

NATIONAL ECONOMIC AND SOCIAL COUNCIL

Report on Inflation

Report No. 9

**NATIONAL ECONOMIC AND SOCIAL COUNCIL
CONSTITUTION AND TERMS OF REFERENCE**

1. The main task of the National Economic and Social Council shall be to provide a forum for discussion of the principles relating to the efficient development of the national economy and the achievement of social justice, and to advise the Government through the Minister for Finance on their application. The Council shall have regard, *inter alia*, to:
 - (i) the realisation of the highest possible levels of employment at adequate reward,
 - (ii) the attainment of the highest sustainable rate of economic growth,
 - (iii) the fair and equitable distribution of the income and wealth of the nation,
 - (iv) reasonable price stability and long-term equilibrium in the balance of payments,
 - (v) the balanced development of all regions in the country, and
 - (vi) the social implications of economic growth, including the need to protect the environment.
2. The Council may consider such matters either on its own initiative or at the request of the Government.
3. Members of the Government shall be entitled to attend the Council's meetings. The Council may at any time present its views to the Government, on matters within its terms of reference. Any reports which the Council may produce shall be submitted to the Government and, together with any comments which the Government may then make thereon, shall be laid before each House of the Oireachtas and published.
4. The membership of the Council shall comprise a Chairman appointed by the Government in consultation with the interests represented on the Council
 - Ten persons nominated by agricultural organisations,
 - Ten persons nominated by the Confederation of Irish Industry and the Irish Employers' Confederation,
 - Ten persons nominated by the Irish Congress of Trade Unions,
 - Ten other persons appointed by the Government, and
 - Six persons representing Government Departments comprising one representative each from the Departments of Finance, Agriculture and Fisheries, Industry and Commerce, Labour and Local Government and one person representing the Departments of Health and Social Welfare.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 Chairman to regulate the numbers attending.
5. The term of office of members shall be for three years renewable. 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 and their membership shall then be renewable on the same basis as that of other members.
6. The Council shall have its own Secretariat, subject to the approval of the Minister for Finance in regard to numbers, remuneration and conditions of service.
7. The Council shall regulate its own procedure.

NATIONAL ECONOMIC AND SOCIAL COUNCIL

Report on Inflation

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CONTENTS

| | Page |
|--|------|
| I. Introduction | 7 |
| II. The Inflation Trap | 13 |
| III. The Inflationary Process | 16 |
| IV. The Policy Framework | 23 |
| V. The Immediate Requirements | 26 |
| VI. Policy Options for 1975 | 29 |
| VII. Policies for 1976 | 44 |
| VIII. Summary | 48 |
| Appendix A: Effects of Changes in Exchange-Rates on Agricultural Prices and Incomes | 56 |
| Appendix B: Effects of Policy Package on Pay and Prices | 59 |
| Addendum: Irish Employers' Confederation | 63 |
| Reservation: Confederation of Irish Industry | 64 |
| Reservation: Irish Congress of Trade Unions | 66 |
| Reservation: Irish Creamery Milk Suppliers' Association | 67 |

PREFACE

In June 1974 the Council commissioned a study from Professor E. V. Morgan on the *Causes and Effects of Inflation in Ireland*. This is being issued separately as NESC publication No. 10. Professor Morgan's study was discussed at a seminar on 18 April 1975. It was agreed that, following the seminar, the secretariat should draft a paper on inflation for discussion by the Economic Policy Committee and the Council. Drafts* were discussed by the Economic Policy Committee at meetings on 8 and 15 May 1975 and by the Council at meetings on 22 and 29 May and on 5 June 1975.

* The drafts were prepared by Derek Chambers and Loudon Ryan in the Council's secretariat. The Appendix on food prices was drafted by Tom Ferris.

I INTRODUCTION

1. The principal objectives of policy in the medium term are to provide increased employment at increasing real living standards. In earlier reports the Council attempted to quantify the task of achieving full employment by 1986 at living standards approaching EEC levels.* We concluded that output might have to grow at an average annual rate of 6 to 9½% if these goals were to be achieved. Growth rates of this order could be reached only by export led industrial growth—the type of growth achieved during much of the 1960s, though at much slower rates than are now required.

2. It is clear that something has gone amiss in the progress towards these objectives over the last few years. Table 1 brings together some statistics which show that the Irish growth rate has not been fast enough, relative to that achieved elsewhere, to make any progress towards closing the gap in living standards. Prices have been rising faster here than overseas, investment has not grown sufficiently, and unemployment remains a serious and growing economic and social problem. Indeed, many of these problems have got even worse in the last year or so. In Ireland, unemployment has not risen as fast as elsewhere following the oil and other commodity price† increases, but inflation has accelerated at a time when other countries have already gone a long way towards recovering from the crisis. Ireland is therefore

* See Report No. 4: *Population and Employment Projections, 1971–86*, NESC, 1974; Report No. 7: *Jobs and Living Standards*, NESC, 1975.

† It must be remembered, however, that the level of unemployment was relatively higher in Ireland than in other countries before these price increases occurred.

