As documented by NESC (1990) there is some empirical support that contracting out can reduce costs, without reducing the quality of service.

The issue surrounding the contracting-out of services is not confined to the public sector. Many private sector organisations have been engaged in a similar exercise. This very fact should serve to underline the point that the ownership issue (i.e., the public/private distinction), is not central to this discussion. It derives rather from the fact that organisations are made up of disparate units which are linked together for the purpose of providing goods or services. Individual departments within these

41 Note that the term in-house provision is used rather than public provision. This is because it may be that the ownership issue again is not the most relevant consideration.

organisations, public or private, can be categorised as facing the kind of incentives discussed earlier, while the managers of the organisation are frequently short of the information necessary to evaluate the performance of these divisions. As with the case of public enterprises it is competition which is the key dimension to ensuring efficiency. The core policy position is, therefore, one of ensuring effective competition where feasible.

(vi) Controlling Tax Expenditures

It was noted earlier that in order to assess comprehensively the role of the public sector, it is necessary to take into account off-budget activities. The most notable of these are tax expenditures, loan guarantees and regulation. The generic title applied to these activities (i.e., off-budget) gives a clue as to why they deserve special attention from a control perspective.

Tax expenditures give rise to particular difficulties from a budgetary control perspective. There is a tendency for tax expenditures to be subject to less control than direct expenditure by virtue of their relative invisibility or lack of transparency, the fact that they do not pass through the normal appropriations channels, and the fact that there is rarely provision for a regular and systematic review of the various expenditures. The Council's policy on tax expenditures, derived from a tax reform perspective, is as follows: the priority of taxation policy must be the widening of the tax base and the simultaneous reduction of effective tax rates on the lines set out in Chapter 7. One important means of widening the base is the reduction of tax expenditures. While this might suggest the wholesale removal of tax expenditures, it must be tempered by the broader policy context - the relative suitability of different interventions, in particular the respective merits of tax-based and direct incentives.

6. CONCLUSION

Despite the progress which has been made in recent years, Ireland's debt/GNP ratio remains high. Further reductions in the debt ratio are required in order to increase the level of budgetary flexibility and reduce the vulnerability of the economy to external movements in interest rates and exchange rates. The *pace* at which Ireland's debt ratio can be reduced will depend on the rate of economic growth and the level of real interest rates.[42]

42 Both of these variables are themselves influenced by the conduct of fiscal policy.

It will depend also on the extent to which we are prepared to trade-off a somewhat slower rate of fiscal correction in order to provide a limited amount of resources to tackle other priorities, specifically in respect of long-term unemployment.

The Council believes that under a baseline assumption of 3% real growth per annum over the next three years, a balanced target would be to reduce the debt/GNP ratio to around 95% by 1996 from the 104% anticipated at end-1993. If pursuit of a coherent strategy of economic stability and structural reform as recommended by the Council results in a faster growth rate, the proceeds should be used to secure further reductions in the debt burden. This requires reducing the EBR below its 1993 level (the budgeted level of which is 3.3% of GNP when privatisation receipts are excluded). These budgetary targets can only be achieved by a significantly greater restraint on public expenditure than has existed for the past three years, particularly in relation to current expenditure. The Council's budgetary targets permit of a very modest real increase in public expenditure, at a rate significantly lower than in the recent past. On the basis that effective restraint will be applied to public spending generally, the Council believes that priority within this modest increase should be given to direct resources targeted on the long-term unemployed. The scope for reducing the tax burden is very limited. However, over and above the targeted increase in expenditure discussed above, savings resulting from the more efficient management of public expenditure and from reform of its strategic control should be targeted towards reducing the total tax burden. This should be carried out within the context of the Council's strategy of tax reform aimed at reducing the negative impact of certain aspects of taxation on employment.

The Council is concerned not only with the control of the total level of expenditure, but also with the efficient management of that expenditure. Developments in public expenditure in Ireland and elsewhere were discussed. The Council notes that administrative budgeting appears to be making a useful contribution to efficiency. Issues of efficiency and effectiveness are reviewed in more detail in the later Chapters dealing with the principal programmes of social expenditure.

The Council is not satisfied, however, that there is a sufficient degree of *strategic* control of public expenditure. This is the extent to which the budgetary system ensures that the activities carried out by the public service achieve the objectives of policy in an efficient manner. The Council does not wish to recommend the adoption of any particular system such as the New Zealand model at this stage, but it does consider there is a need for reform in this area.

The importance of efficient management of expenditure applies equally to resources under the Community Support Framework (CSF) as to other public expenditure. The Council recommends that sufficient resources are allocated to ensure ongoing effective evaluation of the CSF.

An effective fiscal policy is of direct relevance to the issue of employment and unemployment. At one level, there are a variety of programmes, which seek to expand sustainable employment. It would be desirable if in the budgetary process the various programmes were explicitly compared to identify which methods are most effective and to take this into account when allocating resources. More generally, efficiency in the organisation and delivery of public services can be a significant factor in the cost - competitiveness of the traded sector and thus its capacity to maintain and increase market share and jobs. Satisfactory progress towards fiscal policy objectives can also serve to develop confidence in the overall conduct of macroeconomic policy, strengthening the credibility of the exchange rate strategy and contributing to lower interest rates. This in turn encourages investment, increased output and employment.

CHAPTER 6

Exchange Rate Policy in a Macroeconomic Strategy[a]

a This chapter draws heavily on a position paper which was prepared for the Council by Prof. Patrick Honohan of the ESRI. A version of that paper was subsequently published as Honohan (1993).

EXCHANGE RATE POLICY IN A MACROECONOMIC STRATEGY[43]

The purpose of this chapter is to review Ireland's exchange rate strategy. The Council's conclusions on this aspect of macroeconomic strategy will be discussed in the context of the over-riding the requirements for more rapid growth in output and employment.

In *A Strategy for the Nineties*, the Council argued that the strong performance of the economy between 1986 and 1989 was due to a combination of highly favourable external developments and favourable internal factors in the form of cost competitiveness, interest rate reductions and increased confidence. The Council concluded that the stated commitment to maintenance of the exchange rate within the EMS and, more particularly, the adoption of domestic policy measures to underpin this announcement, minimised the exchange rate risk inherent in investing in Irish securities and increased the confidence of potential investors. This was seen as a major contributor to the decoupling of interest rates from the UK and the reduction in the differential over German interest rates.

This led the Council to continue its commitment to the policy of maintaining the nominal value of the Irish pound in the EMS. The Council recognised that the progressive reduction and elimination of exchange controls was likely to increase the volatility of capital flows and hence the volatility of interest rates. It also recognised that, despite the entry of sterling to the ERM, considerable scope remained for fluctuation *vis-à-vis* the Irish pound. The turbulence in exchange rate markets leading to the widening of the ERM bands in August 1993 has substantially loosened an anchor for Ireland's macroeconomic strategy. A review of the objectives of exchange rate strategy is therefore necessary in order to choose the correct macroeconomic policy and address the possibilities of further change in the ERM.

1. OBJECTIVES OF EXCHANGE RATE POLICY

The objectives of exchange rate policy may be summarised as the securing of an external value of the currency which provides a stable environment within which the internationally trading sectors can operate most confidently

43 This chapter draws heavily on a position paper which was prepared for the Council by Prof. Patrick Honohan of the ESRI.

(NESC, 1986). Exchange rate strategy is therefore a central element in the pursuit of price stability, an objective which attained virtually universal significance following the experience of the high-inflation 1970s, reinforced for EC member states by the political decision to pursue economic and monetary union (EMU). Anti-inflationary strategies require a nominal anchor expressed in the form of a target for some nominal magnitude such as the supply of money or credit, nominal GNP or GDP or the exchange rate, all of which are integrally related to the price level. The appropriateness of any particular nominal anchor depends upon the speed and reliability of the signal which it gives of emerging inflationary pressures. For small, open economies, the exchange rate is particularly useful as a nominal anchor because of the close correspondence between price inflation at home and in the country to whose currency one is pegged. Furthermore, the nominal exchange rate can be determined without delay and provides a simple and effective guide to policy rule.

The Council has previously pointed out the futility of looking to a depreciating exchange rate as a means of increasing long-run competitiveness. A currency devaluation increases the domestic price of exports and imports immediately, which soon leads to increased consumer prices and, given the relatively rapid response of wages, increases labour costs. Ultimately (and the period of adjustment may be protracted), the real economy is likely to be left unchanged, with only the domestic price level permanently affected by the reduced nominal exchange rate.

It follows that a realistic and balanced approach is required in formulating an exchange rate strategy. It was these considerations which led the Council, even before the EMU programme was adopted, to conclude that the objective of Irish exchange rate policy should be *to secure stability of the nominal effective exchange rate*. The search for competitiveness would thus be concentrated on the restructuring and investment required to address fundamental problems of inefficiency and low productivity, together with appropriate restructuring of the institutional arrangements for wage bargaining.

2. IRELAND'S MACROECONOMIC EXPERIENCE IN THE EMS

The decision in 1978 to participate fully in the European Monetary System had more far-reaching consequences for Ireland than for any other EC country. The initial side-effects, principally the abolition of the one-for-one sterling link, were decisive for monetary developments in the following decade. These events resulted in a more independent interest rate and they also introduced currency transactions costs and exchange risk to significant sectors of the Irish economy.

(i) Wage Competitiveness

Average wages in Ireland increased by about 1% per annum faster than in our main trading partners, after adjusting for exchange rate changes between 1975 and 1993, though relative to EMS countries the increase in earnings was much higher. This is illustrated by Figures 6.1 to 6.3. The figures show that the rate of increase of the index, indicating a loss of competitiveness, was as high or higher in the couple of years before EMS began as in the subsequent period. The index is volatile, reaching a peak in 1986, which reflects the movements of sterling and the US dollar. This illustrates the difficulty of maintaining stability in competitiveness against the background of volatile worldwide exchange rate movements.

Figure 6.1 shows an average loss of wage competitiveness of almost one per cent per annum, 1975-93. Figure 6.2 shows the UK, Germany and US as comparators at quarterly frequency. By fitting a log-linear trend to these data, Honohan[44] obtained an average loss of 1.3 per cent per annum over 1971-93, and 1.1 per cent during 1979-93, indicating a slow-down in the loss of wage competitiveness during the EMS period, but with sudden losses of competitiveness in early 1983, early 1986 (just before the unilateral devaluation of that year), late 1989 and late 1992. Figure 6.3 traces wage competitiveness against the UK, indicating that, despite considerable fluctuations, there was no trend over time. The index peaked at 111 at the end of 1986, compared with 99 after the 1993 devaluation.

The loss of wage competitiveness would have been greater but for frequent devaluations; the Irish pound was devalued against the DM about once a year on average between 1979 and 1987.

44 In the paper prepared for the Council.

It has been argued (for example by Leddin (1990)) that loss of competitiveness on joining the EMS had a significant negative impact on employment. Such conclusions tend to be based on the assessment either of relative movements in consumer price indices or of wage rates, using the EMS countries as comparators. However, Honohan has pointed out that sharp increases in indirect taxation made an important contribution to consumer price inflation in Ireland during 1981-83. The ratio of customs, excise and VAT revenue to personal consumption rose from 22 per cent in 1980 to almost 28 per cent in 1983, implying a contribution of about 8 per cent to the level of consumer prices. Though possibly leading to higher wages, such indirect taxes have little *direct* effect on competitiveness. Furthermore, focusing on EMS countries neglects the strength of sterling and the US dollar in those years, which helped the competitiveness of Irish firms as competitiveness *vis-à-vis* the EMS currencies was being eroded. As the Council has emphasised in Chapter 2, unit labour costs are an unreliable indicator of competitiveness because of rapid structural change in Irish manufacturing industry towards enterprises with a low labour share in value added.

FIGURE 6.1

Relative Hourly Earnings
Ireland vs. Main Trading Partners

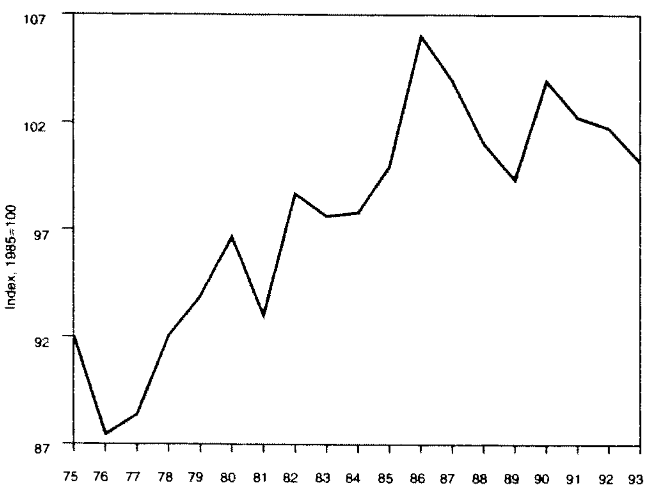


FIGURE 6.2

Wage Competitiveness
Ireland vs. Germany, UK and US

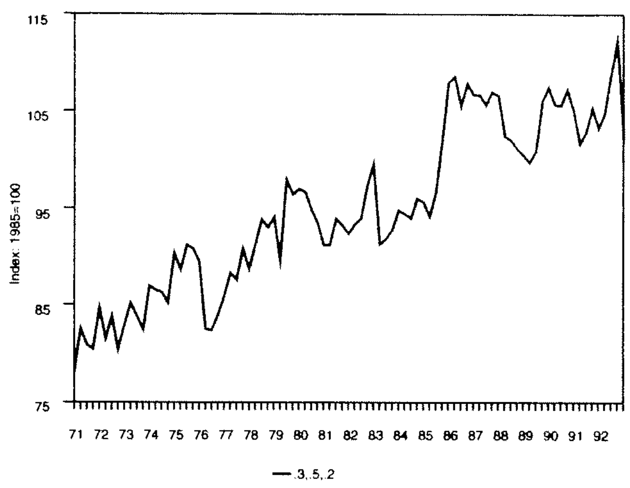
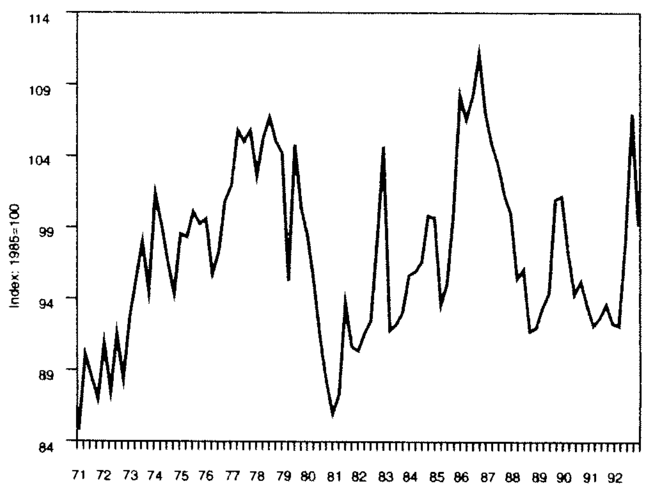


FIGURE 6.3

Wage Competitiveness
Ireland vs. UK



Wage competitiveness depends *both* on exchange rate and on wage movements, the role of exchange rate policy in influencing competitiveness is only a partial one. The fact that wage competitiveness trends have not been noticeably different as between pre- and post-EMS reflects the ability of wage-setting to accommodate to gradual exchange rate movements, suggesting that wage-setting behaviour is the more important factor for wage competitiveness.

(ii) Inflation

Figure 6.4 shows the inflation rate in Ireland, the UK and Germany during the EMS. Before the EMS began, during the sterling link period, Irish inflation was always close to that in the UK. When this correspondence was broken, Irish inflation at first (1980-82) surged far ahead of that in the UK and also increased relative to that of the other EMS countries. This reflected in part the impact of (i) sharp increases in the tax wedge and (ii) high public sector wage settlements on non-tradable price inflation (Bradley and Whelan, 1992). Subsequently, inflation declined to rates which were at or below those of our trading partners. The extent to which the fall in inflation was due to EMS membership is unclear - Anderton *et al* (1992) point out that virtually worldwide macroeconomic stability in the 1980s and the rise in German inflation following reunification have been strongly favourable to nominal convergence in the ERM countries. However, cross-country research indicates that Ireland is one of the countries whose policy response to inflationary shocks was more disciplined in the 1980s than previously. On the other hand, a continuation of the sterling link would have been likely to produce lower inflation in those early years, as in the UK. Honohan has pointed out that (as shown in Figure 6.5), over the whole period since 1979, cumulative Irish inflation has been just a little higher than that in the UK.

Figure 6.6 shows the cumulative excess returns received by a holder of Irish (wholesale) deposits relative to holders of German and UK deposits respectively, measured from the start of the EMS. The gains shown by the relatively steady upward trend in the DM line after 1979 contrast with the flatness of the sterling line before 1979. This reflects the existence of a risk premium over German rates based partly on concern in the pre-1986 period that Irish debt would become unsustainable, leading to a significant devaluation.