TABLE 1
Some Economic Indicators

| | 1969-74 (5 years) | | | | | 1975 (latest figures or estimates) | | | | |
|----------------|------------------------|-------------------|-----------|--------------------|-----------------------|------------------------------------|-------------------|---------|--------------------|------------------------|
| | Average Earnings (1,2) | Retail Prices (1) | GDP (1,3) | Unemployment (4,5) | Investment Rate (4,6) | Foreign Balance (4,6) | Retail Prices (7) | GDP (8) | Unemployment (5,9) | Foreign Balance (6,10) |
| Ireland | (120) | 67 | 19 | 1.4 | 22 | -4½ | 24 | -1 | 2.1 | -5 |
| United Kingdom | 87 | 56 | 12 | 1.5 | 18½ | -¾ | 20 | 1 | 1.6 | -2½ |
| Belgium | 100 | 38 | 23 | 1.7 | 21½ | 2 | 15½ | 2 | 3.3 | ½ |
| Denmark | 110 | 50 | 19 | 1.2 | 22½ | -2½ | 13 | 1 | 3.7 | -1½ |
| France | 83 | 44 | 31 | 2.2 | 26 | -1 | 14 | 3 | 4.9 | -1½ |
| Germany | 68 | 32 | 19 | 1.2 | 25 | 1 | 6 | 1 | 4.3 | 2½ |
| Italy | 132 | 53 | 22 | 0.9 | 20½ | 1 | 24 | -2 | 1.0 | 2½ |
| Netherlands | 86 | 43 | 24 | 2.3 | 24½ | 1½ | 10 | 2 | 4.8 | 3 |

1. Percentage change from 1969 to 1974.

2. Manufacturing industry.

3. Percentage change in GDP at constant market prices.

4. 1969 to 1974 average.

5. Expressed on a proportion of average level during the 1960s. (For Ireland, insured unemployed only.)

6. Expressed as a proportion of GDP at current market prices.

7. Percentage change over year to February 1975.

8. Forecast change, 1974 to 1975.

9. February 1975.

10. Forecast for 1975.

Source: OECD statistics; NESG estimates.

5. The immediate concern must be inflation. Prices have been rising faster and the rate is likely to reach 25% this year. On present trends, the price level could double within about three years. Some of the ill-effects

4. Exports in the first quarter of 1975 were the result of orders placed in 1974. It is impossible to get any detailed picture of export orders now in hand or of the rate at which new export orders are being obtained. However, all the information which is available indicates that exporters are finding it increasingly difficult to sell abroad at present prices, that that the price increases that will follow the increases in money incomes under the 1975 National Agreement will increase the difficulties being faced by exporters, and that investment (domestic and foreign) in export industries is tending to decline. When the expected external deficit for 1975 is adjusted to take account of factors, already in the pipe-line, which will affect the external position (for example, it can take more than 2 years before the full effect of a rise in Irish export prices, relative to those of other countries, is reflected in changes in the Irish balance of payments), and of the low and falling level of employment and output, the *underlying* balance of payments deficit will be larger in 1975 than 1974. This underlying balance gives an indication of what the actual position would be if recent and anticipated increases in unemployment were reversed (or prevented from occurring).

3. The prospects for 1976 are poor because of accelerating inflation and the associated deterioration in the underlying balance of payments. It is true that the trade deficit for the first quarter of 1975 was £17 million lower than in the first quarter of 1974, and that the current balance of payments deficit in 1975 should be considerably lower than 1974. All the main categories of imports in March, after the influence of seasonal factors have been eliminated, were significantly lower than in January 1975. This reflected the low and falling level of national output. Both agricultural and industrial exports (seasonally adjusted) have been falling since January in terms of current money values. The fall in the volume of both exports and imports has, of course, been much larger than the fall in value.

approaching 1976 with poorer prospects of being able to benefit from the upswing in world economic activity that is expected next year.

of inflation, especially at these rates, have already been described elsewhere.* The most serious effects of inflation under present circumstances are the threat to output and employment through loss of competitiveness in export markets, the cash crisis in industry, social hardship and general loss of confidence.

6. A country's competitive position is mainly determined by two inter-related factors—its costs and its exchange rate. Since the foundation of the State, the rate of exchange between the Irish pound and sterling has been maintained at par. Under these circumstances, changes in the competitive position of Irish products can only be made by changes in Irish costs relative to those in the United Kingdom—assuming that the sterling exchange rate is altered to offset movements in UK costs relative to those elsewhere. Table 2 illustrates how these costs have moved in the manufacturing sector (the key sector if full employment is to be based on the growth of industrial exports) compared with the United Kingdom. Over the last few years, earnings have been rising faster relative to productivity in Ireland than in the United Kingdom, so that the competitive position of Irish products has deteriorated. Furthermore, Ireland has been removing tariff barriers much faster than the United Kingdom (Ireland's were much higher to start with) and this has made imports even more competitive on the home market. The report on the economy in 1974 and 1975† looked at the balance of payments position in some detail and suggested that in 1974 Irish costs and prices were probably consistent with the exchange rate. It is clear that Irish inflation has eliminated the sizeable competitive advantage that existed a few years ago. These trends have disturbing implications for the future.

* No. 10: *Causes and Effects of Inflation in Ireland*, NESC, 1975, pp. 156–179. The secretariat's report on the economy in 1974 and 1975 summarised the domestic ill-effects of inflation as follows: "inflation brings unease and uncertainty, it tends to redistribute wealth to those who are financially sophisticated (usually the better off), it distorts the incentives within the economy and encourages the pursuit of speculative/financial activities rather than increased real output, it favours borrowers at the expense of savers and can jeopardise medium-term economic expansion by eating into real profits and discouraging productive investment. Finally, inflation tends to feed on itself and accelerate".

† Report No. 3: *The Economy in 1974 and Outlook for 1975*, NESC Secretariat, 1974.