Another aspect of devaluation risk derived from the perception that Ireland's ERM commitment was qualified by an objective of maintaining competitiveness with the UK by staying within a target range against sterling.

This is confirmed by the fact that periods of weakness in the value of sterling have systematically prompted interest rate increases here, reflecting the efforts of traders to take advantage of perceived cheapness of sterling ("leading and lagging") or of investors to hedge their positions against the risk of a devaluation. Regression analysis (Honohan and Conroy (1993), Walsh (1993)) has suggested that every 10 pence fall in the value of sterling has tended to be associated with an increase in money market interest rates of the order of 2.5 percentage points.

The interest rate premium prior to 1987 was in effect an indication of the lack of credibility of the Irish commitment to a fixed exchange rate within the EMS. This was evident from the cumulative depreciation of the central parity against the DM of about 29 per cent by January 1987. So it is clear that the DM rate was not functioning as the nominal anchor in this period.

FIGURE 6.4

Inflation: Ireland, Germany, UK
Private Consumption Deflator

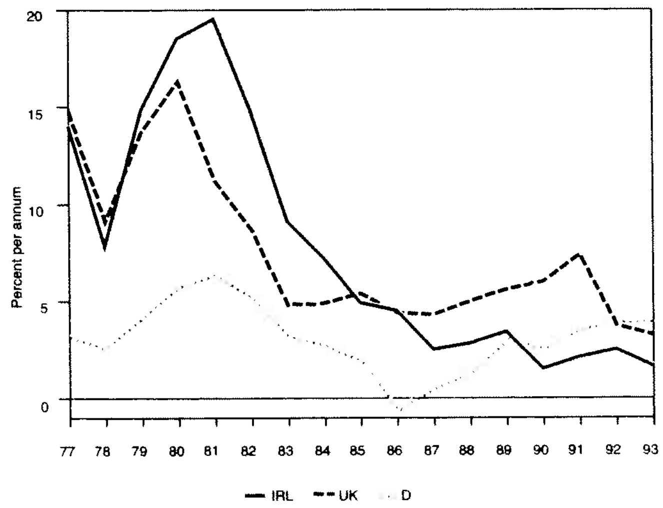


FIGURE 6.5

Purchasing Power Parity: Ireland vs. UK

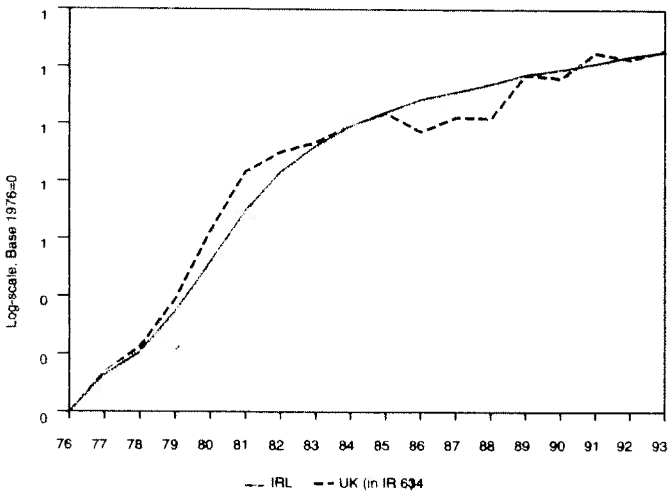
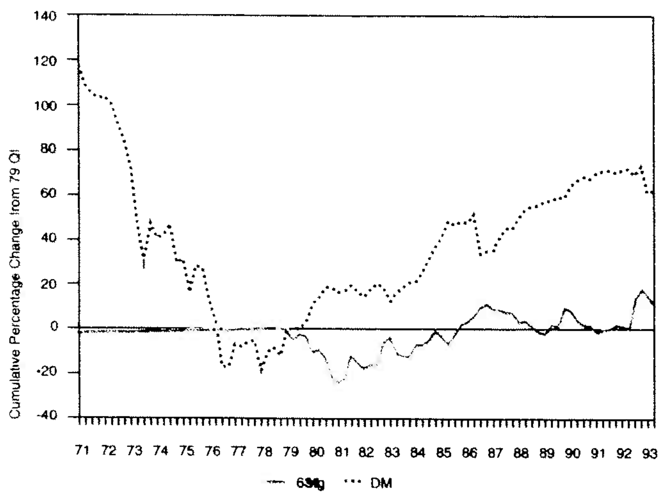


FIGURE 6.6

Cumulative Excess Returns on Irish Assets Against £ and DM (Short-Term)



(iii) Overview of EMS Experience

The 1986 devaluation and the consequent competitiveness gain, allowed a lengthy period of stability, facilitated by the strength of sterling during 1988 and much of 1989. Stability in the EMS, generally low rates of wage and price inflation, an export boom, lower unemployment, and a successful stabilisation of the public finances reinforced the stability of the Irish pound within the ERM. The renewed sterling weakness of late 1989 and into 1990, though it did result in some increase in domestic interest rates, did not trigger a devaluation, suggesting that exchange rate policy had hardened. Subsequently, the two-year period of adherence of sterling to the ERM removed the main drawback of the EMS as an exchange rate regime for Ireland. The events of recent months, following sterling's withdrawal from the ERM, will be discussed below.

This review of Irish experience suggests that the achievement of lower inflation by the mid-1980s was principally the consequence of fiscal contraction at home and worldwide disinflation, rather than the result of a hard currency-induced squeeze on domestic costs. Nevertheless it is significant that Ireland's commitment to the ERM was such that the authorities undertook realignments as a defensive response to competitiveness loss, and never used them as a means of achieving a competitive advantage. Most devaluations occurred in the context of a general realignment, with the authorities preferring a middle course to an extreme position.

(iv) Exchange Rate Performance in Recent Months

Recent events have given rise to the need to redefine an appropriate strategy for Ireland. The first phase of these events covers the four months of turbulence prior to devaluation of the Irish pound on 30 January 1993. Given past experience, the withdrawal of sterling from the ERM did not necessarily imply a devaluation of the Irish pound, but with the sharp and sudden fall of sterling with no prospect of recovery, devaluation became a pressing question. The appreciation of the effective exchange rate index was lower than had occurred over a period of months before the 1986 devaluation and it was no larger than had occurred at end-1989, when there was no devaluation. However, the scale of the sterling collapse and the turbulence in currency markets generally, underlined the importance of the sudden loss of Irish competitiveness in a key market, leading to expectations that a devaluation would have to follow.

In the event, the loss of competitiveness on the UK market and *vis-à-vis* UK competitors may have been somewhat less than was initially perceived, partly as a result of prudent management of currency risk by firms, but also as a result of the Market Development Fund operated by the Department of Enterprise and Employment. It was, however, the surge in interest rates which was widely perceived to constitute the greatest threat to the viability of companies and employment, and this provided the proximate source of pressure for a realignment of the Irish pound. This was despite the action of the Central Bank in reducing the impact on retail bank rates of the dramatic overnight rates necessary to deter speculation.

The devaluation of 30 January had the effect of reducing the nominal effective trade weighted index to the level of the second quarter of 1992, reversing an appreciation of 7.5% over that period. It effected a restoration of competitiveness which had been lost, not as a result of excessive growth in domestic costs, but from external events. The Council has recognised that a non-accommodating exchange rate strategy should be applied having regard to the stability of the overall trade-weighted nominal effective exchange rate, so that prudent domestic performance, especially with regard to wage costs, is not penalised by a rise in the nominal exchange rate. The devaluation of 30 January did not, therefore, represent a departure from the non-accommodating strategy.

The second phase of turbulence, in which the Irish pound was not involved, culminated in the widening of the ERM bands for most participating currencies in August 1993. This reflected primarily the inappropriateness of the interest rates effectively determined by German monetary policy for domestic macroeconomic conditions in most member states. This imbalance was compounded by the political uncertainties regarding the timetable for EMU established by the Maastricht Treaty. The outcome of these events was a substantial widening of the ERM bands, to the extent that the Irish pound, in common with other EMS currencies, was effectively floating on foreign exchange markets.

Recent events prompt the need to examine the implications of alternatives to an exchange rate strategy based on ERM narrow-band membership, especially as regards the problems of high real interest rates, speculative surges, and the vulnerability to sterling movements which have been the chief weaknesses of the EMS regime.

Some countries have operated more complex exchange rate regimes with reasonable success. Of these, *the crawling peg systems* can be ruled out: though they provide some form of nominal restraint, it is of a sort that is suited mainly to high-inflation countries. Another complex option would be management of the currency according to a set of indicators or a

closely-managed float. In this type of regime, the authorities typically fix the exchange rate for short periods of time, but also allow it to drift occasionally in order to track a set of objectives that may be, but more typically are not, formally announced. Because it allows considerable discretion to the authorities, such a regime could respond promptly to shocks, but equally a weakness of the approach is its lack of a nominal anchor. Given the frequency of defensive realignments in the EMS, Honohan has suggested that Irish exchange rate policy prior to 1987 had many of the characteristics of a managed float.

A completely *free float* characterises the three main currencies - US dollar, DM and Japanese Yen which all float *vis-à-vis* each other, and they have, of course, been joined in the recent past by most European currencies. Floating currencies are affected by various aspects of macroeconomic policy. The authorities in such areas often respond to currency market pressures either with direct intervention in that market or with action in the domestic money market. Thus, exchange rate policy becomes a flexible byproduct of monetary and other policy.

The case for market determination of prices is weakened in the case of exchange rates by virtue of the degree to which market participants evaluate currencies on the basis of expectations with regard to future government policy. The case against floating exchange rates is that large misalignments of rates, which could occur in a floating regime, may be avoided by explicit adherence to an exchange rate rule offering a credible nominal anchor.

The Council considers that there are considerable disadvantages to a floating exchange rate strategy, either free-floating or a managed float. The small size of the economy renders the operation of an independent monetary policy implausible in the Irish context. Moreover, over time the level of price and wage uncertainty with a floating currency would be increased and this would discourage Irish pound asset holdings. In addition, insofar as the high level of unemployment is perceived by potential holders of Irish pounds as a medium-term threat to currency stability, this threat was appreciably diminished by the credibility of our general adherence to the EMS, even as modified by occasional defensive devaluations. A strategy of floating would have to be supplemented by an alternative nominal anchor, and building credibility for that could be difficult. A failure to achieve credibility could lead to a steep decline in the value of the currency, fuelling inflation and threatening competitiveness. Furthermore, a relatively free float would be likely to result in an even more volatile sterling rate than has applied to date, with serious implications for low margin exporters.

At the other end of the spectrum is the option of a *fixed currency peg*. An argument could be made for the dollar or sterling on the French franc as appropriate pegs to provide a nominal anchor. The problem is that, with our main trading partners grouped in different currency blocs (DM, £ Sterling and US dollar), no simple peg gives a truly fixed exchange rate. Any rigid peg risks making us uncompetitive against some major partners. Furthermore, any peg is prone to speculative attack. This would doubtless apply even to a sterling peg, recommended by some. The Council believes that there is no going back to the certainties of the old link and that even if a new link were at par, it too would come under pressure if sterling were to strengthen dramatically.

The fact that divergent movements in partner currencies could lead to job losses, even if the average value of the Irish pound had not changed, has led some to suggest the strategy of tracking the weakest of our major trading partners. The Council rejects this approach also. It would impart a significant inflationary bias, weaken competitive discipline on enterprises and encourage an expectation of constant adjustment to protect enterprises. Besides, the Council believes that the difficulties faced by firms in positioning themselves for profitable long-term operation in an environment of fluctuating exchange rates can be overstated.

(v) EMU: Risks and Benefits

The Council has pointed out on a number of occasions that the advantages for Ireland of a single currency system are considerable. The main advantages include the micro-economic gains of the elimination of transaction costs and the stabilisation of inflation at a low rate. The inherent loss of flexibility in the operation of exchange rate policy is, of course, significant, especially in the context of asymmetric economic shocks. However, real wage rigidity in the Irish economy is such that the exchange rate is a relatively ineffective instrument in such circumstances. The loss of exchange rate flexibility is therefore far outweighed by the benefits of a single currency.

The Council recognises the difficulty which could arise if sterling should weaken sharply outside the EMU while Ireland was without the option to devalue, especially since exports to the UK are relatively labour intensive on average. However, many such exports are largely insulated from exchange rate effects by the operation of the Common Agricultural Policy and others form part of the worldwide operations of multinational companies and are relatively insensitive to sterling movements. The continued diversification of exports away from the UK and strengthening of non-wage competitiveness

would also narrow the range of companies whose viability is threatened by sterling movements. Furthermore, such companies should already have been examining ways of reducing their vulnerability through financial hedges and appropriate contracting with unions, suppliers and customers. Moreover, the Council is satisfied that the removal of the risk of speculative interest rate surges will be far more significant for the performance of Irish firms than the possible negative consequences of volatility in the sterling exchange rate.

The Council has drawn attention to the possible dangers of aspects of the approach to the achievement of EMU (NESC, 1989, 1990). These include: the strong risk that capital outflows could be a continuous feature of the economy of Ireland and of other peripheral countries; an over-emphasis on nominal rather than real economic convergence; and the consequent need for financial and monetary integration to be accompanied by the development of Community policy in an appropriate range of new areas. The Council's analysis (NESC, 1989) suggested that the achievement of convergence requires four types of policy measures; structural funds, macroeconomic co-ordination, differential application of Community policy, and inter-regional redistribution through an enlarged Community budget. Nevertheless, *the Council is satisfied that a rapid move to the single currency should be favoured.* Ideally, this should embrace all EMS countries. It may well be that not all member states will be part of EMU from the beginning: the Treaty on European Union foresees such an eventuality. However, Ireland should so conduct macroeconomic policy as to ensure that we will be part of the first group of member States to participate in EMU: this requires strict adherence to the convergence criteria. Furthermore, the Council believes that the continuation and acceleration of the EMU programme should be a priority for Ireland's policy towards the development of the Community and that this should inform the approach taken to related Community issues. However, it has to be recognised that at this point the single currency may well be six years away. The question of how policy is to develop in the interim has been given renewed significance by the experience of recent months.

(vi) Strategic Approach

The Council reaffirms its opposition to an accommodating exchange rate strategy. It has been argued that such a strategy has been effective in supporting growth and employment in some of the Nordic countries, principally as a means of stimulating investment (Korkman, 1992). However, a fixed exchange rate policy has also been central to the strategy of other and equally successful small industrialised countries. The Council strongly believes that it is the consistency of macroeconomic strategy generally and of income developments with the exchange rate policy which is at the heart of a successful development performance. Furthermore as Dr. Lars Mjøset demonstrated in his report for the Council (NESC, 1993), internationalisation of financial markets and the deregulation of financial systems have radically altered the context in which monetary and exchange rate policies are set. This new global environment virtually removes the scope for manipulating exchange rates in order to support output growth. *It follows that a credible non-accommodating exchange rate strategy is the appropriate stance to adopt in pursuit of sustainable development.* Credibility in this context is dependent, in particular, on the approach taken to the management of fiscal policy and to the development of incomes.

The Council notes that, in the aftermath of widening of the ERM bands, the effective exchange rate is currently significantly below the average for the period prior to the 1992 exchange rate turbulence. Interest rates, especially the one-month rates, have remained close to their German counterparts and *below the rates* applying in a number of ERM countries.

(vii) The Problem of Multiple Partner Currencies

The conduct of exchange rate policy, both at the present time and in the context of membership of the narrow-band of the ERM, is complicated by the fact that our trade is distributed widely among countries whose currencies have fluctuated widely in relative value. Thus, 32% of Irish exports were sold to the UK in 1991, compared to 42% to the rest of the EC. This is almost an exact reversal of export shares in 1980.

While small countries such as Ireland are price takers in the world market, this is not altogether true of larger countries, such as the UK. Thus, a fall in the relative price of sterling *vis-à-vis* the DM will not result in a quick and full increase in all sterling prices in the UK to compensate. As a result, Irish exporters to the UK may be faced with lower prices expressed in Irish pounds and hence with an erosion or elimination of profitability. However, other exporters to the UK will be similarly affected placing upward pressure on UK prices, especially to the extent that UK producers are not in a position to supply the domestic market fully at the lower price. Furthermore, cost pressures resulting from the devaluation both directly, and indirectly through higher wage settlements as the inflationary effects of the devaluation begin to be felt, will tend over time to drive up the price at which UK producers are willing to supply the market. Eventually, the law of one price is likely to hold sway once more and the impact of the devaluation will, in many cases,

scarcely be felt, especially where the UK is not a major force in the production of the product in question.

The adjustment process outlined above will often be a protracted one (especially where imports do not supply much of UK consumption of the product), and it is not likely to restore the position that prevailed immediately before the devaluation. It is nevertheless important to recognise that much of the sudden loss of profitability for Irish exporters will be transitory. The ability of those exporters to continue to supply the UK market during the transition will depend, for example, on the degree to which their cost structure is sunk or committed; on the capacity to adjust variable costs, including wage costs, in line with competitiveness pressures; on the degree to which it is important for them not to lose workers with specialised skills pending price recovery in the export market; and on the capitalisation and financial structure of the enterprise. It is in these dimensions that a number of Irish exporters to the UK are thought to be vulnerable. Furthermore, some may have expanded their operations in the recent past to take advantage of booming demand and unsustainable UK prices: for these, the adjustment to equilibrium will not be enough to restore the profitability they had briefly enjoyed. The impact of the transitional period will also reflect the significance of imports from the UK, both on retail price levels and on the cost structure of importers of UK raw materials and components. In this regard it must be recognised that for cultural and institutional reasons, imports from the UK can respond relatively quickly to exchange rates movements which confer a price advantage on the Irish market.

A second issue raised by divergent movements in different partner currencies is the question of measuring and interpreting the data on currency movements. If it weakens against some currencies and strengthens against others are we to say that the Irish pound is appreciating or depreciating? The simplest approach is to take an average of partner currency movements, weighted by each country's share in Irish trade. A variety of weighted average measures are available (described in Honohan, 1979), some of them taking account of the consideration (mentioned above) that exporters to (say) the UK are competing not only with UK producers but with producers from different parts of the world. Unfortunately, since the end of the sterling link, the divergent movements of sterling and other currencies have resulted in such weighted averages giving rather different answers. Furthermore, there is the question of modifying trade weights to take account of specific product considerations. Thus, it is arguable that exports of agricultural produce subject to effectively guaranteed Irish pound or ECU prices should not be assigned to the currency of the destination country. Furthermore, merchandise trade may be an inadequate basis on which to weight the significance of diverging currencies, given the growing significance of traded services. A strong case can be made for trade in products produced with a low labour content to be weighted differently, to the extent that there is a concern to maintain wage competitiveness. The employment content of exports varies substantially as between the high-tech and traditional sectors, and their respective trade patterns are quite distinct, with substantially greater reliance on non-UK markets in the high-tech sector.A fundamental measurement difficulty is that an average, however weighted, does not do justice to the asymmetry of effect. An enterprise faced with closure due to loss of competitiveness in one currency-market may not be balanced, at least in the short-run, by expansion of employment in other enterprises geared to exploit increased profit margins in other markets.

In sum then, though measuring them is as yet a most imperfect science, divergent movements of partner currencies create transitory, but nonetheless damaging, shifts of profitability. Firms generally take a long-term view of likely relative costs before making location decisions. Sound management practice requires that firms structure their finances to allow for fluctuations in profitability induced by currency movements and hedge their very short-term receivables or payables in the forward foreign exchange market or otherwise.

(viii) ERM Narrow-Band Membership

In the interests of stability and the continuation and acceleration of progress towards the EMU objective, the Council favours the earliest possible restoration of the narrow-band structure of the ERM. The conduct of and policy approach towards narrow-band membership should, however, reflect the lessons of past experience. The Council in *A Strategy for the Nineties* emphasised the vulnerability of the ERM in general to speculative attack in the absence of effective exchange controls. A speculative attack is much more likely - and simply brings forward the date of devaluation - when domestic macroeconomic policies make an exchange rate unsustainable anyway. The Council recognises, and recent Irish experience demonstrates that even if policy is coherent and credible, a speculative attack may induce a policy response which validates the attack *ex post* (through higher wage settlements and credit expansion in response to a forced devaluation, for example). Furthermore, speculative pressures may be self-fulfilling where resistance requires high interest rates which in themselves trigger doubts about sustainability and fuel further speculation.

It is clear that speculation (as such) cannot be outlawed in our type of open trading economy, where speculation is only an aspect of a spectrum of mostly useful financial activities. Modern economics textbooks define speculation in terms of the transfer of capital risk from those unwilling to assume it to those who are. Sellers of a devaluation-prone currency may be on either side of this market, depending on the vulnerability of their overall financial position to exchange risk. Most financial and non-financial companies try to avoid assuming foreign exchange risk. In particular most financial companies act as intermediaries by pooling or diversifying risk. While there are professional speculators who enter the market accepting high risk with a view to high returns, most of the problem for the authorities arises when, in the form of the Central Bank intervention in the foreign exchange market, the authorities themselves become the only or main assumers of risk. Private speculators in such circumstances are assuming only a small risk relative to the expected return: the authorities are giving them a bargain. The dilemma facing the authorities is how to achieve exchange rate stability without offering that bargain.Four possible responses have been suggested in this connection, and are now considered. First, exchange controls, and analogous quantitative measures; second, a foreign exchange transactions tax; third, wider margins or target zones; fourth, revised management rules within the ERM.

The elimination of *exchange controls* was widely expected to increase the risk of destabilising speculation in the EMS. This was seen to be strongly associated with the level, structure and management of public debt (Giavazzi and Pagano, 1990). Indeed, it was argued (Padoa-Schioppa, 1987) that the abolition of exchange controls could seriously disrupt and possibly destroy the EMS by increasing the amount, but reducing the effectiveness of exchange market interventions required to defend the exchange rate. The greater reliance on defensive interest rate increases was argued to be likely to reduce countries' willingness to defend exchange rates, leading to widespread instability. It is likely that the liberalisation of financial markets generally, and the greater international integration of the industrial economies, more than the removal of exchange controls *per se* have increased the difficulty of pegging exchange rates. Indeed, it is hard to imagine how effective exchange controls could be implemented in the modern environment. Those that could be enforced would slow the outward movement of funds a little, and could considerably reduce leveraged speculative operations, but they would still be insufficient to maintain an exchange rate not thought credible by the market. Furthermore, their use over a prolonged period introduces all kinds of distortions by diverting funds through unpoliced channels.[45]

As an alternative to reintroduction of exchange controls there have been suggestions that other types of administrative control could be used, including a limitation on bank lending, as speculators who do not own Irish pounds have to borrow them in order to sell them speculatively. The only merit to such a scheme relative to more traditional exchange controls would be that it might not contravene EC undertakings. The same kinds of distortion would emerge: to whom would the rationed loans go, and at what price?

It is also argued against exchange controls that their use in an emergency indicates a reluctance by the authorities to face up to market realities, and hence is not conducive to the market participants believing that the government has a coherent and credible policy approach. Such confidence arguments are difficult to evaluate, and probably depend on timing and other contingencies. For instance, an increase in interest rates, which is the first line of defence against the speculators, may be taken to indicate that the authorities are prepared to take politically unpopular actions in order to maintain the parity; later on, successively higher interest rates can destabilise confidence if they are interpreted as desperate, or last-ditch attempts to discourage speculation before an inevitable devaluation.

A *tax on foreign exchange transactions* has been advocated (most notably by Tobin) as a means of reducing the incentive for speculation. The proposal is that a 'modest' rate of tax - say 1 per cent - would not materially affect international trade, but would be enough to discourage purchases and sales of currency that are merely motivated by a small probability of moderate exchange rate gain. This proposal has recently been reiterated in the EMS context (Eichengreen and Wyplosz, 1993). While the proposal might stabilise floating currencies, it is hard to see how this would work reliably for the EMS, where potential overnight gains as a result of devaluation can be up to 8 per cent. In addition, the proposal neglects the volume of spot and foreign exchange transactions which occur in the normal course of trade: each commodity trade may trigger several foreign exchange transactions in order to hedge risk. Accordingly, even a 1 per cent transactions tax would cascade into something much more. Whatever about the merits of the scheme introduced at the European level, it is quite clear that unilateral introduction

45 A rather negative evaluation of Irish experience with exchange controls is contained in Mathieson and Rojas Suarez (1993).

of such a proposal is totally infeasible: it would simply drive the entire foreign exchange business of the Irish banking system off-shore.

Basically, both exchange controls and foreign exchange transactions taxes are incompatible with the move to an increasingly open trading environment and the financial liberalisation which have characterised policy in recent years and are at the heart of the European single market concept.

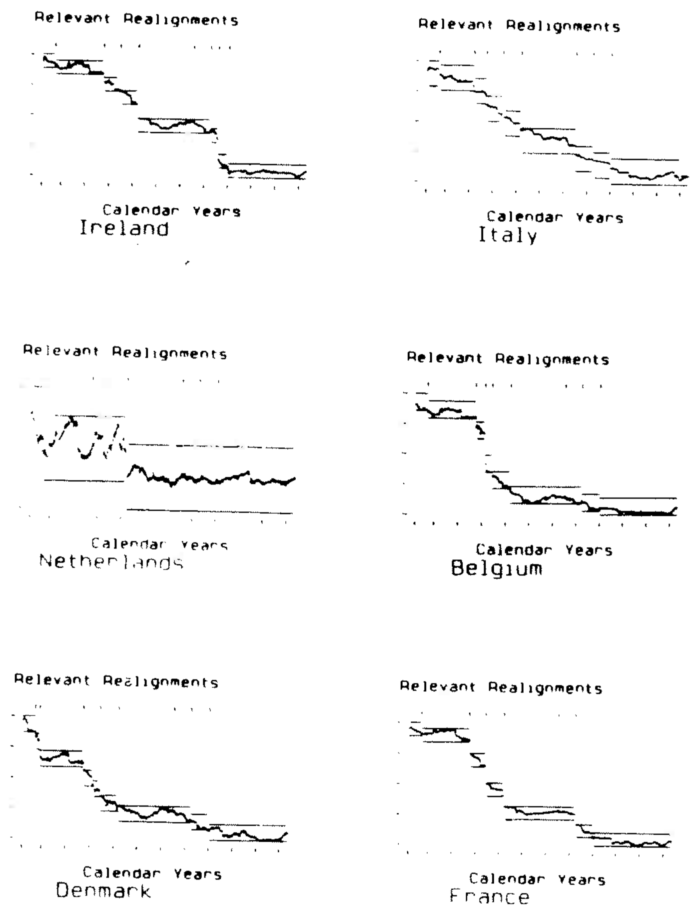
The operation of exchange rate policy with *wider margins* has been proposed in the context of reducing the impact of speculation and this is, of course, the framework with which exchange rate policy is operating at present. Wide margins permit necessary realignments of central parities to take place without any discrete jump in exchange rates at the time of realignment. If there is no discrete jump, the gain to anticipating a realignment correctly and speculating against the currency is greatly reduced. Identifying wider margins as a remedy for speculation is based on the observation that speculation against a week currency is not only practically riskless (the currency will not quickly rise in the band) but potentially involves an enormous gain relative to the net interest cost of borrowing the weak currency for a few days. The wider margins remove the enormous gain, and eliminate the lottery character of the foreign exchange market.

The argument has been that wider margins allow realignments to take place without jumps in market exchange rates. Figure 6.7 (from Flood, Rose and Mathieson 1991, Figure 2) shows how this has worked in the EMS so far. It plots daily DM exchange rates for the EMS currencies, along with the intervention limits for the DM. Note that at some realignments, the new upper intervention limit is still above the old lower intervention limit. When that happens, there is no necessary change in the market exchange rate against the DM. This permits a realignment to be implemented without any large capital gain for speculators. Without the prospect of a large capital gain, speculation against the currency is unlikely to be strong, and interest rates need not move to very high levels to limit capital outflows. Wider margins or more frequent realignments make the achievement of such overlapping bands more likely. Italy, for example, had overlapping bands at each of its 9 realignments against the DM, whereas Ireland has had overlapping bands at only 4 of its 9 realignments.

FIGURE 6.7

Exchange rates against DM and intervention limits, 1979-90

Scales vary by Country



The operation of wider margins does not eliminate speculation. Though the severity of speculation is reduced, there can still be speculation against a currency even if no margins are being defended. For example, Spain has been forced into 3 realignments in a matter of months despite having wider

margins. More significantly in an Irish context, the operation of wider margins in association with a target trade weighted average exchange rate would not guarantee stability in the value of sterling. In a paper for the Council, Honohan has simulated how wider margins might have functioned in the past if employed to stabilise the average trade-weighted value of the Irish pound (the Central Bank's Effective Exchange Rate Index (EER). He estimates that despite the wider margins, realignments would have been almost as frequent as actually occurred. This is because the exact stabilisation of the EER contrasts with the actual experience, where very sharp EER shifts were tolerated without realignment. Second, the calculated value of the currency would have been higher during almost all of the period under review, notably resulting in sterling values of between 95p and 101p during the whole period 1986-92. Third, while the variance of the sterling exchange rate was reduced (by 40 per cent), as was that of the dollar, there was an increase in the variance of the DM rate in this simulation.

The Council rejects the option of operating an exchange rate strategy with wider margins on a long-term basis. This would be ineffective as a nominal anchor and would lack disciplinary effect. Furthermore, given the volatility of sterling and the need for a strategy for movement within a wider band there would be no significant reduction in the risk of realignment with wider margins. The loss of a strong basis for domestic price stability would not be compensated by worthwhile exchange rate stability. Furthermore, the Council is satisfied that the impact of purely speculative pressure on the exchange rate is significantly less than pressure arising from a perceived mismatch of macroeconomic conditions with the exchange rate. Wider margins would do nothing to reinforce the pursuit of appropriate macroeconomic policies. These comments on methods to deter speculation are offered in the context of a return to a more onerous exchange rate regime within the EMS. The Council would favour such a development in the context of its strong attachment to a non-accommodating exchange rate policy although there are few signs of such a development. However, the Council believes that this should be supported in the context of proposals to improve the operation of a revived ERM, as discussed in the following section.

(ix) Future Operation of the ERM

Given the Council's desire for greater stability through a return to the narrow-band discipline, it is necessary to consider whether the *management of the ERM* is capable of being strengthened to reduce the impact, and therefore the risk of speculation. Market intervention on an EMS-wide basis might be effective in seeing off a speculative attack on a currency whose parity is not undermined by macroeconomic factors. Such intervention on a co-ordinated basis would be far more effective than that of one country alone and it has been already a feature of EMS practice to some extent. It has been suggested that such intervention would be more effective if triggered on a compulsory basis by a rule-based procedure within the EMS. Such an approach is more likely when convergence of economic policy and performance is supported by a more comprehensive form of surveillance and review arising from the Maastricht programme.

The operation of a non-accommodating exchange rate strategy is not the same as having a fixed exchange rate. A truly fixed exchange rate requires the degree of real and nominal convergence which is associated with a currency union. In the absence of such convergence or an irreversible move to monetary union, all exchange rate positions are perceived to be liable to change and, in certain circumstances vulnerable to speculative pressure. The prime distinguishing characteristic of a non-accommodating exchange rate strategy is that it does not seek to maintain international competitiveness by accommodating increases in domestic costs. It follows that realignments in the value of the currency may be necessary and appropriate having regard to changes in the nominal effective trade weighted index. This does not mean that devaluation should follow every significant deterioration in the index, for example as a result of the continuing volatility of sterling. To do so would be to undermine the credibility of the overall exchange rate strategy and, equally importantly, to reduce the pressure on domestic economic agents to control costs and manage sensibly their exposure to currency fluctuations.

It is not an easy judgement as to when a change in the nominal value of the currency within the narrow-band of the ERM is consistent with and reinforces a non-accommodating exchange rate strategy. Accordingly, the bias must always be against devaluation in the approach to situations such as the turbulence in the EMS in the recent past.

While the Council does not intend to review the management of the currency during the period of crisis,[46] it supports in principle the determination of the authorities to defend to the limits of prudence the exchange rate within the narrow-band of the ERM while this is operating. This derives from the fact that temporary surges in interest rates, such as occurred at the end of 1992, are an inherent risk in the operation of the ERM in the absence of exchange controls, not least as a result of speculative pressures, and because the

46 The Council notes that the events in question have been reviewed systematically at the initiative of the Minister for Finance.

strength of such defence is capable of adding to the credibility of the exchange rate strategy as a whole.

It must be accepted that, pending the transition to EMU, realignments are a possibility within the ERM and should not necessarily be taken as indicating a failure of policy. The risk of devaluation is, of course, reduced when the competitive strength of the economy is judged to be such that adverse exchange rate movements can credibly be resisted. A prime example of this arose in late 1989 and 1990 when the effective exchange rate appreciated to a degree which was similar to that experienced in late 1992. While domestic interest rates were raised on that occasion a devaluation did not follow. This was because the strong performance of the economy, the reduction in unemployment and the successful stabilisation of the public finances as part of the overall strategy recommended by the Council in 1986, were perceived to make devaluation unnecessary. By contrast, the weaker economic performance induced by international conditions, and the consequent rise in unemployment were seen in 1992 to have made the economy more vulnerable to the effects of sterling weakness. *It follows that the best guarantee against devaluation pressure is the underlying strength of performance of the economy.* A particular dimension of this performance is in relation to fiscal balance. High levels of public debt are perceived to make interest rate increases less viable, to the point where increases necessary to deter speculation *of themselves* induce further speculative pressure and trigger a spiral culminating in devaluation. A conflict between the requirements for internal and external balance is therefore a particular weakness which should be avoided in the interest of a credible exchange rate strategy.