TABLE 2
Trends in Unit Wage and Salary Costs
(Manufacturing industry only, 1971 = 100)

| | 1960 | 1965 | 1970 | 1975 |
|--|------|------|------|------|
| Ireland: | | | | |
| Output | 52 | 70 | 96 | 121 |
| Average earnings | 37 | 53 | 87 | 209 |
| Employment | 77 | 88 | 101 | 104 |
| Productivity | 68 | 80 | 95 | 117 |
| Unit wage costs | 56 | 67 | 91 | 180 |
| United Kingdom: | | | | |
| Output | 75 | 88 | 100 | 111 |
| Average earnings | 44 | 57 | 85 | 177 |
| Employment | 111 | 113 | 110 | 95 |
| Productivity | 68 | 78 | 91 | 117 |
| Unit wage costs | 65 | 74 | 93 | 151 |
| Index of relative unit wage costs: Ireland/UK x 100 | 86 | 91 | 100 | 119 |

TABLE 2—continued

Ireland: Money Incomes In Agriculture and Industry

| | 1960 | 1965 | 1970 | 1971 | 1972 | 1973 | 1974 |
|--|-------|-------|---------|---------|---------|---------|---------|
| (a) Average industrial earnings | 431.3 | 615.2 | 999.0 | 1,150.6 | 1,329.4 | 1,591.6 | 1,849.1 |
| (b) Average industrial (male) earnings £ (1) | 508.6 | 718.6 | 1,206.4 | 1,388.4 | 1,588.1 | 1,878.2 | 2,213.1 |
| (c) Average <i>per capita</i> farm incomes £ (2) | 332.2 | 486.2 | 748.7 | 854.5 | 1,220.5 | 1,666.7 | 1,412.7 |
| (d) (c) as a percentage of (a) | 77.0% | 79.0% | 74.9% | 74.3% | 91.8% | 105.4% | 76.4% |
| (e) (c) as a percentage of (b) | 65.3% | 67.7% | 62.1% | 61.5% | 76.9% | 88.7% | 63.8% |

12

(1) For 1960 and 1965, the figures related to one week in October and were collected for males aged 18 years and over. For 1970-1974, the figures are the average for the four quarters and relate to males on adult rates of pay. For all years, the weekly figure available was multiplied by 52 to give the figures shown in the table.

(2) Family Farm Income divided by the number of farmers and farmers' relatives.

Sources: UK: National Income and Expenditure; National Institute Economic Review; OECD Labour Force Statistics. Ireland: Census of Industrial Production; Quarterly Industrial Inquiry; OECD Labour Force Statistics. NES estimates.

II THE INFLATION TRAP

7. If inflation continues to accelerate and if the competitive position continues to deteriorate, then the following is very likely to happen. First, the underlying balance of payments position will deteriorate.* (The actual external deficit may improve, but only because of increased unemployment and the resulting lower demand for imports.) Because the prices of Irish goods will be rising faster than the prices of those produced in other countries, people abroad will tend to buy less Irish goods and more of those produced elsewhere (i.e., exports will fall) and Irish people may tend to buy foreign goods instead of Irish goods (i.e., imports will rise). This change in buying patterns will reduce the demand for Irish goods and cause a fall in employment in Ireland. If the Government, in the interests of preserving employment, were to increase the level of total demand in order to raise the demand for Irish goods, the balance of payments position would deteriorate further because there would also be an increase in the demand for imports.

8. A balance of payments deficit has to be financed by borrowing money abroad.† Overseas Governments, institutions, and firms will lend this money only if there is the prospect of being repaid. A steadily increasing deficit in the Irish balance of payments would not offer lenders this prospect and would eventually lead to a loss of confidence in Ireland's ability to repay. This in turn would mean that loans would not be forthcoming, so that Ireland would not have the foreign currency needed to pay for its imports.

9. These developments could *force* the Irish Government into one or other or both of two policies—first, deflation; second, devaluation.

*See paragraph 4 above for an explanation of what is meant by the underlying balance of payments.

†An external deficit can be financed, but only for a limited period, by running down external reserves.

13

Deflation means cutting demand and therefore expenditure by cutting government expenditure or raising taxes. The inevitable result would be more unemployment—something that all would wish to avoid. Devaluation of the Irish pound would make Irish goods cheaper in terms of foreign currencies and foreign goods more expensive in terms of Irish pounds. The initial effect would be to make both the rate of increase in domestic prices and the balance of payments position worse. The hope, however, would be that a devaluation would make Irish goods more competitive and thus lead to increased demand for them, and hence to further export growth, increased employment and a recovery in the balance of payments.* But the success of a devaluation depends on policies being applied which facilitate the necessary transfer overseas of a larger proportion of national output. This in turn means that there must not be increases in money incomes to offset the rise in prices in Ireland which resulted from the rise in the prices of imported goods.

10. Devaluation would merely recognise the fact that real incomes were higher than could be sustained by domestic output. *A devaluation would succeed only if average real incomes were reduced.* If the Irish community were to offset the fall in living standards by paying itself higher money incomes, this would raise prices further and leave the economy with an even faster rate of inflation. In other words, the economy would be back to where it started, needing devaluation or deflation.

11. Even if money incomes were not raised to prevent the fall in real incomes, any beneficial effects that might follow devaluation would not occur immediately. It could take some considerable time for exports to react fully to the additional opportunities abroad, and therefore for the

* A similar effect can also be produced by substitution of Irish goods for imported goods on the Irish market. It is not of great importance whether exports are increased or there is import substitution, so long as the total effect exceeds the initial unfavourable terms of trade effect (lower export prices in terms of foreign currency and higher import prices in terms of Irish pounds) of the devaluation. If an Irish devaluation were accompanied by the successful implementation of the necessary accompanying policies (restraint of domestic demand and incomes) the overall effect of an Irish devaluation would be an improvement in the balance of payments. The effects of devaluation on agricultural trade and prices are discussed in Appendix A.

balance of payments to recover from the initial "terms-of-trade effect" and get back even to where it was to start with. In the meantime, overseas creditors might lose patience or confidence, and increasing unwillingness to hold Irish pounds or to lend foreign currency to cover the external deficit could lead to another devaluation. Another (though somewhat similar) problem is that the increased volume of exports required if the devaluation is to work might require investment in additional export capacity. Much of this kind of investment in Ireland is undertaken by foreigners. The risk of losing money if the Irish pound is devalued further might dissuade potential investors from investing in Ireland, making another devaluation all the more likely.