Overall, the Council believes that the experience of recent months confirms the crucial importance of consistency across the areas of macroeconomic policy, exchange rate strategy and income developments. Where these are consistent, the conditions are created for sustainable growth through competitive international performance. Where these are not consistent, a vicious circle ensues, of which devaluation is but one of the likely consequences. Even where a realignment is necessary in response to external forces, the underlying consistency of economic policy is necessary if such a realignment is to be credible and effective. For example, the credibility of Irish fiscal policy enabled a defensive realignment in the face of the fall in the value of sterling to be undertaken last January without generating any fear of inflation of deficit spending, as reflected in the rapid convergence of interest rates on the low level of European interest rates generally. Equally, flexibility in wage determination systems and the consistency of income levels generally with the stated exchange rate position are crucial elements of credibility. It is for this reason that the Council believes that the pursuit of an overall strategy for economic and social development is essential in bringing together and integrating the complementary elements of economic performance.

3. CONCLUSIONS ON EXCHANGE RATE STRATEGY

The difficulties created for exchange rate policy by the high interest rates emanating from Germany are a good illustration of the dependence of exchange rate performance on the underlying macroeconomic performance. Where countries' macroeconomic conditions diverge, whether through internal developments or the asymmetric impact of external shocks, a realignment of currencies may be necessary. In reviewing the events of the past few months, both the Committee of Governors of the EC Central Banks and the Monetary Committee argued that the difficulties had been exacerbated as a result of a growing tendency to treat the EMS as already a quasi-monetary union, with the result that realignments, which were objectively indicated, were resisted. Their proposals envisaged quicker action on necessary realignments within the ERM narrow-band framework, with other participating countries taking the initiative in proposing such a realignment for a currency whose parity they consider unsustainable. In the event, the widening of the ERM bands indicated a loss of confidence in the capacity of the quasi-fixed exchange rate system to cope with divergent economic conditions at national level.

The Council believes that exchange rate stability is an important element in securing the strong and sustained growth required to produce more rapid employment growth. In particular, exchange rate stability is a foundation for low inflation and low real interest rates. However, the stability of an exchange rate is ultimately dependent upon its compatibility with economic conditions and the credibility of economic policy. Such credibility is, in the Council's view, most effectively secured by adhering to a clear non-accommodating exchange rate strategy. In particular, the Council reaffirms its support for EMU as the goal for exchange rate policy.

In the short term, the Council favours the earliest possible restoration of the ERM narrow bands, managed to take into account the experience of recent months, and Ireland's resumption of membership as soon as they are restored. It must be admitted that the prospects of such a development in the short-term seem slim. Should that prove to be the case, the Irish authorities will be required to conduct a policy within the very broad bands of fluctuation

currently permitted. The Council considers that this would not be desirable in that it would represent a very unreal nominal anchor for policy and for the economy. In such circumstances - and having regard to its core recommendation for a non-accommodating exchange rate - the Council favours the pursuit of low inflation via a fluctuation zone within the ERM considerably narrower than the currently-permitted ERM band, but without rigid enforcement of this zone. The Council wishes to emphasise that the evolution of domestic policy, including incomes policy, will be a critical influence on the achievement of the goals of exchange rate strategy, both now and in the future. The Council remains strongly of the view that EMU is the most appropriate exchange rate regime for Ireland and urges an active approach by the Irish authorities to advance that objective.

CHAPTER 7

Taxation Policy

TAXATION POLICY

1. INTRODUCTION

The reform of taxation was one of the central elements in the Council's structural policy programme in *A Strategy for the Nineties*. The Council expressed the view that tax reform in any new programme for economic and social development must give priority to the overall objective of increasing employment and reducing inequities. In the context of European integration the Council considered that tax policy must incorporate the necessary changes in the areas of indirect taxation and DIRT. The Council made a number of specific recommendations to achieve these objectives.

This chapter will examine the extent to which tax policy since 1990 has been consistent with the principles and recommendations of the Council. Given the Council's view that all elements of the policy framework in the present Strategy should be evaluated on their employment impact, the relationship between tax policy and employment will be reviewed and the changes in tax policy which could be expected to have the greatest impact on increasing sustainable employment in the years ahead will be identified.

In considering how the tax system should be reformed the Council has endorsed the main principles adopted by the Commission on Taxation:

(i) a comprehensive definition of income;

(ii) equivalent tax treatment of income from different sources;

(iii) neutrality with respect to inflation;

(iv) minimum tax impact on individual or business choices;

(v) general reliance on direct payments to those in need rather than assistance through the tax system;

(vi) no earmarking of taxes; and finally

(vii) evaluation of compulsory social insurance contributions as taxes.

2. COMPOSITION OF TAX REVENUE

(i) The Tax Burden

The overall tax burden[47] (i.e. share of taxation in national income) in Ireland rose sharply throughout most of the 1980s and declined from 1988 to 1990. Since then it has been broadly stable. Ireland has not been unique in experiencing a rising tax share in GDP over time (see Figure 7.1). In 1991, the latest year for which comparable data are available the share of taxation in GDP in Ireland was 37.2%, below the EC average (41.2%) (OECD 1993b). The international convention is to express tax as a share of GDP for comparative purposes, but given the difference between GDP and GNP for Ireland, it is appropriate to consider tax as a share of GNP in Ireland's case. In 1991 taxation was equal to 40.6% of GNP for Ireland, slightly below the EC average.

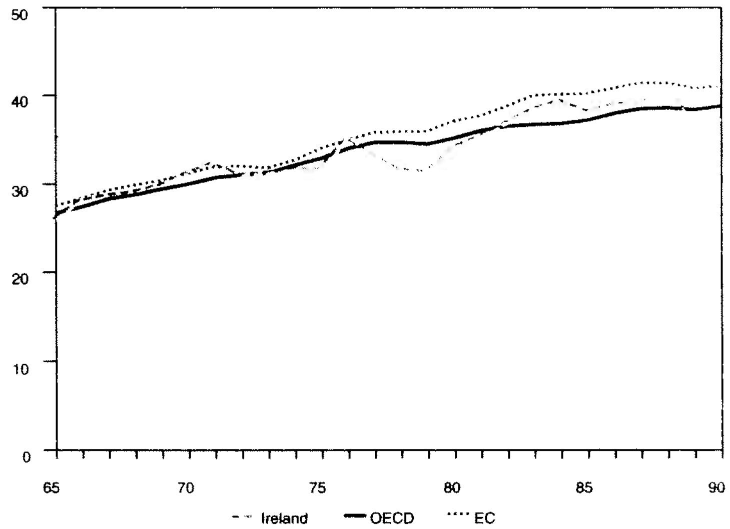
Since Ireland is at a less advanced stage of development than the EC as a whole it might be expected that the tax burden in Ireland would be below the EC average. However, while there is a positive relationship between the stage of development and the tax burden, this relationship is not particularly close.[48] Countries as divergent as the United States and Turkey to Ireland in terms of economic development have similar burdens. Particular features which contribute to a higher tax burden in Ireland are the high debt/GNP ratio and dependency ratio. In addition, the proximity of the UK and the common labour market have implications for any divergence in the area of taxation and in the standard of public service provision between Ireland and the UK.

47 The Commission on Taxation considered that the phrase, "burden" of taxation carries the misleading implication that all taxes constitute a diminution of welfare for which the citizen receives nothing in return. Many of the services financed from taxation are essential to the efficient functioning of the private sector, and many are carried out by the public sector because this is the most efficient way - and for some services the only way - of doing so. In addition, much present taxation is part of a process in which money is taken from people at one stage of their lives only to be returned then at another time of greater need. Accordingly, we use the term tax burden for convenience rather than in a judgemental sense.

48 Regressing GDP per capita at current prices and current exchange rates on tax revenue as a percentage of GDP for OECD countries in 1990 produces an R^2 of 0.13. This implies that 13% of the variation in tax revenue as a percentage of GDP can be explained by differences in GDP per capita. Sources used for these calculations were: OECD Economic Surveys, Ireland, 1993 and OECD Revenue Statistics of the Member Countries, 1965-1991, 1992.

FIGURE 7.1

Evolution of Tax Burden
Per-Cent of GDP

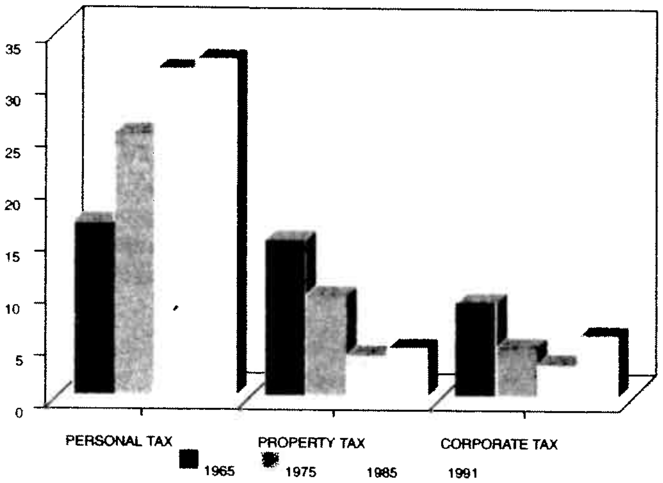


Source: OECD Revenue Statistics of the Member Countries, 1965-1991, Paris, 1992.

While the general tax burden has grown over time, the individual elements of the tax burden have not grown evenly. The long-run trend has been for the share of personal tax in total revenue to increase, with declines in the shares of property tax and corporate tax (see Figure 7.2). This trend appears to have stabilised in recent years: since the late 1980s personal tax has not grown rapidly as a share of tax revenue, while there has been an increase in the corporate tax shares. However, the share of personal tax in revenue continues to be much higher than in the 1970s and 1960s, while the share of property is much lower. There are clear differences between the composition of taxation in Ireland and in other countries. In particular, the share of taxation accounted for by goods and services is higher than elsewhere, while the share of social security taxes is below the European norm. The share of taxation derived from property taxes (while differing in its composition) is similar to the EC average, although lower than in some countries such as the UK and the US. The share of taxation derived from personal income in Ireland (31.9%) is significantly above the EC average (25.9%).

FIGURE 7.2

Composition of Tax Revenue for Ireland
1965-1991



Source: OECD, *Revenue Statistics of the Member Countries, 1965-1991*, Paris, 1992..

3. PERSONAL INCOME TAXATION

In *A Strategy for the Nineties* the Council made the following recommendations in the area of personal taxation:

1. The Council recommended reductions in effective marginal and average rates of tax on earned income.

2. The Council warned that reductions in income tax rates, especially those which flatten the schedule, may tend to reduce progressivity over the relevant ranges of income.

3. The Council saw little prospect of, or benefit in, further schedule rate reductions without significant widening of the base.

4. The Council recommended the imposition of employee's PRSI at a single rate with no exemption and no ceiling.

5. Given the pressures on revenue the Council considered that further reductions in taxes on earned income are only possible with

measures to broaden the tax base, including a comprehensive property tax. This recommendation was subject to reservations by the IFA, ICMSA, ICOS and CIF.

We now outline the main developments in income taxation since 1990. The discussion treats PRSI contributions and the various levies as taxes. As noted in the 1990 Strategy Report, these bear many of the characteristics of taxes and also give rise to much the same economic effects and incentives. Indeed, the Council argued in 1990 that, in analysing issues such as labour supply or work effort, the tax and social welfare systems should be considered jointly.

(i) Changes in Marginal Income Tax Rates

In comparing marginal tax rates over time we need to take account of the effects of inflation. Therefore we compare the marginal tax faced by a taxpayer in 1990 to the marginal tax rate faced by a taxpayer with the same *real* income in 1993.

Table 7.1 shows marginal tax rates facing single workers in 1990 and 1993. There have been reductions for *most* taxpayers in their marginal rate. One of the notable characteristics of the Irish tax system is the high marginal tax rates faced by single workers well below average industrial earnings. Not all workers below average industrial earnings have experienced a reduction in their marginal rate. Those earning between 73% and 93% of average industrial earnings have had an increase in their marginal rate of 1%. This group was on the 48% tax band in 1990 to 1993 and had an increase of 1% from the income levy introduced in the 1993 Budget.

TABLE 7.1

Marginal Tax Rates, Single Persons
Incomes in 1990 Prices

	1990/91	1993/94	Change 1990-1993
5,000	37.75	34.75	-3.0
7,500	37.75	34.75	-3.0
10,000	55.75	56.75	+1.0
15,000	60.75	56.75	-4.0
20,000	54.00	56.75	+2.75
25,000	54.00	51.25	-2.75
50,000	54.00	51.25	-2.75

Single taxpayers earning between £17,300 and £20,000 in 1990 experienced an increase in their marginal rate due to the extension of the PRSI and health contribution ceilings. However, this group earns well in excess of average industrial earnings.

TABLE 7.2

Marginal Tax Rates, Married Couple Incomes in 1990 Prices

	1990/91	1993/94	Change 1990-1993
5,000	5.5	5.5	-
7,500	55.75	55.75	-
10,000	37.75	35.75	-2.0
15,000	37.75	35.75	-2.0
20,000	49.00	51.25	+2.25
25,000	54.00	51.25	-2.25
50,000	54.00	51.25	-2.25

Marginal tax rates faced by married taxpayers and one-earner couples are presented in Table 7.2. Most of these experienced a reduction in their marginal rate. However, those taxpayers who were at the upper-end of the 48% tax band in 1990 had an increase in their marginal rate due to the lifting of the PRSI/levy ceilings.

There are some groups of married and single taxpayers below average earnings whose marginal rates did not change. Those whose only liability is PRSI have the same marginal rate of 5.5%. Those on marginal relief have continued with a marginal rate of 55.75. Finally, those earning £60 per week (the exemption limit for PRSI) face a particularly high rate of 336% which has not changed since 1990. This high marginal rate arises because earning £1 above £60 makes the employee liable for PRSI at 5.5%, which reduces net earnings below £60. This is not an esoteric point: it tends to produce a bunching of employees earning £60 per week.

Our conclusion on marginal rate changes is that most taxpayers have had a reduction in their marginal rate since 1990, which is a positive development.

(ii) Average Income Tax Rates

Average income tax rates are an important element of the tax system since they strongly influence the perceived fairness of the system, reflect the progressivity of the system and probably influence labour supply and migration. The Council recommended reductions in average income tax rates.

TABLE 7.3

Average Tax Rate, Single Person Incomes in Constant 1990 Prices

	1990/91	1993/94	Change
5,000	18.9	18.7	-0.2
7,500	25.2	24.0	-1.2
10,000	29.0	27.7	-1.3
15,000	39.6	37.4	-2.2
20,000	43.2	41.8	-1.4
25,000	45.4	43.7	-1.7
50,000	49.7	47.5	-2.2

TABLE 7.4

Average Tax Rates, Married Couple Incomes in Constant 1990 Prices

	1990/95.51	1993/94	Change
5,000	5.5	5.5	-
7,500	14.1	13.7	-0.4
10,000	22.2	22.4	+0.2
15,000	27.4	26.8	-0.6
20,000	30.6	29.7	-0.9
25,000	34.4	34.0	-0.4
50,000	44.2	42.6	-1.6

Changes in average tax rates for single persons are shown in Table 7.3. There has been a general modest reduction in average income tax rates. The gains in both percentage and absolute terms are smaller for those on low pay. Those earning average industrial earnings gained substantially in percentage terms.

Single taxpayers earning between £17,300 and £20,000 in 1990 experienced an increase in their marginal rate due to the extension of the PRSI and health contribution ceilings. However, this group earns well in excess of average industrial earnings.

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15,000	27.4	26.8	-0.6
20,000	30.6	29.7	-0.9
25,000	34.4	34.0	-0.4
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10,000	37.75	35.75	-2.0
15,000	37.75	35.75	-2.0
20,000	49.00	51.25	+2.25
25,000	54.00	51.25	-2.25
50,000	54.00	51.25	-2.25

Marginal tax rates faced by married taxpayers and one-earner couples are presented in Table 7.2. Most of these experienced a reduction in their marginal rate. However, those taxpayers who were at the upper-end of the 48% tax band in 1990 had an increase in their marginal rate due to the lifting of the PRSI/levy ceilings.

There are some groups of married and single taxpayers below average earnings whose marginal rates did not change. Those whose only liability is PRSI have the same marginal rate of 5.5%. Those on marginal relief have continued with a marginal rate of 55.75. Finally, those earning £60 per week (the exemption limit for PRSI) face a particularly high rate of 336% which has not changed since 1990. This high marginal rate arises because earning £1 above £60 makes the employee liable for PRSI at 5.5%, which reduces net earnings below £60. This is not an esoteric point: it tends to produce a bunching of employees earning £60 per week.