12. All this means that devaluation might not be enough in itself. Indeed, if devaluation were the only measure used the economy could get into a "vicious circle" of accelerating inflation and a depreciating exchange rate, both being continuously aggravated by erosion of confidence in the country's ability to solve its problems and in its currency. Sooner or later severe deflation would become the only way out. *This would imply a prolonged period of greatly increased unemployment, perhaps even major social or political crises.*

13. This is a picture of what could happen if domestic efforts to expand demand, output and employment continue to be associated with accelerating inflation and loss of competitiveness. The easiest course is to convince ourselves that what has been happening is inevitable, and considerable success has already been achieved in this direction. The hardest course is to face the logic of a continuation of past trends and to take steps that will re-establish the conditions in which significant progress can again be achieved towards increasing employment and raising living standards. The most important single step is to slow down the rate of inflation. If this is to be achieved, it is necessary to try to identify how the inflationary process has developed in Ireland in recent years.

III THE INFLATIONARY PROCESS

14. The previous section described what could happen if present inflationary trends were allowed to continue. If the rate of inflation in Ireland is to be slowed down, its causes must be identified and social and political realities recognised. Without agreement on the causes, there is unlikely to be agreement on the broad policies that would remove them or mitigate their effects. If the policies are to be effective, they must take into account what can be done in practice rather than what might be done in theory.

15. There has been controversy about the relative importance of the various causes of inflation in this country. There is general agreement that in recent years a significant part of Irish inflation has been "imported"—that is, caused by price increases that have occurred outside this country. Directly imported inflation was particularly important between 1972 and early 1974, but is relatively much less important in 1975. Some part of Irish inflation has been the result of domestic causes.* The strength of these has varied from one year to another, but they have become relatively more important in 1975.

16. The main ways in which inflation is imported can be stated briefly. Ireland is a small country which must import raw materials, materials for further processing, machinery and other capital goods and finished goods for everyday consumption, and which exports a significant part of its agricultural and industrial output. If the prices at which Irish exporters can sell their products outside Ireland rise, then these products will in general only be supplied to the home market if a similar increase in prices can be obtained. Higher intervention prices for butter, skim

* See, for example, the March 1973 Report of the National Prices Commission. Paragraph 18 states: "Over the past five or six years, money incomes have been rising at a faster rate than could be justified by the impact of increases in import and export prices on the consumer price index and by the increases in output per person employed".

milk and beef, resulting from EEC decisions, necessarily mean higher prices for milk, dairy produce and meat in this country.

17. Imported goods are bought with foreign currencies. If their prices in foreign currencies rise, then (given the rates of exchange between the Irish pound and other currencies) their prices will rise correspondingly in terms of Irish money. If the prices of imported raw materials, materials for further production and capital goods rise, then costs of production in this country are increased. Generally firms must raise their prices to cover these increases in costs if they are not to be forced out of business. If the prices of imported finished goods rise, then these increases are reflected quickly in the shops. The effects of changes in exchange rates on food prices are discussed in Appendix A.

18. In recent years, the prices at which exports can be sold, and the prices that have to be paid for imports in terms of foreign currencies, have both risen sharply. All countries were affected by the sharp rise in the prices of basic commodities that accompanied the rapid growth in world output and trade during 1972 and 1973. All western countries were affected by the very large increase in oil prices at the end of 1973. But for Ireland, these price increases have been even more severe by the fall in the value of the Irish pound (in line with sterling) in terms of other currencies. For example, if the price of some basic commodity doubles in terms of Deutschmarks (say from DM 100 to DM 200) and if the external value of the Irish pound is halved (say it falls from £1 = DM 10 to £1 = DM 5), then its price in Irish money will rise fourfold (from £10 to £40).

19. There is no precise and satisfactory way of measuring the contribution that imported inflation has made to the price increases that have occurred in this country. Since the general price level* in Ireland

* For example, the consumer price index has risen faster here than in Britain, even though the price of food has risen more slowly here than in Britain since before accession to EEC. Moreover, the differences in the rates of increase in prices in the two countries cannot be explained by differences in indirect tax rates and subsidies. Nor can the differences be explained by the differing effects of the "oil-crisis"—Irish prices had been rising faster than in Britain before November 1973. The best measure of changes in Irish prices is the implicit price deflator of GDP at factor cost, which excludes the direct effects of import prices, indirect taxes and subsidies. This has been rising faster here than has the corresponding index for Britain.

has risen faster than in Britain, it would be difficult to sustain any argument that imported inflation by itself is a sufficient explanation of what has happened here. To argue that, given the relationship between the Irish pound and sterling, Irish prices must necessarily rise at the same rate as in Britain would mean accepting that Government, trade unions and employers in Ireland are powerless to affect the behaviour of any prices in this country. This argument cannot be sustained.* The Government, trade unions and employers can, and do, affect prices and pay in Ireland, and believe that they have the power to affect them.