Our conclusion on marginal rate changes is that most taxpayers have had a reduction in their marginal rate since 1990, which is a positive development.

Average income tax rates are an important element of the tax system since they strongly influence the perceived fairness of the system, reflect the progressivity of the system and probably influence labour supply and migration. The Council recommended reductions in average income tax rates.

TABLE 7.3

Average Tax Rate, Single Person
Incomes in Constant 1990 Prices

	1990/91	1993/94	Change
5,000	18.9	18.7	-0.2
7,500	25.2	24.0	-1.2
10,000	29.0	27.7	-1.3
15,000	39.6	37.4	-2.2
20,000	43.2	41.8	-1.4
25,000	45.4	43.7	-1.7
50,000	49.7	47.5	-2.2

TABLE 7.4

Average Tax Rates, Married Couple
Incomes in Constant 1990 Prices

	1990/95.51	1993/94	Change
5,000	5.5	5.5	-
7,500	14.1	13.7	-0.4
10,000	22.2	22.4	+0.2
15,000	27.4	26.8	-0.6
20,000	30.6	29.7	-0.9
25,000	34.4	34.0	-0.4
50,000	44.2	42.6	-1.6

Changes in average tax rates for single persons are shown in Table 7.3. There has been a general modest reduction in average income tax rates. The gains in both percentage and absolute terms are smaller for those on low pay. Those earning average industrial earnings gained substantially in percentage terms.

The reductions in average tax rates for married persons have been greatest for those earning above average pay (Table 7.4). Furthermore, those whose only liability is for PRSI have not had any reduction in average tax rates.

A warning needs to be attached to the statement that there has been a real reduction in average tax system rates. Given the progressive structure of the tax, if average earnings rise in real terms then tax as a proportion of earnings will rise, even if the system is fully indexed for inflation. Due to the growth in average earnings since 1990, average tax as a share of average industrial earnings for a one-earner couple has not fallen, despite the reduction in average tax rates at given real income levels.

(iii) Tax Rates and Bands

The evolution of average and marginal rates discussed above depends on the development of tax rates and bands. The Council has emphasised the desirability of securing a situation whereby the maximum proportion of taxpayers are liable to tax at the standard rate. In *A Strategy for the Nineties*, the Council welcomed the decline in the proportion of taxpayers paying above the standard rate and the increase in the proportion paying at the standard rate.

Since 1990 this trend has been reversed. The proportion of taxpayers paying above the standard rate increased from 38.4% to 40.7%, while in absolute terms the numbers paying above the standard rate increased from 326,000 to 359,000.

The change in the distribution of taxpayers depends on both the evolution of rate bands and changes in real income. Since 1990 the standard rate band has increased by 15%. This is faster than the highest increase envisaged under the PESP. Therefore the increase in the proportion paying above the standard rate is *not* due to a failure to index tax bands, but due to an increase in real incomes for the group affected.

The evolution of tax bands and rates is shown in Table 7.5. The rate schedules have been reduced from three rates to two so there is now only one tax band (the 27% band). The exemption limit has been increased marginally more than inflation. Child additions have been added to the general exemption limits: this had a significant beneficial impact on the tax liability of low income families.

In considering tax rates and bands it is important to include PRSI and levies. The Council recommended the abolition of the PRSI ceiling and exemption

and a lowering of the rate. This recommendation has not been adopted although the ceiling has been increased. The ceiling for the health levy was abolished, which is in line with the Council's principles. However, a new 1% income levy on incomes over £9,000 p.a. was introduced in the 1993 Budget. This represents a fifth separate levy or tax on income and adds another and arguably unnecessary degree of complexity. It represents an ad hoc revenue device and is not consistent with the strategic approach to tax reform developed by the Council.

TABLE 7.5

Evolution of Marginal Rate Bands in Constant 1990 Prices 1990-1993

SINGLE	
1990/91	**1993/94**
£6,500 @ 30%	£7,089 @ 27%
£3,100 @ 48%	Balance @ 48%
Balance @ 53%	
Exemption limit £3,250	£3,325
Allowance £3,136	£3,012
MARRIED	
1990/91	**1993/94**
£13,000 @ 30%	£14,178 @ 27%
£6,200 @ 48%	Balance @ 48%
Balance @ 53%	
Exemption limit £6,500	£6,650
Allowance £5,186	£5,021

(iv) Evolution of the Tax Base

The efficiency and equity of the tax system depends not only on tax rates and bands but also on the tax base. The wide array of allowances, exemptions and reliefs which narrow the base for personal income tax can be allocated to categories as follows:

(i) Basic Allowances, i.e. single, married and widowed persons allowances;

(ii) 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;

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

(iv) Other Allowances, i.e. PAYE and PRSI allowances.

Since 1990 the real value of basic allowances has been reduced in real terms by 2% - 3%. The real value of secondary and other (PAYE and PRSI) allowances has also declined in real terms, with most of the allowances declining by almost 8% (see Table 7.6)

TABLE 7.6

Evolution of Basic and Secondary Allowances and Exemption Limits

	Change in Real Terms 1981-82 to 1986-87 %	**Change in Real Terms 1986-87 to 1990-91 %**	**Change in Real Terms 1990/91 to 1993/94 %**
Married Person's Allowance	+21.3	-9.7	-2.0
Single Person's Allowance	+21.3	-9.7	-2.0
Widowed Person's Allowance	+42.7	-10.1	-3.1
Widowed Parent Allowance	+56.2	-9.0	-0.2
Single Parent Allowance	+108.2	-10.0	-2.0
Age Allowance - Single Married	+68.8 +50.6	-11.9 -11.9	-7.6 -7.6
Dependent Relative Allowance	-22.0	-11.9	-16.0
Blind Person's Allowance	+1.5	-11.9	-7.6
Person Employed to take care of Incapacitated Individual	+238.2	-11.9	-7.6
Age Exemption Limit (3) -65+ -75+	-7.3 -11.2	+4.9 +4.3	+1.0 -0.2
General Exemption Limit (3)	-10.3	+8.1	+2.3
PAYE Allowance	-24.1	+0.8	-7.6
PRSI Allowance	-	-11.8	-7.6

These changes undoubtedly extend the tax base, but it is necessary to consider whether they are in line with strategy of tax reform advocated by the Council and the Commission on Taxation.

In the case of personal allowances, the Commission proposed not reduction but abolition *with replacement by tax credits*. In the case of the other secondary allowances the Commission proposed abolition *with provision for compensatory payments*.

In contrast to basic and secondary allowances, *discretionary allowances* tend to reduce the progressivity of the system and distort the economic effects of the tax system. The Council has emphasised the desirability of reducing discretionary allowances which narrow the tax base and offer opportunities for tax avoidance. There have been some developments in this area since 1990. Tax relief on life assurance costs was reduced from 50% in 1990/91, to 25% in 1991/92, and finally abolished in respect of any premia paid after 6th April 1992. Relief on medical expenses and VHI premia is, however, still available. With regard to mortgage interest relief, the 1993 Budget increased the interest ceilings for single and married taxpayers and also increased, for one year, the percentage of interest qualifying for relief to 90%. In addition, 100% relief was introduced for first-time buyers, to apply for three years. The measure was stated to be a response to exceptionally high interest rates which arose as a result of turbulence in the ERM.

Efforts have been made to curb abuse of various tax relief schemes whose original purpose had been to promote investment in industry, while others have been added. The 1992 Budget abolished, for example, a scheme granting relief on dividends from share-holdings in companies paying the 10% rate of Corporation Tax. Tax relief associated with various employee profit-sharing schemes was also removed. The concession on profit sharing was, however, subsequently restored, subject to a maximum relief in any one year of £2,000. The limit on the amount of tax relief employees may obtain for subscribing for new shares was also increased from £750 to £3,000 this year. New restrictions were placed on the Business Expansion Scheme, limiting the type of activities eligible for such investment and the total amount of money that a company could raise under the scheme. A lifetime cap on the amount of money on which any taxpayer could claim relief was also introduced in 1991, but this was removed in the last budget. Three new incentive schemes based on relief of income tax were introduced in the 1993 Finance Bill.

Section 23 relief on the provision of residential accommodation has been abolished in respect of building work carried out after July 1992, although it has been retained until 1993 for residential investments in the areas designated under the urban renewal programme.

Some improvement has occurred in relation to the taxation of benefits-in-kind. The 1992 Budget reduced tax concessions associated with share options. The annual benefit in kind charge on company cars was increased from 20% to 30% of the cost of the car, with a sliding scale to allow for motoring expenses met by employees.

Most significant of all, perhaps, was the inclusion of disability and injury benefits as income for tax purposes from April 1993, and the decision to make unemployment benefits part of the income tax base.

Table 7.7 presents comparable information on the extent to which a number of discretionary allowances narrowed the tax base in 1989/90 and 1992/93. The total real value of these reliefs has been maintained since 1993. The increase in the total value of the tax exemption from mortgage interest relief more than offset the elimination of the life assurance deduction. Furthermore the percentage of income exempted from the tax base due to these discretionary reliefs has increased from 14.9% in 1989/90 to 15.4% in 1992/93. It is clear, therefore, that discretionary reliefs continue to erode the income tax base.

TABLE 7.7

Estimates of the Reduction in the Tax Base from some Discretionary Reliefs

	Real Change 1989/90 to 1992/93	Diminution of Base	
		1989/90	1992/93
Interest Relief	+10.2	434.7	525.7
Medical Insurance	+16.6	127.5	148.7
Life Assurance	-	-85.0	
Premiums under Permanent Health Benefit Schemes	+127.9%	3.2	8.0
Preferential Loans	-	-14.0	-
Artists Relief	+3.0	2.3	2.6
Covenanted Subscriptions	+86.5	32.6	66.7
TOTAL	+0.1%	699.3	751.7

Source: Revenue Commissioners.

4. CAPITAL TAXATION

The discussion of capital taxation includes Capital Gains Tax (CGT), Capital Acquisition Tax (CAT) and Residential Property Tax (RPT). An amnesty for

CAT was held in 1991 which resulted in total revenue from capital taxes of £103 million in 1991 compared to £71 million the previous year. Apart from this one-off event, capital taxation revenue has increased broadly in line with inflation since 1990.

A number of reforms were introduced in the area of CGT. The rate structure was rationalised by replacing previous rates with a single flat rate of 40%. Self-assessment was introduced and the exemption for small gains was halved. These changes are consistent with the principles advocated by the Council. The charging of all capital gains at 40% narrows the gap with the top rate of income tax (48%) so therefore reduces the incentive to convert income to capital gains in an effort to reduce tax liability. There are still however many exemptions from CGT: (i) small gains; (ii) gains on principal private residence (except where sale price reflects development potential); (iii) gains realised on Irish government securities;[49] and (iv) Lotto and Prize Bond winnings. There is no obvious rationale for these exemptions. The Council has previously endorsed the view of the Commission on Taxation that: "The equity and efficiency of these exemptions are not essentially different from the implications of analogous exemptions in other parts of the system of personal taxation" (First Report of the Commission on Taxation).

A specific incentive included in the 1993 Finance Bill was the provision of relief from capital gains tax where an entrepreneur disposes of shares in a company and reinvests them in an unquoted company in manufacturing or exposed services. This slightly reduces the capital gains tax base but it is designed to encourage productive investment.

As regards Capital Acquisitions Tax (CAT) the principal developments have been as follows: thresholds have been indexed with inflation since 1990, the top two rates of CAT (i.e. 45% and 55%) were abolished leaving 40% as the highest rate of CAT, agricultural relief was increased to facilitate structural change in agriculture, anti-avoidance measures have been introduced concerning the valuation of shares in non-trading companies and the treatment of gifts.

The 1993 Budget introduced a 2% probate tax on estates above £10,000. This tax applies to all assets passing on inheritance, except the family home where that is inherited by the spouse of the deceased. Hardship provisions, similar to those which exist for capital acquisitions tax, apply to this tax. The estimated yield from this tax in a full year is £12 million.

49 Due to recent changes most capital gains on government securities are effectively subject to tax.

Members of the Council hold divergent views on whether a probate tax should have been introduced, given the existence of CAT. Members also hold divergent views on the structure and operation of CAT.

TABLE 7.8

Capital Acquisitions Tax Thresholds

		1990	1993
(a)	Child (or grandchild under 18 where parent deceased)	156,000	171,750
(b)	Brother, sister, nephew, niece	20,800	22,900
(c)	Other	10,400	11,450

The valuation threshold for the Residential Property Tax (RPT) was reduced in 1992 to £91,000 and the income limit was reduced to £27,000. It was announced that these thresholds would be indexed with inflation. The yield from RPT continues to amount to a very modest level of revenue, due to the size of the exemption limits. This low yield favours investment in residential property over more productive investment.

The Council concludes that there continues to be considerable potential for increasing revenue in the area of capital taxation. The major scope for increasing revenue comes from a comprehensive residential property tax on the basis which is outlined below (Section 10 (iv)). If this potential were exploited it would provide revenue to *reduce taxes on labour which in turn could promote employment.* This is discussed in more detail below.

5. CORPORATION TAX

The main developments in corporation tax since 1990 have been as follows: phasing out of accelerated capital allowances (announced in 1988) and the introduction of a new regime for the annual wear-and-tear allowance for plant and machinery involving a 15% p.a. straight line deduction; restrictions on Section 84 loans; reform of the tax arrangements for life assurance companies; taxation of building societies' capital gains on gilts and the phased removal of the taxation exemption for co-ops. Export Sales Relief (ESR) terminated on 5 April 1991 and the standard rate of corporation tax has been reduced on a phased basis from 50% in 1988 to 40% from April 1991, which has mainly benefited the services sector.

The changes in corporation tax since 1988 have been consistent with the core principle of tax reform advocated by the Council: reducing rates and broadening the base. There has been strong growth in revenue due to a number of factors: (i) broadening of the base (including the ending of ESR); (ii) the coming on stream of IFSC related tax revenues; (iii) improvement in the profitability of the corporate sector generally; and (iv) the introduction of self-assessment in 1989 resulting in more timely tax payments.

While the general thrust of change in this area has been consistent with the Council's principles, the anomaly of the bank levy still exists. However, it was provided in the 1992 budget that where a bank's corporation tax exceeded a certain threshold, all or part of its levy payment could be offset against the excess corporation tax. The arrangements for the levy are due for review in the 1995 Budget.

The most significant relief in the corporate tax system is the regime for manufacturing companies. Although it is not an immediate issue, consideration needs to be given to whether the 10% manufacturing corporate tax rate should be extended beyond 2010. Other things being equal, the 10% tax incentive implies a higher tax burden on firms in the rest of the economy which would tend to be more labour intensive, tending to reduce employment. However, other things are not necessarily equal: the low corporate tax rate is undoubtedly an important incentive in attracting internationally mobile investment to Ireland.

(i) Advance Corporation Tax

The Industrial Policy Review Group drew attention to a specific issue concerning Advance Corporation Tax (ACT). ACT is tax payable by a company when it distributes dividends to its shareholders. Under double taxation agreements the State essentially recognises foreign tax as equivalent to Irish tax paid. However, when a foreign subsidiary of an Irish company repatriates profits to the Irish headquarters and these profits are then distributed to shareholders, ACT is payable on these dividends. Because of the availability of foreign tax credits the ACT payment may exceed the company's mainstream corporate tax liability, resulting in ACT being a net tax payment for that year, rather than an advance payment of corporation tax which is due in any event. This surplus ACT can, however, be carried forwards (or backwards within limits) against the company's corporate tax liability in other years. In addition there is a provision in the tax code which gives exemption on repatriated dividends if they are used for employment maintenance or creation within the State.

The Moriarty Task Force on the Implementation of the Culliton Report argued that this tax does not appear to be imposing particular burdens or distortions on firms with headquarters operating here at present. However, it recognised a potential problem could be a reluctance by Irish headquarters to repatriate profits from foreign operations which could drive headquarters operations offshore in the longer-term.

This issue concerning ACT arises in other EC states and has been discussed in the Ruding Report. The Council concurs with the recommendation of the Task Force that ACT should be a priority for EC tax harmonisation with the objective of achieving harmonisation across the EC within three years.

6. INDIRECT TAXES

The Council's policy on indirect taxes is based on two principles: (i) Indirect taxation should be efficient and effective. Therefore, it is desirable to widen the tax base and reduce rates, a policy which the Council argued applied to indirect as well as direct taxes; (ii) Changes required as part of the process of European integration must be accommodated. In addition, the Council recommended that measures to compensate the least well off must accompany the imposition of VAT on items currently zero-rated. The Council did not offer advice on the appropriate rate of VAT in specific sectors.

Since 1990 the VAT structure has been rationalised to two rates of 12.5% and 21%. The 1993 budget reduced the rate on a number of labour intensive services from 16% to 12.5%. The range of zero-rated items has remained unchanged, so the issue of compensating the least well-off for an increase here has not yet arisen.

We conclude that changes in recent years have been consistent with the need to accommodate EC requirements. However, base-widening has not occurred to any significant extent (which is mainly an issue in relation to VAT).

7. CONCLUSIONS ON TAX CHANGES SINCE 1990

(i) Income Tax

There have been reductions in marginal tax rates for the vast majority of taxpayers, but not for a limited number of taxpayers below the average industrial wage. There have been modest reductions in average tax rates for

taxpayers generally (except those whose only liability is for PRSI). Single persons on average industrial earnings have gained substantially but the gains in absolute and proportionate terms have tended to favour those with incomes well above average industrial earnings. The introduction of child additions to the general exemption limit has had a significant beneficial impact on the tax liability of low income families. Some restrictions on discretionary reliefs were imposed, but new reliefs have been introduced and the tax foregone under some old reliefs has increased (e.g. mortgage interest). In *A Strategy for the Nineties* the Council noted that there had been significant changes in the tax treatment of the self-employed, including the introduction of current year assessment for this group.

The slow progress of reform cannot be attributed to lack of economic growth. The Council's proposals for reform were designed to promote growth, but they were not dependent on revenue buoyancy. A central recommendation of the Council was the introduction of a property tax and a widening of the tax base. These would provide significant revenue to reduce average and marginal rates. The issue is therefore one of policy.

The type of tax schedule changes which have taken place tend to reduce progressivity. In particular, the reduction in the top rate of income tax combined with non-indexation of basic and secondary allowances reduces progressivity from both ends. In 1990 the Council, for these reasons saw little benefit in further schedule rate reductions without base widening.

(ii) Indirect Taxes and DIRT

Changes in these areas have been consistent with the need to accommodate EC requirements. However, there has been little base widening in the area of indirect taxation.

(iii) Corporation and Capital Taxes

The implementation of a stated programme of reform of corporation tax has continued. This reform has involved base widening and rate reduction and constitutes genuine reform along the lines advocated by the Council. The introduction of self-assessment for capital gains tax and the rationalisation of the rate structure are in accordance with the Council's principles. Members of the Council hold divergent views on whether a probate tax should have been introduced, given the existence of CAT. Members also hold divergent views on the structure and operation of CAT.

8. EVIDENCE ON TAXATION AND EMPLOYMENT

The purpose of this section is to review the evidence on the effects of tax on employment and unemployment. We will then review trends in tax policy internationally. This provides the background against which the Council outlines the desired direction of tax reform from the point of view of increasing employment and reducing unemployment on a sustainable basis.

When considering the effects of taxation on employment, it is necessary to distinguish between demand and supply side effects. By definition, tax will reduce the level of demand for non-exchequer provided goods and services. The associated public spending can be expected to provide an offsetting stimulus to demand. The supply-side effects of tax on employment are of more concern. At a general level excessive tax rates can undermine risk taking behaviour and initiative and channel investment and energy into tax driven schemes, with negative consequences for economic development. In analysing the supply-side effects of tax on the labour market, economists typically focus on the tax wedge: the gap between the real value of take-home pay and gross labour costs. An increase in the tax wedge can affect employment through the following chain of events:

(i) the increase in the tax wedge will tend to affect wage bargaining behaviour and increase total labour costs;

(ii) the increase in labour costs will tend to reduce employment.

Table 7.9 shows the evolution of the average tax wedge in Ireland in recent years. The pattern of slow decline was reversed in 1993.

TABLE 7.9

Average Tax Wedge[1]
1990-1993

	Single	Married
1990	42.73	34.14
1991	42.67	33.84
1992	41.21	32.93
1993	42.61	34.03

1 Average Male Earnings in Manufacturing Industry. The tax wedge used here is calculated as total direct taxation (income tax, employee's and employer's PRSI) as a percentage of earnings.

While an increase in the average tax wedge will increase wage pressure, the marginal tax wedge also affects wage behaviour. Other things being equal, the higher the marginal tax wedge, the greater the increase in gross pay needed for a given increase in net pay to employees.

Table 7.10 compares the tax wedge in Ireland and a number of EC countries. It can be seen that for a married couple on standard industrial earnings the tax wedge in Ireland is not particularly out of line with other EC countries. For a single person the average tax wedge is higher than for a married couple, but again it is not significantly out of line with other EC countries. However, the *marginal* tax wedge for a *single* person in Ireland is the second highest for the countries shown.

TABLE 7.10

Tax Wedge At Standard Industrial Wage

	Average		Marginal	
	Single	Married	Single	Married
Ireland	39.0%	32.0%	61.0%	44.0%
United Kingdom	32.6%	29.4%	40.2%	40.2%
Germany	45.5%	40.0%	48.0%	55.8%
France	47.0%	44.0%	51.5%	48.0%
Spain	39.3%	39.3%	48.0%	48.0%
Denmark	45.0%	37.0%	57.0%	51.0%
Belgium	54.8%	49.1%	64.7%	61.7%
Italy	43.4%	45.4%	54.0%	54.0%
Portugal	37.0%	35.0%	49.0%	41.0%
Australia	30.0%	30.0%	44.5%	44.5%
United States	29.0%	25.8%	34.0%	34.0%

Source: Reform of the Irish Taxation System from an Industrial Point of View, A Report by Arthur Anderson & Co. to the Industrial Policy Review Group.

A high or increasing tax wedge increases the cost of employment to the employer (the product wage) while maintaining or reducing the take-home pay of the employee (the consumption wage). This will tend to reduce the demand for labour at any given wage rate. If employees seek to resist a fall in the consumption wage by compensatory increases in nominal wages this will also tend to reduce the demand for labour. The econometric evidence suggests that, in the Irish economy, wage setting behaviour *is* influenced by the tax wedge. It has been estimated that in the traded sector each 1% increase in the tax wedge is associated with a 0.24% wage increase in the short-term and 0.5% in the long-run (Bradley, Whelan and Wright, 1993). Such wage increases tend to be transmitted to the other sectors of the economy. Though significant, real wage resistance, defined as the extent to which wage earners attempt to compensate in the short-run for the erosion of the real consumption wage, is low in Ireland relative to most OECD countries (OECD, 1989).

The first half of the 1980s was characterised by rapid growth in the tax wedge (while it has fallen since the late-1980s). Murphy (1987) has estimated that a 1% increase in the tax wedge reduces employment by from 0.2% to 0.25%. The Council has previously estimated that the tax wedge grew by 27.3% between 1980 and 1985 (NESC, 1986). This would imply that the increase in the tax wedge over that period was responsible for a decline of up to 6.8% in employment. Murphy's study was based on the manufacturing sector and manufacturing sector employment fell by 17% over this period. On this basis Barry (1991) concluded that the increase in the tax wedge was capable of explaining up to 30% of the fall in manufacturing employment which occurred in this period. Walsh (1987) concurs with the judgement that the increase in taxation was not responsible for the bulk of the decline in employment and increase in unemployment which occurred in the first half of the 1980s, but he notes that the effects were non-trivial. Recent research by Browne and McGettigan (1993) has examined the causes of the growth of unemployment in Ireland. They estimated the growth of the combined tax and real exchange rate wedge in the first half of the 1980s accounted for over 40% of the increase in unemployment in that period.

Cross-section research reported in OECD (1990) finds that, in the long-run, labour is unable to pass on the increase in the tax wedge to employers, so that in the long-run the cost is borne entirely by labour. This means that the tax wedge eventually reduces the real value of wages to employees rather than increasing labour costs. This depends, however, on labour supply being wage inelastic, which in the case of Ireland may not be the case. The same study also finds that the short-run effects of the tax wedge are significant and, given lags in the system, this could result in the effects of the tax wedge lasting for up to a decade. A number of researchers have identified hysteresis as a characteristic of Irish unemployment, so that it is plausible that there could be long-run effects from a rise in labour costs due to an increase in the tax wedge. An increase in the tax wedge may increase labour costs and reduce employment so that even if labour costs are subsequently reduced the displaced employees may have lost their skills and may therefore no longer

represent *effective* labour supply. This can lead to an increase in long-term unemployment.

The above discussion needs to be set against a number of considerations which suggest caution in drawing conclusions about the influence of the tax wedge on employment. Kennedy (1987) has pointed out that the rise in the tax wedge was partly a consequence as well as a cause of the poor economic performance in the first half of the 1980s. Given the imbalances in the public finances in Ireland which existed at the start of the 1980s, any approach to redressing these imbalances would have to have had an adverse effect on unemployment. For example, if the rise in the tax wedge had been avoided by a sharp reduction in public sector employment, this would also have had a direct and indirect influence on the level of employment. In all discussions of taxation it needs to be borne in mind that taxation is essential to public expenditure and changes in taxation cannot be discussed independently of the constraints on the public finances.

On the basis of this review the Council concludes that the growth of the tax wedge has played a significant role in Ireland's unemployment. However, it is not clear that alternative approaches to tackling the imbalances in the economy which prompted the rise in the tax wedge would have had a more satisfactory outcome.

9. INTERNATIONAL TRENDS IN TAX REFORM

This section, drawing on OECD material, provides a short overview of trends in tax policy over the past decade. In general, tax changes have been motivated by a desire to introduce greater tax neutrality, in particular through widening of the personal and corporate tax base, with reductions in tax rates and in tax incentives which are perceived to distort the pattern of saving and investment. In general, there has been far less change in the structure of social security contributions, other than the removal of income ceilings on contributions in some countries.

While many countries have adopted policies intended to reduce the tax burden overall, that is the ratio of tax revenue to national income, the tax ratio in most countries rose over the 1980s, with some slight reductions towards the end of the decade. The impact of fiscal deficits and demographic pressures contributed to this pattern. The composition of taxation, and movements within it over the 1980s, are shown in Appendix 7.2. The overall pattern has remained broadly unchanged, with the exception that countries introducing a VAT system showed some shift towards consumption taxes.

A further pattern which can be discerned is a shift from personal income tax to corporate income tax, and from specific consumption taxes to general consumption taxes.

Within the income tax system, the trend has been towards reduced top rates of income tax, in many cases on a substantial scale. Appendix 7.3 (which relates only to central government taxes) shows the scale of these reductions. It also shows reductions in the first and, in many cases, standard rate of tax within the personal income tax code. Substantial reductions in first positive rates occurred in Austria and the Netherlands as well as in Ireland. In other countries, however, they have increased significantly. The overall impact of changes in the rate schedule has been to reduce nominal progressivity. However, this has been offset by measures to broaden the tax base or to increase tax thresholds. Reductions in tax expenditures as a means of broadening the tax base have occurred widely in the areas of home ownership and business expenses. One measure designed to protect the tax base has been the introduction of a minimum tax expressed as a percentage of gross income (in Canada and the USA) or as a supplementary gross income tax (in Denmark and Norway). Applying to the highest income groups, these measures are designed to prevent tax reliefs being used to reduce tax liability below a basic minimum.

With regard to corporate income tax, the general pattern has been towards greater neutrality, with widening of the appropriate tax base and reductions in rates, either generally or for specific categories of business. Ireland, together with Belgium and France, continues to use the corporate tax system on a strongly interventionist basis. Appendix 7.4 shows the pattern of change in the corporate income tax schedule for OECD countries.

The rates of corporate income tax shown in Appendix 7.4 are nominal. The more relevant question is the effective tax rates, especially on marginal investments. The higher the effective tax rate the higher the pre-tax rate of return required to yield the same return as the market interest rate. The rate of return to individuals investing in the corporate sector is also affected by the personal income tax rate. The size and composition of the tax wedge between corporate pre-tax rates of return and net income from investment may influence the composition of investment, as well as its level. Appendix 7.5 shows the pre-tax rate of return required for a 5% after tax rate of return in 1991. It can be seen that the aggregate required rate of return in Ireland is among the lowest in the OECD, with substantially less variation as between different sources of finance than for most countries. The required rate of return on investment in buildings is significantly below the OECD average but not significantly lower than for investment in machinery and stock.

A further dimension of the effective impact of corporate taxation is the question of neutrality as between domestic and foreign investment. The rules governing taxation of profits crossing frontiers can produce different net rates of return from marginal investments in the domestic and overseas economies. Appendix 7.6 presents material showing that, on average, the required pre-tax rate of return for a comparable net rate of return is lower for domestic investment than for investment overseas, notably so in the Irish case.

With regard to trends in social security contributions, it has already been noted that the literature suggests that increases in employers' contributions are, in the long-run, shifted into lower wages but, in the short-run, such increases may adversely affect the demand for labour. Variations in relative reliance on social security contributions and in the attitudes taken towards social security as a tax or as an insurance-based contribution are long established. Thus, Australia and New Zealand no longer collect earmarked social security contributions. In the Netherlands all employers' social security contributions have been shifted to employees, with compensatory payments from employers to employees for a transitional period. Concern at the employment effects of social security contribution has led to reductions in contributions in respect of the low paid in France and Spain. France has also exempted small enterprises from social security contributions for two years from the date of first recruitment, while Italy has reduced employers' contributions for companies operating in certain regions.

This brief overview of international trends provides a context within which to review options for policy changes in Ireland.

10. TAX POLICY IN AN EMPLOYMENT STRATEGY

(i) The Council's Approach

The priority of the Council is to maximise the growth of sustainable employment through improving the rate of economic growth and the labour intensity of growth. This primary objective provides the guiding principle for the Council in considering the desired direction of tax policy in the years ahead.

The Council's priority with tax reform is to increase sustainable employment and to reduce unemployment. The Council considers that, from this perspective, the focus should be on reducing *effective* tax rates on earned income. The Council further believes that it follows from certain key characteristics of the labour market that reducing the cost of employing lower paid employees relative to the cost of other factors of production would make the most direct contribution to reducing unemployment.[50] Firstly, *high unemployment is heavily concentrated among those workers classified as "unskilled"*. As stated in Chapter 3 above, almost three-quarters of those who were unemployed in 1991 had either no qualifications or an Intermediate/ Group Certificate only. Secondly, there is evidence of a trend in the skill composition of the employed labour force. For any given system of wages and wage differentials, the demand for labour calls for a declining proportion of unskilled jobs. Thirdly, the demand for unskilled labour is the most cost sensitive: at higher levels non-cost factors become more significant.[51] For this reason, the Council considers that reductions in taxation on earned incomes should be focused mainly on persons with low-to-middle incomes. This would be of general benefit to new entrants to the labour force who typically start on modest earnings. Changes in the income tax and PRSI codes which reduce the cost of unskilled labour and are expected to continue indefinitely can be expected to have a greater effect than temporary exemptions.

Given the limited scope for a reduction in overall tax revenues, pursuit of the Council's priorities will necessarily require increasing revenues from other sources. This will require broadening the taxation base in the wide sense, both in the area of income tax and otherwise. The Council's approach to tax reform and base-broadening would also be guided by the following more general principles:

1. Discretionary reliefs and exemptions should be minimised. The advantages of this include: (i) extending the tax base, which facilitates rate reductions; (ii) reducing the rewards from socially unproductive tax planning; and (iii) helping to simplify the system and thereby reducing compliance costs to the benefit of productive enterprises and improving administrative efficiency for the State.

2. Disincentives which adversely affect the growth of employment should be reduced, including those arising from the interaction of the tax and social welfare system.

50 Dreze and Malinvaud (1993) argue that the characteristics of the unemployed and labour demand trends justify immediate measures to reduce the cost of unskilled labour relative to the cost of skilled labour and of capital.

51 A consistent result among studies examining all the disaggregations of the labour force is that the own-price elasticity is lower, the greater is the amount of human capital embodied in the average worker in the particular class of labour. Thus, skill per se ties employers to workers by making labour demand less sensitive to exogenous changes in wage rates (Hamermesh, 1986).

3. The balance between labour and other factors of production (capital and energy) should be redressed.

A faster growth rate of sustainable employment would make a vital contribution to a more equitable society. The Council considers that there should be general reliance on direct payments to those in need rather than assistance through the tax system. The elimination of poverty is among the goals of the Council's strategy and therefore the direct distributional implications of taxation must also shape policy for tax reform.

Finally, in considering the desired direction of tax policy in the years ahead the constraints arising from the international mobility of elements of the potential tax base and the freedom of consumers in the Single Market to take advantage of fiscal differentials have to be taken into account. In the light of these considerations, the following sections set out the Council's recommendations on the strategy to be pursued.

(ii) Social Security Taxes - PRSI

The Council has endorsed the principle of earmarked social security contributions but has emphasised that PRSI should be evaluated as a tax. For a one-earner couple earning the average industrial wage the combined employer and employee PRSI liability exceeds the income tax liability. Viewed as a tax, there are a number of aspects to PRSI which are unsatisfactory and which merit attention in an employment strategy.