20. Imported inflation has been a powerful force generating inflation here. But the subsequent reactions to this imported inflation by Govern-

* The most that can be said is that, if the one-to-one parity is maintained over the long run, there will be market forces which will tend to bring the Irish price level towards the British level. This long-run "equilibrium" concept is a useful analytical tool for economists. But the existence of these forces does not mean that prices, output, employment and so on are beyond Irish control, or that policy can achieve nothing. It is useful to keep three points in mind:

- (a) At any given time the economy will have suffered shocks, external or internal, and market forces will be *tending* to bring the price level towards the UK level. But the economy is not really expected ever to reach the "equilibrium" situation, and even if it did there is no reason to think that it would stay there. Since the economy will always be in disequilibrium it matters a great deal whether, over a run of years, prices are below those in Britain and being forced up (i.e. demand for Irish goods is stronger than would otherwise be the case, and hence output and employment are higher) or vice versa.
- (b) While the price level may be influenced by UK developments, the influence on wage costs is less straightforward. It is possible to imagine Ireland in "equilibrium" with regard to prices (if only for a very short period), but with wages higher and profit margins lower than in Britain (which would suggest low profits, low investment, little output growth, little employment growth) or vice versa. In other words even if prices are strongly influenced by developments in the United Kingdom there is still room for some interchange of pay and employment levels.
- (c) If Irish price developments get seriously out of line with the United Kingdom, economic forces could bring Ireland back towards the British price level. On the other hand, the basic assumption of the one-to-one sterling parity, could break down before "equilibrium" were reached. This could mean forced devaluation or revaluation, depending on whether Irish costs and prices were "too high" or "too low" compared with the United Kingdom.

ment, trade unions and employers have magnified its effects on the Irish price level. In other words, actions within this country, even if triggered by what has happened elsewhere, have caused a part (and now a growing part) of the rise in Irish prices. These domestic causes of inflation (or contributions to it) must therefore be examined.

21. The rises in import prices reduce the real purchasing power of earned incomes in Ireland. In the past increases in money incomes have been sought to compensate for these price increases. But it is not only import price increases which lead to demands for compensating increases in money incomes—any price rise can be expected to have the same result. The consequence of the compensating increase in money incomes is a price rise, leading to further income and price increases. Price increases have probably been the most important single factor generating pay increases (and therefore further price increases) in recent years, with the inevitable result of a domestic inflationary spiral (incomes chasing prices and prices chasing incomes). This incomes/prices spiral, although frequently set off by imported inflation of one of the types described above, has been an important domestic source of inflation. In recent years it may even have become more potent as all seek compensation not only for past price increases but for future (even greater) price increases and for that part of the increased incomes which they will lose in additional direct tax payments.

22. In recent years the domestic incomes/prices spiral has received institutional support from the National Agreements. These Agreements have been reached, not because the inflationary consequences were desired, but because they have been one way of trying to ensure that real employee incomes keep pace with inflation and give some increase in real living standards, because the settlements had to be acceptable to groups in a strong bargaining position, because they made provision for groups in a weak bargaining position, and because they reduced industrial strife. These aims are shared by both employers and employees. The basic increases in money incomes have been determined by free negotiations between employers and unions and ratified by both sides.

23. However, the domestic pay/price spiral has been only one reason for the increases that have occurred in money incomes. Increases have

been sought by particular groups to improve or restore their pay differentials. Groups in a strong bargaining position were able to press these claims to a successful conclusion. In doing so, from their viewpoint they removed an anomaly—but may have created an anomaly from the viewpoint of others. Another continuing process of incomes increases was therefore created and was enabled to become self-perpetuating by monetary and fiscal policies which facilitated it. These increases have been added to the basic increases in the National Agreements.

24. The pay increases can be passed on in higher prices by firms whose activities are sheltered from external competition. Exporters or firms subject to competition from abroad may not be able to raise their prices, so that profits are reduced (or, in the case of farmers, net incomes are lowered).

25. In the negotiation of National Agreements in the Employer/Labour Conference, the Government and the public sector have been represented in their role as employers. The principle of National Agreements has been supported by successive Governments. The White Paper on *A National Partnership*, published in November 1974, accepted indexation of employee incomes. The first phase of the 1975 Agreement gave full indexation. The remaining three phases each give a minimum increase of 4% (if prices rise by 4% or less) and a maximum of 5% (if prices rise by 5% or more).

26. The National Agreements have had important implications for public expenditure. A large part of public current expenditure is influenced by movements in wages and salaries. Increases under National Agreements must be paid to those directly or indirectly employed by the public sector. Anomaly settlements have been negotiated under the National Agreements for public servants and these have further increased public spending. As well as the National Agreements, there has been continuing pressure to raise social welfare payments (such as old age pensions, children's allowances and unemployment benefit and assistance) in line with pay increases, if not faster. Other current Government expenditure has risen in line with prices.

27. This increased expenditure has been needed merely to maintain the level of public spending in real terms. In addition, there have been pressures to improve existing services (such as education and health) and to introduce new policies. These add to the rate of increase in public spending. Moreover, there have been substantial increases in the cost of servicing Government borrowing undertaken to finance spending in previous and current years. The net result has been that public expenditure has risen faster than the value of national output.*

28. Despite the rise in prices and in money incomes, the revenue from direct and indirect taxes (at the existing rates) has not risen fast enough to match the growth in public spending. In their attempt to bridge the growing gap between revenue and expenditure by increases in tax rates, Governments faced real constraints. Increases in the rate of indirect taxation raise prices and therefore the consumer price index and hence employee incomes. Given the size of the public sector, a significant proportion of the additional revenue from higher indirect taxation may be needed to meet the consequent increases in public service remuneration and social welfare payments.

29. In an inflationary period, the value in real terms of personal and dependants' allowances is reduced. Moreover, increases in money incomes bring the recipients into higher direct tax brackets. As a result the spendable incomes (that is, after direct taxation has been paid) of employees rise at a slower rate than their incomes before tax. If the increases in money incomes were claimed in order to maintain or improve real incomes, then after they have paid their taxes the claimants feel that they have been thwarted. In these circumstances, all the pressures are for increases in tax allowances and for reductions in tax rates. If tax rates are raised, further increases in money incomes may be demanded to escape the cut in real incomes, thus adding to the inflationary pressures and (when facilitated by monetary and credit policies) sparking off a spiral of tax rise, money income rise, price and tax rise again.