(a) The *structure* of PRSI means that it is regressive, increasing the cost of low-paid labour more than high-paid labour. This follows from the combination of a flat rate with a ceiling. The total annual PRSI liability for an employee earning £40,000 is 10% of earnings. The total liability of an employee earning £10,000 is 20% of earnings.

Aside from equity considerations, a tax whose impact is greatest on unskilled labour has two distinct disadvantages from the point of view of seeking to reduce unemployment:

- workers classified as unskilled are over-represented on the live register;

- Such workers are potential employees in areas which are cost sensitive. Firms which are significant employers of unskilled workers have to compete primarily on cost.

(b) The *base* for PRSI is limited. Apart from the limitations of the ceiling and exemption, PRSI is confined to income from employment (including self employment). Investment income, benefits in kind, capital gains, gifts and inheritances and all other forms of income are excluded. Those in the public service also pay a much lower rate. The limited base of PRSI implies that:

- it strengthens the incentive to substitute labour for capital;
- it is a greater burden on firms in labour intensive sectors;
- by directly increasing the cost of labour it has an adverse impact on competitiveness.

(c) Another unsatisfactory aspect of PRSI is that it is not related to the employer's ability to pay and it may be negatively related: labour intensive firms tend to be less profitable, so their PRSI liability will tend to be a higher proportion of their profits. In fact PRSI payments may exceed profits for some companies.

There is some evidence that the existing structure of payroll taxes acts as a disincentive to the hiring of unskilled, low-wage workers (OECD, 1993).

Employers' PRSI is a tax which directly and immediately affects labour costs. Sexton (1991) has modelled the effects of reducing employers' PRSI by £300 million. Initially he examined the effect of this reduction with no offsetting increase in revenue from other sources. This led to a short-run increase in employment of 5,000 and by the year 2,000 employment would be 13,000 higher than it would otherwise be. He then examined the effect of using the revenue from a property tax to offset the tax reduction from reducing employers' PRSI. This revenue neutral package had a more modest impact on employment. The gain in employment in 1992 was 4,000 while by the year 2,000 the employment gain was 6,000 respectively. Over time therefore the property tax reduces the employment stimulus from the reduction in employers' PRSI.

Therefore a revenue neutral reduction of employers' PRSI would make a contribution to increasing employment. However, using the proceeds of base-broadening measures in selected areas *without a rigorous reform of the entire system* would mean that base-broadening measures, such as a property tax, will be politically much more difficult and may leave the structure with other anomalies intact.

In *A Strategy for the Nineties*, the Council recommended the introduction of a single lower rate of employees' PRSI without an exemption at the lower

end or a ceiling at the upper end. The Council is of the view that, as part of its overall programme of tax reform, a restructuring of PRSI can contribute to improve employment performance.

The impact on employment of restructuring PRSI could be maximised if the restructuring was focused on achieving greater reductions at lower income levels, given the labour market characteristics outlined above. This could be achieved by, for example, (a) a progressive rate structure or (b) an exemption from employer's PRSI for low-wage employees which would be phased out in a linear manner. This approach is recommended by Dreze and Malinvaud (1993). However, this approach would have to have regard to the impact on marginal tax rates and the potentially negative effects of high marginal rates.

A long-run solution could be to replace PRSI with a more broadly based social security tax (i.e. including non-wage forms of income in the base). This approach was recommended by the Commission on Taxation (see First Report, Fourth Report).

The Council considers that these options for restructuring PRSI merit serious consideration. If some of the proceeds of base broadening measures were applied to PRSI it would be possible to make more progress in this area. Finally, there is the issue of the PRSI status of public servants. This is a complex issue which the Council notes is under discussion between the government and ICTU.

(iii) Income Tax

The Council favours reductions in marginal and average rates financed by base widening. There are, however, many different types of schedule changes which can produce lower marginal and average rates. This section considers which types of schedule adjustment will make the most direct contribution to the growth of sustainable employment.

The impact of tax rate reductions on the growth of sustainable employment depends on the supply-side effects. One approach to examining where the incentive effects are greatest distinguishes between income and substitution effects. The substitution effect (the tendency to substitute leisure for income) depends on the *marginal* tax rate: the higher the marginal tax rate, the lower the return from each additional hour of work. The income effect (the tendency to work longer to compensate for the loss of earnings due to tax) depends on the *average* tax rate. Using this analysis one arrives at the conclusion that the efficiency effect of tax depends entirely on the marginal rate. Possibly the greatest significance of marginal tax rates is their impact on wage determination. Other things being equal, the higher the marginal tax rate, the higher the gross pay increase needed to achieve a given increase in net pay.

In the context of the current level of unemployment, the impact of taxation on total labour costs in an internationally competitive situation is an important consideration, and this depends on average as well as marginal rates. There are other significant efficiency aspects of tax that relate to average tax rates. Insofar as tax influences migration decisions this is likely to depend on the average, rather than the marginal tax rate. In addition, a decision on whether or not low-paid employment is worthwhile will depend on the combined effect of tax and social welfare provisions. This decision will depend on the replacement ratio, which can be interpreted as an effective average tax rate. This discussion implies that an employment-oriented review of income tax requires consideration of both average and marginal tax rates.

In considering which incóme tax changes are desirable, equity concerns also need to be considered. In *A Strategy for the Nineties*, the Council expressed concern about the loss of progressivity in the income tax code which occurred between 1986 and 1990 due to the reduction in tax rates without any significant base-widening. The Council noted that a reduction in progressivity was in fact a central objective of many tax reforming governments in the 1980s. The Council's view was that further income tax rate reductions were desirable provided they were combined with base-widening measures which would preserve or even enhance the progressivity of the system.

However, since then micro-simulation analysis by Callan (1991) indicates that the idea that cuts in tax rates and broadening of bands financed by extension of the tax base would maintain the overall progressivity of the system does not seem to be borne out. Callan's analysis was based on a combination of cutting rates and increasing the standard rate band. Different redistributive effects would emerge if the proceeds of base broadening were applied to changes in bands and allowances.

Given the characteristics of the labour market outlined in section (i) above, income tax reform can most directly contribute to lower unemployment if it helps to reduce the cost of employing lower paid employees. This implies targeting income tax reductions on low to middle income earners.[52]

McCarthy (1993) has argued that the most important tax reform which needs to be undertaken is to stop levying high taxes on low incomes: "It does not

52 Some changes, for example extending the standard rate band, will also benefit high income earners.

make sense in terms of getting the labour market to work, to seek taxes from people whose gross income may be little better than social welfare entitlements". The distinctive feature of the Irish tax system is not the highest marginal rate, which is no longer particularly high by international standards. Rather *it is the relatively low income at which single taxpayers become liable for the highest marginal rate*. The marginal tax rate faced by single people on the average industrial wage in Ireland is among the highest in the OECD (see Table 7.9). Accordingly, the Council recommends the extension of the standard rate band.

The problem of high taxation at low incomes is not confined to the speed with which one reaches the top rate. O'Toole (1993) has argued that "perhaps a greater concern should be the speed at which one reaches the standard (and initial) rate in the case of Ireland and the magnitude of that rate". The initial rate in Ireland is second only to Iceland in the OECD. There are a number of ways, including changes to PRSI as outlined above, in which relief can be provided for the low paid.

(iv) Property Tax

The introduction of a more comprehensive property tax is an important reform from the point of view of maximising the growth of sustainable employment. The net revenue gained from a property tax should be used to reduce income tax (including social security taxes). The efficiency of a property tax is based on elasticity or responsiveness considerations. The elasticity of existing property with respect to taxation is essentially zero. While the elasticity of new property with respect to taxation is not zero, the order of magnitude involved is different to income or social security taxes. Ireland has a property tax on commercial and industrial property, a limited income-related residential property tax and no tax on agricultural land.

There is a clear equity rationale for residential property tax: at present the imputed income from owner-occupation is exempt from tax. The *practical* basis, however, is that such a tax is on *unmovable* property; it exists in competing economies and it represents an internationally accepted link between an asset and the return an owner might be expected to pay for its use. Taxation on housing represents an efficient method of paying for the provision of infrastructure and services to housing, either at national or local government level. While care must be taken to avoid double counting, it is important to note that if the income is directly applied to the funding of local government, the subsequent adjustment of central funds would still allow reductions in the income tax.

A comprehensive property tax would have implications for some existing revenue. It would subsume the existing Residential Property Tax (£7.5 million) and may have implications for local service charges (£35 million). A property tax in itself would not justify changes to stamp duties. The offsetting effect of subsuming this revenue is not of great significance in the context of the potential yield of a more comprehensive tax.

Imposition of a flat rate[53] property tax would justify the allowance of mortgage interest relief at the standard rate (strictly speaking only *real* interest would be justified). A residential property tax based on taxing imputed income would justify allowance of mortgage interest relief at the marginal rate. A residential property tax could potentially have an adverse effect on those on low incomes. Accordingly, the Council considers that a residential property tax should provide some form of relief for those on low incomes. There is a choice of schemes available from other countries and an extensive literature which could help to overcome these problems.

It is sometimes argued that existing commercial rates are a disincentive to developing and upgrading property. In urban areas the Council recommends that consideration be given to reducing the burden of rates on buildings while raising it on sites: this implies valuing sites separately from buildings and taxing sites at a higher rate than buildings. Copeland and Walsh (1975) have presented evidence to suggest that the economic case for lessening tax on buildings and increasing it on sites is convincing.

With regard to the taxation of agricultural land, the Council notes and agrees with the position of the Commission on Taxation that where income from land is charged to income tax, profits from the sale of land are charged to capital gains tax and transfers of land come fully within the scope of taxes on gifts and inheritances, a further charge of land to property tax would be inequitable. The Council notes that this reasoning also applies to farm buildings.

The Council remains of the view that the achievement of its objectives for a beneficial impact on employment arising from targeted reductions in taxes on earned incomes requires a restructuring of the overall system, including the introduction of a comprehensive property tax.[54] The Council recommends that the design and implementation of such a tax should take

53 For example, if a 5% rate of return on housing is assumed then a property tax levied on 1.4% of the market value of property would be equivalent to taxing the imputed return at the current standard rate (27%).

54 For a CIF reservation on the property tax proposal, see footnote in Chapter 15.

account of the comments made above regarding different types of property and existing liability for rates.

(v) Savings and Investment

The current level of *savings* is not a constraint on the development of the Irish economy. Increasing the level of sustainable employment will however require a higher level of *investment*. In a small open economy such as Ireland there is no necessary connection between the level of savings and the level of investment.

There is some disagreement about the desirability of using the tax system to promote productive investment. On the one hand, the tax system is one of the limited number of instruments available to government to encourage investment. On the other hand, provision of investment incentives erodes the tax base and thereby requires higher tax rates in the rest of the economy. Tax expenditures suffer from the disadvantages that they are less subject to control than direct expenditure, are more difficult to evaluate, are slower to change and are more prone to distort the economy in unforseen and undesired ways.

Whatever the desirability of using the tax system to encourage productive investment, the tax system should not *discriminate against such investment*. At present the tax system provides direct incentives for a number of low risk savings options. These include pension funds, life assurance funds (which are subject only to standard rate tax), freedom from capital gains on gilts,[55] the favoured tax treatment of owner-occupied housing and special savings and investment accounts. These tax incentives for low risk investments discriminate against direct investment by individuals in more economically productive areas. Of course, this is not the only barrier to productive investment. However, given society's interest in promoting risk investment, the Council considers that it is not desirable to provide tax incentives to channel resources to low risk areas. The reduction of tax incentives which encourage the flow of savings to low risk areas must recognise the constraints imposed by the provisions of the Single Market.

If neutrality were established the issue of more positive measures to direct the flow of savings to productive investment would assume greater importance. The Council does not wish to rule out the use of tax expenditures to promote productive investment, provided that they are *carefully controlled*

55 Due to recent changes most capital gains on government securities are effectively subject to tax.

and subject to the same degree of rigorous evaluation as direct public expenditure.

The introduction of special savings and investment accounts has been a response to capital mobility and international tax competition. These factors have a number of consequences. They provide incentives to invest in financial assets rather than real assets. They also affect the relative tax burden between labour and capital. This may have adverse consequences on wage moderation. These problems are shared by other European countries. International co-operation is needed to cope with the effects of capital mobility. Dreze and Malinvaud (1993) identify two possible approaches. The first consists of organised reporting at an EC-level of all interest income of residents, which could then be subject to income tax in the home country. This approach is currently advocated by Denmark and the Netherlands. Alternatively a substantial withholding tax on all interest income of residents could be organised on a uniform basis at the European level. The Council considers that a uniform withholding tax is likely to be the more effective approach and recommends that proposals for such action at European level should be actively pursued.

Direct Expenditure Tax:

There has been no official response to the Commission on Taxation's proposals to replace the higher rate of income tax with a direct expenditure tax, which would remove many of the anomalies arising from the present mixture of income and direct expenditure taxes. Furthermore, it would address some of the vexed issues arising from the differential treatment of savings and investments in different forms.

It is beyond the scope of this report to explore this issue, but the possibility of an efficient and non-discriminatory tax on higher incomes should be pursued. It would be revenue neutral, removing some existing incentives and replacing them with a general allowance for saving and investment.

(vi) Carbon Taxes

The rationale for a carbon tax derives in the first place from environmental concerns. The rationale is to increase the price of energy to make it more accurately reflect total social costs (i.e. including environmental costs). Such a tax has been proposed by the European Commission. The purpose of a carbon tax is to reduce carbon dioxide emissions and energy use.

The ESRI has published a study of the economic impact of carbon taxes. In this study, Fitzgerald and McCoy (1992) have modelled the effects of introducing a carbon tax on a unilateral basis in Ireland. If there is no other tax adjustment, the introduction of the carbon tax results in a fall in GNP, employment and competitiveness. There would be adverse competitive effects for Irish industry, not only in relation to EC competitors, but also in relation to non-EC countries. However, if the proceeds of the tax were applied exclusively to a reduction in PRSI rates, the imposition of the tax could have a beneficial impact on employment. The reason for the positive impact is that, while Ireland is a net importer of energy, Irish industry is not very energy intensive, but it is a large employer of labour.

However, the revenue estimates used by Fitzgerald and McCoy were for illustrative purposes only. The package currently emerging at EC level would yield revenues well below those used by Fitzgerald and McCoy. The positive impact from the redistribution of such revenues, as identified by the authors, would therefore be of considerably smaller magnitude.

The analysis was based on unilateral adoption of the tax by Ireland. However, if the EC proposal is accepted, the tax will be imposed throughout the EC. The impact of such a tax at EC level is uncertain, although some research suggests that growth would be slightly lower as a result of the tax. Lower EC growth would, of course, adversely affect Ireland's economic performance. It would therefore be necessary to consider the likely economic affect on Ireland and the EC in any evaluation of a carbon tax.

The ESRI's study also addressed the distributional aspects of a carbon tax. It was found to have a higher incidence on lower income households which spend a higher proportion of their income on fuels. It would therefore be necessary to take measures to alleviate the impact of the tax on lower income households. There are a number of options, but such measures would need to be carefully constructed, to avoid either widening existing poverty traps or the creation of new ones. It must be recognised however, that use of carbon tax revenues for this purpose will somewhat reduce the amount available for redistribution through other channels, such as PRSI reduction, and this would further limit the potential benefits of the tax.

Companies who are intensive consumers of energy would be adversely affected. A report commissioned by the Department of Enterprise and Employment into the industrial implications of the carbon/energy tax found that energy costs would rise significantly, and for certain sectors and sub-sectors of Irish industry, growth and employment prospects could be impaired. For a number of energy intensive firms in Ireland, the threat to their viability was judged to be significant. Even if there is an equivalent reduction in social insurance contributions so that there is no increase in total costs to industry as a whole, some energy intensive enterprises would suffer net losses. The implications for mobile investment and the regional implications of a carbon tax also need to be considered.

(vii) Indirect Taxation

The following considerations should inform the general direction of policy on indirect taxation. Firstly, the Council reiterates its view that the principle of broadening the base and reducing rates applies to indirect taxation as it does to direct taxation. Application of this principle promotes both economic and administrative efficiency. While it could be argued that a more complex rate structure would be desirable on distribution grounds, the Council considers that indirect taxation is not an efficient way of pursuing redistributive objectives.

Secondly, applying the principle of broadening the base will have undesirable distributional consequences. The Council is in no doubt that the movement in this direction must be accompanied by a set of compensatory measures. This requires a targeted set of measures, rather than generalised social welfare increases.

Thirdly, indirect taxation needs to conform to EC requirements. The EC VAT Rates Directive stipulates that the standard rate of VAT cannot be lower than 15%; it gives member states the option of having two reduced rates (minimum of 5%) applicable to a specified list of goods and services; member states with existing zero rates also have the option of retaining this until at least end-1996. Strictly speaking, the introduction of a 3% VAT rate on currently zero-rated items as recommended in *A Strategy for the Nineties* would not be permitted. However, the Council recommends its application as a transitional measure.