* Public current expenditure plus the Public Capital Programme rose from over 39% of GNP in 1969-70 to 46% this year.

30. The net result of these influences has been that public expenditure has risen much faster than tax revenues. As a consequence, the net borrowing requirement of the Government has risen dramatically and is now about 13% of the gross national product. These requirements have been met from a net expansion of bank credit and from State and State-guaranteed external borrowing. These borrowings are an approximate measure of the extent to which Government adds to the purchasing power within the country.

31. The increased level of national spending that results creates an environment that is favourable to inflation. The demand for goods and services is more buoyant. Firms sheltered from external competition find it easier to raise their prices and pass on increases in their costs. Higher increases in money incomes may be sought because the pressure of demand makes it more likely that they will be granted. More goods are imported, or goods that might be exported are diverted to meet the demands of the home market, so that the current external deficit becomes larger. Ultimately, the competitiveness of Irish goods is adversely affected, and the balance of payments deteriorates and unemployment rises. These do not stop the process—indeed, over a limited range, the rise in unemployment may become a reason why it is maintained.

32. The domestic sources of inflation that have been discussed in this section cannot be kept in water-tight compartments. Each institution and each cause has been influenced by, and at the same time has influenced, the others. Frequently the domestic sources are a reaction to influences from overseas.

IV THE POLICY FRAMEWORK

33. When the inflationary influences are so intertwined there is little point in attempting to apportion responsibility*. It is clear, however, that if policies and attitudes remain as they are at present, then the problem is likely to continue to worsen and the gloomy picture sketched in Section II (the combination of accelerating inflation, massive unemployment and devaluation) could become more and more realistic.†

34. One possibility would be for the Government, acting on its own, to "do something about it", by introducing strong deflationary policies before they are imposed from the outside. Table I gives a very rough indication of what this might imply. Since the oil crisis Ireland has performed better than most other EEC countries in maintaining demand, output and employment. Unemployment among insured employees has risen to about double the level of the 1960's and emigration has stopped. In many other countries the unemployment level is now about four times that of the 1960's and emigration (or the return of immigrant workers) has begun. But this has helped these other countries to make

* In its report on *Incomes and Prices Policy*, published in the spring of 1970, the National Industrial Economic Council concluded that in any examination and discussion of inflation it very soon became clear that no one was prepared to accept primary responsibility either for causing it or curing it. There was universal acceptance that dire consequences would follow if Irish inflation proceeded for long at a rate faster than inflation in neighbouring countries. At the same time, no body or agency was prepared to accept that it or its members had made, or were making, a major contribution to inflation. Each saw itself as making the minimum adjustment to what the others had done. It was the view of NIEC that, unless those who contributed towards inflation were prepared to recognise and accept responsibility for their contribution there was very little hope of keeping inflation in Ireland within the bounds of what was occurring in other countries.

†It was the unanimous conclusion of NIEC that, if the then current rate of domestic inflation was not curbed, even the existing level of employment could not be maintained and that it would be utterly unrealistic for Ireland to aspire towards full employment. Subsequent events have confirmed the NIEC's predictions.

progress towards solving the inflation problem while the Irish record has been bad—partly because the maintenance of relatively high levels of demand accommodated this inflation. If the Government were to try to reduce the rate of inflation in this way, an increase in unemployment to much higher levels than those now existing, and a return of large-scale emigration, might be involved.

35. The opposition to deflationary policies remains strong, because of the effects they would have on unemployment. But if present trends continue, the difficulty of financing the growing budgetary and external deficits, associated with attempts to expand output and employment, could soon make deflationary policies unavoidable. Action to reduce the rate of inflation is urgently required. If "voluntary" deflation is unacceptable, and if "involuntary" deflation is to be avoided, what alternative courses of action exist?

36. The preceding discussion suggests that there are two broad strands to the inflation problem:

- (i) the effective demands by Irish society (employers, employees, farmers, government, pensioners, parents, etc.) add up to more than the national output;
- (ii) the processes by which Ireland reacts to external shocks to the economy have reinforced the external inflationary pressures.

The danger with this sort of statement is that it tends to lead into discussions of inflation in terms of human nature and attitudes. These may be important but they cannot be changed quickly*. However,

* The emphasis on attitudes and on the influences which determine them is dangerous to the extent that it focusses attention on things which are virtually unalterable in the short-term. The result can too easily be a climate of opinion in which inflation is regarded as inevitable, because no action that seems possible can alter the attitudes which are seen as the fundamental causes of it. Recent economic history gives little support for any such conclusion. Other EEC countries in the last few years have suffered accelerating inflation but most are succeeding in reducing the rate of inflation in 1975 as compared with 1974. It is worth remembering that Ireland has had a similar success in the past. In 1965-66, corrective measures were applied which eliminated excess demand and the "Tenth Round" increases in

there are things which can be done to allow economic and social development to proceed without intolerable and accelerating inflation. These are discussed in the next three sections.

incomes (£1 per week) were moderate. These measures set the stage for the export-led expansion of 1967. The domestic inflationary pressures that developed thereafter were not inevitable.

The efficacy of understanding inflation and its causes in achieving a slower rate of inflation is open to question. Government, employers and unions were represented on the NIEC. The NIEC reports on the *Economy in 1968 and the Prospects for 1969*, the *Economy in 1969 and the Prospects for 1970* and *Incomes and Prices Policy* all showed a deep understanding of the causes, consequences and dangers of inflation and of the policies by which it might be slowed down. Nevertheless, inflation has accelerated over the last five years.

V THE IMMEDIATE REQUIREMENTS

37. In recent years, a considerable part of Irish inflation has been imported; a growing part is now being generated domestically. The effect on the Irish price level of the higher prices that have to be paid for imports or at which exports can be sold could be reduced if the Irish pound were revalued against other currencies. At present, the Irish pound and sterling exchange at par. If the Irish pound could be revalued—to take an example, if the rate could be changed from £1 sterling = £1 Irish to £1 sterling = 90 pence Irish—and if (as is generally the case) the prices of imports and exports are fixed in terms of foreign currencies, the immediate effects would be as follows.

An imported item that cost £1,000 sterling would now cost only £900 Irish (ignoring insurance and freight). But an exporter who could sell his product for £1,000 sterling would now receive only £900 Irish.

38. Revaluation of the currency against sterling could therefore be a very powerful once-for-all means of moderating the effect on the economy of price increases emanating from abroad. However, revaluation could not be contemplated in present circumstances. The competitive advantage which Irish goods possessed a few years ago is fast disappearing. At present, the underlying external deficit is very large and inflation is proceeding at a rate substantially higher than in other countries—the reverse of the conditions normally required for a successful revaluation. In these circumstances, a revaluation would have serious effects on output and employment. These are illustrated by the example at the end of the previous paragraph. Many exporters are now finding it difficult to get prices in foreign currencies which cover their costs in Irish pounds. If an exporter's receipts were to fall from £1,000 Irish to

£900 Irish, because of revaluation of the currency and because his export prices are fixed in terms of foreign exchange by world market conditions, he could no longer cover his costs. He would go out of business and his workers would become unemployed.

39. In present circumstances, therefore, the aim must be to avoid devaluation and to create the conditions in which the link with sterling could be broken and/or the Irish pound revalued if strong inflationary trends continue outside Ireland (notably in the United Kingdom). The only way to do this is to bring the rate of inflation in Ireland down below that obtaining in the United Kingdom. This would restore the competitive advantage of Irish goods, making revaluation against sterling (and therefore better insulation of the economy against external inflationary pressures) a feasible step.

40. This cannot be achieved instantaneously but it can be done over a relatively short period. If for a few years, the rate of inflation in Ireland could be kept below that in the UK (say, by 3 to 5 percentage points), and there was some prospect of this margin being maintained, then a revaluation against sterling could be contemplated and would have some prospect of being successful. Considering the likely rate of inflation in the United Kingdom, this would not imply draconian measures to reduce the Irish inflation rate. Rather it implies that if, for example, the Irish rate can be reduced successfully by domestic policy to 10% (assuming a UK rate of about 15%), then after a relatively short time the sterling link could be broken, and the Irish pound could be revalued against sterling, thus offsetting some of the external inflationary forces. If the efforts to restrain domestic inflation continued to be successful, and if the external inflationary forces remained strong, further periodic revaluations would be feasible and desirable*.

* In practice, once the link with sterling was broken, the Irish pound would probably be linked to a stronger currency or currencies. The maintenance of the new link would probably mean continuing and gradual revaluations against sterling. The new link would also mean that the external inflationary forces affecting the Irish economy would be weaker, and the link with stronger currencies would impose greater discipline on domestic policies and actions. The possibility of allowing the Irish pound to "float" alone is not considered, because the Irish economy is too small to withstand the pressures that could build up in foreign exchange markets.

41. It is true that a revaluation of the Irish pound might add another complication to the relationship between the Republic and Northern Ireland. This would be regrettable. However, the Republic cannot continue indefinitely with its price level and general economic prospects being so closely related to those in the UK, if policies in the latter do not become more effective in restraining inflation and in accelerating economic growth.

VI POLICY OPTIONS FOR 1975*

42. Action to reduce the rate of inflation is therefore urgently required. It is necessary in order to establish the conditions for any sustainable expansion in national output and employment. The previous sections have shown that in present circumstances, there could not be a revaluation of the Irish pound relative to sterling, to reduce the impact of overseas inflation on Irish prices. This means that the rate of inflation can be reduced only by first tackling the inflationary forces at work within this country—mainly, the behaviour of money incomes and domestic economic policies.

43. Given the terms of the 1975 National Agreement, existing policies and likely developments in the world economy, the prospects for 1975 are as follows:—

- (i) A fall in national output of 1% to 2%, and a further rise in unemployment of 20,000 to 30,000 in the course of the year.
- (ii) A rise in the consumer price index of 25% or more, and a continuing squeeze on cash flows in the private sector. This latter will cause redundancies and reduce investment.
- (iii) Public sector borrowing which will be much larger than was expected at the time of the budget and which may be difficult to finance.
- (iv) The current external deficit will be considerably lower in 1975 than in 1974, but only as a result of the low levels of demand, output and employment. The erosion of the competitiveness of Irish goods means that any attempt to expand output and employment (unless accompanied by effective measures to

* This section and the one which follows recommend specific changes in taxation and public expenditure. The Secretaries of Departments who are members of the Council cannot, of course, commit their Ministers to these recommendations.

reduce the rate of increase in costs and prices) would cause a large increase in the external deficit—so large that the attempts to correct it would force the application of deflationary policies.

- (v) Inequality and inequity in the distribution of job-security and rewards. Those employees most likely to remain in employment also seem likely to be those who will get the full increases in incomes under the 1975 National Agreement—for example, public service employees, others whose pay is financed by the Exchequer, bank officials. Unemployment will be concentrated among employees in the private sector.
- (vi) The Irish economy is still influenced to a significant extent by what is happening in Britain. There, the indications are that inflation will get worse and that sterling will continue to weaken. These could lead to some combination of tougher pay and fiscal policies. Such policies would have adverse effects on the Irish economy. This increases uncertainty about developments here—but it offers no prospect of things being better than envisaged above.