11. CONCLUSIONS

The scope for tax reductions is limited given the needs of the population and the need to reduce the debt/GNP ratio. However, there is considerable scope for tax *reform* to contribute to the growth of sustainable employment. Possibly the most significant negative impact on employment is the levying of taxes (including PRSI) at low income levels. Another fundamental problem is the provision of incentives which are operated on a domino

principle: one tax incentive is granted and another has to be added to compensate for a change created by the first, and so on potentially indefinitely.

The Council views tax reform as a central part of its strategy to increase employment and reduce unemployment. The Council considers that, from this perspective, the focus should be on reducing *effective* tax rates on earned income. The Council further believes that it is reasonable to infer from certain key characteristics of the labour market (see Section 10(i) above) that reducing the relative cost of employing lower paid employees would make the most direct contribution to reducing unemployment. Reducing the impact of taxation on the cost of lower paid employees would be of general benefit to new entrants to the labour force who typically start on modest earnings.

In *A Strategy for the Nineties*, the Council recommended the introduction of a single lower rate of employees' PRSI without exemption at the lower end or a ceiling at the upper end. The Council is of the view that, as part of its overall programe of tax reform, a restructuring of PRSI can contribute to improved employment performance.

The impact on employment of restructuring PRSI could be maximised if the restructuring was focused on achieving greater reductions at lower income levels, given the labour market characteristics outlined above. This could be achived by, for example (a) a progressive rate structure or (b) an exemption from employer's PRSI for low-wage employees which would be phased out in a linear manner. This approach is recommended by Dreze and Malinvaud (1993). However, this approach would have to have regard to the impact on marginal tax rates and the potentially negative effects of high marginal rates. A long-run solution could be to replace PRSI with a more braodly-based social security tax (i.e. including non-wage forms of income in the base). The Council considers that these options for restructuring PRSI merit serious consideration.

While the introduction of a carbon tax would adversely affect employment in energy intensive companies, it would make it possible to make more progress in reforming PRSI which would promote employment.

The Council considers that income tax reductions should be directed towards those in the lower to middle range of the income distribution. This can be achieved in a number of different ways: increasing the standard rate band, increasing personal allowances/ exemption limit, reducing the standard rate (or more radically replacing personal allowances with tax credits). These changes would improve both efficiency and equity. Given the need to reduce the debt/GNP ratio, significant movement in these areas requires base widening measures.

The most significant base widening measure required is the introduction of a property tax. However, it is important to emphasise that there are other significant base widening opportunities. In particular, if it is decided *not* to introduce a property tax, then the Council recommends restrictions on mortgage interest relief. Chapter 12 highlights some of the difficulties which arise in part from the differential tax treatment of saving and investment media. It underlines the urgent need for a detailed review of this area with a view to, at a minimum, establishing greater neutrality. Other feasible base widening measures include abolition of exemptions for capital gains tax.

The Council recommends the reduction of reliefs in the savings market which discriminate against productive investment. The Council does not wish to rule out the use of tax expenditures to facilitate productive investment, but emphasises that such expenditures need to be subject to the same degree of rigorous control as direct public expenditure. The Council recommends that Ireland should support a uniform withholding tax at a European level to address the problems posed by capital mobility.

The Council also recommends that the principle of base broadening and rate reduction should apply to indirect, as well as direct taxation. Where there are adverse distributional consequences, these should be addressed by targeted compensatory measures.

The restructuring of the tax system recommended by the Council is designed to be revenue neutral. It is acknowledged, however, that there would be difficulties associated with implementation. The difficulties arising from base widening measures may be more immediately visible than the gains from lower income and social security taxes. Tax reform requires difficult decisions to be taken but the Council believes that over time the benefits of tax reform would become more visible.

The Council acknowledges that its proposals would lead to some increase in the effective progressivity of the system. As in *Strategy for Development* the Council accepts that the intended effect of a steeply progressive structure may be frustrated by the tax evasion and avoidance to which such a system may give rise. 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" (NESC, 1986). However, the Council recognises that the potential negative incentive effects of high marginal tax rates pose limits to the effective progressivity of the tax system.

The changes summarised here would have the effect of reducing the cost of labour while simultaneously increasing the incentive to accept employment. While individually each of these measures would have a limited impact on the demand for labour, taken together and combined with moderate income growth, macroeconomic stability, structural reform and the confidence generated accordingly, they could make a significant contribution to increasing the level of sustainable employment. They must, however, be implemented within the context of a reform of the tax system. Otherwise they too will be handicapped by measures elsewhere in the system which militate against the competitive position of the Irish economy.

APPENDICES TO CHAPTER 7

APPENDIX 7.1

Personal Income Tax at the Income Level of an APW (Excluding the Effects of Non-Standard Tax Reliefs)

	Expressed as a Percentage of Gross Earnings	
	Single People	**Two-Child Families**
Australia	21.4	16.7
Austria	8.3	4.8
Belgium	23.3	11.6
Canada	20.6	12.5
Denmark	44.4	36.0
Finland	28.3	21.8
France	8.1	1.0
Germany	18.4	8.7
Greece	n.a.	n.a.
Iceland	17.9	0.3
Ireland	24.9	16.4
Italy	18.1	14.2
Japan	8.5	2.4
Luxembourg	11.8	-
Netherlands	12.2	10.0
New Zealand	23.4	21.4
Norway	24.4	17.8
Portugal	6.1	0.9
Spain	11.3	6.4
Sweden	28.0	28.0
Switzerland	9.6	5.4
Turkey	n.a.	n.a.
United Kingdom	18.8	15.5
United States	18.6	11.3

Source: OECD. *The Tax/Benefit Position of Production Workers*. Paris. 1992

APPENDIX 7.2

Tax Structures 1980 and 1990*

(Particular Tax Revenues as % of Total Tax Receipts) (to nearest percentage point)

	Personal Income 1100		Corporate Income 1200		Income & Profits 1000		Social Security 2000		Goods & Services 5000		Gen. Consumption 5110	
	1980	1990	1980	1990	1980	1990	1980	1990	1980	1990	1980	1990
Australia*	44	45	12	13	56	57	0	0	31	28	5	9
Austria	23	21	3	3	27	26	31	33	32	32	20	21
Belgium*	35	31	6	7	41	38	30	34	26	25	17	16
Canada	34	40	12	7	47	48	11	14	33	28	12	14
Denmark	52	53	3	3	55	59	2	3	37	34	22	21
Finland	45	48	4	4	49	52	10	7	39	37	21	24
France	13	12	5	5	18	17	43	44	30	28	21	19
Germany	30	28	5	5	35	32	34	37	27	27	17	17
Greece*	15	13	4	5	19	18	33	32	41	45	13	26
Iceland	23	26	3	3	26	29	2	3	60	52	29	32
Ireland	32	32	5	5	37	37	14	15	44	42	15	21
Italy	23	22	8	4	31	38	38	33	26	26	16	15
Japan*	24	25	22	24	46	49	29	28	16	13	0	3
Lux.*	27	23	16	18	43	41	29	26	21	24	11	14
N'Lands	26	25	7	8	33	32	38	38	25	26	16	16
N.Zealand*	62	47	8	9	70	59	0	0	22	33	10	21
Norway	28	26	13	9	41	35	21	26	35	35	18	18
Portugal	N.A.	16	N.A.	7	20	25	30	27	45	44	16	20
Spain*	20	23	5	9	26	33	49	35	21	29	10	17
Sweden	41	37	2	3	43	41	29	28	24	24	13	15
Switz.	36	34	6	7	41	41	31	33	20	18	9	10
Turkey	44	27	4	7	52	33	14	21	26	28	0	20
UK	30	23	8	17	38	39	17	17	29	31	14	17
US*	37	36	10	9	47	44	26	29	17	16	7	7
Unweighted average:												
OECD Total	32	30	7	8	39	39	23	23	30	30	14	17
OECD Europe	30	27	6	7	36	35	26	26	32	32	16	19
EEC	26	25	7	8	33	34	30	28	31	32	16	18

* Figures refer to 1989 rather than 1990 for countries indicated

Source: OECD.

APPENDIX 7.3

Top and First Positive Rates of the Central Governments (1) Personal Income Tax: 1986 and Rates as of January 1992 (2) (to nearest percentage point of taxable income)

Country	TOP RATES* 1986 A	1992 B	Differences C	Country	FIRST POSITIVE RATES** 1986 D	1992 E	Differences F
Sweden	50	20	30	Austria	21	10	11
Norway (1) (3)	40	13	27	Netherlands (4)	19	13	6
New Zealand	57	33	24	Ireland	35	29(5)	6
UK	60	40	20	UK	29	20	4
Japan	70	50	20	Germany	22	19	3
US (1) (3)	50	31	19	Australia	24	22	2
Belgium (1)	72	55	17	Italy	12	10	2
Greece	63	50	13	Luxembourg	12	10	2
Austria	62	50	12	Japan	10.5	10	0.5
Spain	66	53	13	Switzerland	1	1	0
Finland (1)	51	39	12	France	5	5	0
Italy	62	50	12	Turkey	25	25	0
N'lands (4)	72	60	12	Finland	6	7	-1
Australia	57	48	9	Belgium	24	25	-1
France	65	57	8	Denmark	20	22	-2
Ireland	58	52(6)	6	US	11	15	-4
Iceland	38.5	33	5.5	Norway (4)	3	8	-5
DK (1) (3)	45	40	5	New Zealand	17.5	24	-6.5
Canada (1) (3)	34	29	5	Greece	10	18	-8
Germany	56	53	3	Canada	6	17	-11
Luxembourg	57	56	1	Spain	8	20	-12
Turkey	50	50	0	Iceland	18.5	33	-14.5
Switz. (1)	13	13	0	Sweden (7)	4	20	-16

* Countries ranked by order in column C. ** Countries ranked by order in column F.

1. Countries with important taxes at subordinate levels of government, typical rates for 1992 being *flat* Belgium 7, Canada 17, Denmark 30, Finland 16, Iceland 7, Norway 28, Sweden 31, *progressive* Japan 5 to 16, Switzerland 5 to 31 (cantonal and communal), United States 2 to 14.
2. Comparison not possible for Portugal where system is completely changed.
3. Countries with separate alternative minimum or additional income taxes on a wider tax base. In Norway the latter were increased from 6 to 8.5 per cent in 1989.
4. 1986 figures refer to the personal income tax only, where 1992 refer also to social security contributions, now levied on the same base as the income tax.
5. Reduced to 27% in the 1992 budget.
6. Reduced to 48% in the 1992 budget.
7. In 1991, the state income tax was abolished for the majority of taxpayers who now only pay local tax (31 per cent on the average).

Source: OECD

APPENDIX 7.4

Changes in Rate Structure of Corporate Income Tax of Central Government (1) (Tax rates to nearest percentage point)

COUNTRY	BASIC RATE 1986	1992
Australia	49	39
Austria*	30/40/50/55	30
Belgium	45**	39**
Canada*	36(15)**	29/24**(13/12)(5)
Denmark	50	34
Finland*	33**(17)	19**(17)
France	45	34
Germany*	56	50/36(6)
Greece	49	46/40
Iceland	51	45
Ireland	50/10	40/10
Italy*	36(10)	36(16)
Japan*	43**(19)	38**(19)
Luxembourg*	40	33(9)
Netherlands	42	40/35
New Zealand	45	33
Norway*	28(23)	0(28)
Portugal*	42/47	36(4)
Spain (2)	35	35**
Sweden	52	30
Switzerland*(3)	4-10	4-10(4-16)
Turkey	46	49
United Kingdom	35**	33**
United States	15/18/30/40/46	34**(6.5)

* Countries with corporate taxes at subordinate levels of government.
** There is a reduced rate of tax for small enterprises or for corporations with profit below a certain threshold

1. State/local tax rates are shown in brackets where information is available.
2. Special tax rates on certain enterprises such as co-operatives (20%), non-profit bodies (25%) and certain financial institutions (1%).
3. The direct federal tax is imposed at rates of 3.63% to 9.8% of net profits. As a general rule, the maximum income tax rate on profit before tax for federal, cantonal and communal taxes is approximately 20% and 35%, depending on the company's canton of residence.
4. A 5% surtax applies on taxable income between $100,000 and $333,000.
5. 24% for the manufacturing sector, otherwise 29%.
6. On distributed profits. The temporary solidarity surcharge increases the rate on retained earnings to 51.875% for calendar years 1991 and 1992, and on distributed earnings to 37.35% for each of these years.

Note: The table does not refer to the reduced rates for certain specified industries and qualified companies in a number of countries including Canada (now abolished), Greece and Ireland.

Source: OECD

APPENDIX 7.5

The Pre-corporate Tax Required Rate of Return Necessary to give a Financer a 5% After Tax Rate of Return (1) 1991

COUNTRY	Average for each source of finance			Average for each type of asset			Overall average
	retained earning	new equity	debt	buildings	machinery	inventories	
Australia	9.0	9.0	3.6	7.0	6.4	8.9	7.1
Austria	7.3	7.3	2.3	5.4	4.1	8.9	5.5
Belgium	7.1	7.1	2.4	5.3	4.0	8.9	5.4
Canada	8.1	5.5	3.5	6.3	5.3	8.1	6.2
Denmark	7.5	7.5	2.8	6.0	5.3	7.0	5.9
Finland	8.0	2.8	2.8	5.3	4.9	7.7	5.6
France	7.3	3.1	3.2	5.4	4.5	7.6	5.4
Germany	9.5	1.6	0.6	5.9	5.1	6.2	5.6
Greece	7.3	2.2	2.2	4.9	4.8	5.5	5.0
Iceland	8.0	8.0	4.3	7.7	5.8	7.6	6.7
Ireland	5.5	5.0	4.5	4.8	5.0	5.6	5.1
Italy	9.1	1.9	1.9	6.5	5.5	5.7	5.9
Japan	9.0	9.0	1.6	7.0	5.9	6.7	6.4
Luxembourg	8.1	8.1	3.0	6.8	4.9	8.9	6.3
Netherlands	7.1	7.1	2.8	6.0	5.2	5.9	5.6
New Zealand	8.3	8.3	3.9	6.7	6.3	8.0	6.8
Norway	10.0	4.5	2.4	6.4	5.3	10.6	6.8
Portugal	7.5	7.5	2.3	6.1	5.2	6.1	5.7
Spain	7.8	7.8	3.2	5.7	5.5	8.4	6.2
Sweden	6.6	4.3	2.7	5.0	4.3	6.6	5.0
Switzerland	6.6	6.6	3.1	5.6	5.1	5.8	5.4
Turkey	9.8	9.8	2.5	6.5	6.0	10.9	7.2
United Kingdom	7.7	4.6	3.5	5.7	5.2	7.8	5.9
United States	7.6	7.6	2.6	6.6	5.2	6.1	5.8
Average	**7.9**	**6.1**	**2.8**	**6.0**	**5.2**	**7.5**	**5.9**

1. No personal taxes, average inflation at 4.5 per cent average weight. Real interest rate assessed at 5% enables comparisons of effective tax rates on domestic and international investment and thereby also an assessment of whether capital export and capital import neutrality are achieved in practice. As it is seen from the table, tax systems tend almost universally to discriminate in favour of domestic investment. This effect of ACT is not included in this table.

Source: OECD, *Taxing Profits in a Global Economy*, Paris, 1992.

APPENDIX 7.6

Overall Average Required Transnational Pre-Tax Rates of Return[1]

Country	Average required rate of return		
	Domestic Investment	Residence (investment from named country into all other countries)	Source (investment from all other countries into named country)
Australia	7.1	7.3	8.1
Austria	5.5	7.2	7.1
Belgium	5.4	7.0	6.8
Canada	6.2	7.5	8.4
Denmark	5.9	6.4	7.2
Finland	5.6	6.6	7.3
France	5.4	6.6	7.9
Germany	5.6	7.7	6.4
Greece	5.0	8.3	7.4
Iceland	6.7	7.8	9.2
Ireland	5.1	8.8	6.6
Italy	5.6	7.4	6.8
Japan	6.4	8.0	8.1
Luxembourg	6.3	7.2	7.4
Netherlands	5.6	6.9	7.0
New Zealand	6.8	7.3	9.7
Norway	6.8	8.7	6.5
Portugal	5.7	9.9	7.9
Spain	6.2	7.1	8.0
Sweden	5.0	6.8	6.3
Switzerland	5.4	6.8	6.9
Turkey	7.2	8.3	8.2
United Kingdom	5.9	6.7	7.0
United States	5.8	7.1	7.4
Average	**5.9**	**7.5**	**7.5**

1 Subsidiary financed by one third loans from the parent, one third new equity from the parent, and third retentions by the subsidiary. Weighted average of three sources of finance by parent. Weighted average of three assets (machinery, buildings and inventories). Inflation of 4.5% everywhere. No personal taxes.

Source: OECD, *Taxing Profits in a Global Economy*, Paris, 1992.