44. In so far as these gloomy prospects are caused by the state of the world economy, they cannot be changed by any action taken in Ireland. In so far as they are caused by developments in Ireland, fiscal and monetary policies can do little to improve them, because of the constraints imposed by the existing level of public sector borrowing and the detailed terms of the 1975 National Agreement.

45. The aim of the 1975 Agreement was to ensure that the money incomes of employees were adjusted to compensate for price increases. The detailed terms of the Agreement were negotiated and ratified at a time when prices were expected to rise by about 21% during 1975, before any allowance was made for the effects on prices of any 1975 Agreement. This expectation was reflected in the detailed terms of the Agreement, which provided for a 1st phase equal to the percentage increase in the consumer price index between November 1974 and February 1975, and for 2nd, 3rd and 4th phases of a minimum of 4%

and a maximum of 5% (if the consumer price index rose by 5% or more in the relevant quarter).

46. Given the detailed terms (as opposed to the spirit and objective) of the 1975 National Agreement, very little can be done in the short-run to reduce public sector borrowing and any addition to it (for example, as a result of efforts by Government to expand output and employment) would be difficult to finance.

47. Because of the importance of wages, salaries, pensions, social service payments and debt service charges in public current expenditure, and because of the waste involved in cutting capital expenditures before projects are completed, it is very difficult to cut public expenditure significantly in the short-run. When employee incomes are indexed, increases in indirect taxes raise prices and therefore incomes: this reduces the net revenue the increases yield to the Exchequer and further raises incomes and costs in the private sector.

48. An increase in personal income taxation would raise additional revenue and therefore reduce public sector borrowing. It would not cause increases in money incomes and prices under the terms of the 1975 National Agreement—but it could have implications for the behaviour of money incomes in 1976. However, the reduction in public sector borrowing would further reduce spending power, demand, output and employment. Given the further rise in unemployment that is likely to occur in 1975, it is understandable that any action that would make it even worse is not favoured.

49. Furthermore, given the detailed terms of the 1975 Agreement, action by Government to reduce the rate of increase in consumer prices (for example, by reductions in indirect tax rates or by subsidies) would not improve the economic prospect. If the rate of increase in prices was reduced below 4% per quarter (for example, by subsidies or tax reductions) money incomes would still rise by 4% each quarter, given the terms of the Agreement. The cost of the subsidies and tax reductions would add to public sector borrowing. No improvement in competitiveness would be achieved, and the rise in real incomes would increase the domestic inflationary pressures. The increase in real

incomes would lead to higher imports, and without an increase in competitiveness to raise exports, the balance of payments deficit would become so large as to force deflationary policies.

50. If the growth in money incomes in 1975 cannot be reduced, there is little or no prospect of any improvement in the economic situation in 1976. Competitiveness will probably have deteriorated to an extent that will inhibit the growth in industrial exports as the world economy starts improving in 1976. It will be very difficult to avoid a deflationary budget in 1976, and it is likely that there will be a further reduction in output and a further rise in unemployment.

51. If the 4% floor to increases in money incomes in the 2nd, 3rd and 4th phases of the 1975 Agreement could be removed, it would be possible to take action which would significantly improve the prospects for 1975 and 1976, while at the same time safeguarding both the spirit and the objective of the 1975 Agreement. The rest of this section presents an example of the kind of policy package which would:

- (i) reduce the rate of inflation significantly below what it otherwise will be;
- (ii) improve employment prospects;
- (iii) leave public sector borrowing by mid-1976 running at a rate no higher than it otherwise would be;
- (iv) leave those earning up to the national average rate of pay better off in real terms.

It must be emphasised that this example is not the only programme which could be devised. However, it is more rewarding to work through one concrete set of measures than to deal in generalities.

52. The 1975 Agreement seeks to protect employees' living standards by providing pay increases which compensate for the increase in prices that was expected when it was negotiated. The *first* element in the package discussed here is that this principle should be incorporated more explicitly and more simply in any revision of the Agreement's

provisions—i.e., that, subject to the qualifications below, pay should increase in line with price increases in the previous quarter.

53. When pay is linked directly to prices, the most attractive option for achieving a reduction in the rate of price and nominal pay increases is to cut indirect tax rates or to increase subsidies. The *second* element in the package, therefore, is that the Government should introduce at the earliest possible date measures which would have the immediate effect of reducing prices by 4½%. This is the equivalent of the maximum post-tax pay increase allowed in the second phase of the 1975 Agreement* and the suggested *quid pro quo*, or *third* element, is that there should be no increases in pay under the second phase of the 1975 Agreement.

54. The 4½% reduction in prices could not be achieved by straightforward reductions in VAT rates, because there is no guarantee that all prices would be reduced at retail level by the full extent of the tax cuts. But selective VAT cuts, reductions in public sector prices (which have similar effects), and subsidies on basic foods can be used. The following measures, for example, would affect the consumer price index directly as follows:

- (i) remove the recent increase in ESB prices, which was applied from the beginning of the May-June billing period: estimated cost, £16 million p.a., 0.3 percentage points reduction in consumer price index (CPI);
- (ii) remove the increases applied by CIE in mid-May 1975 to fares on Dublin city bus services, road passenger provincial services and Dublin suburban rail services: estimated cost, £6 to £6.5 million p.a., 0.6 percentage points reduction in CPI;
- (iii) remove VAT from electricity and town and bottled gas: estimated cost, £8 to £9 million p.a., 0.2 percentage points reduction in CPI;**

* The second phase of the 1975 Agreement increases (due on 1st July at the earliest) could give increases in money incomes up to 5%. But most people pay tax at (at least) the 26% rate on income increases, and the average increase in post-tax incomes would be closer to 4%.

**No price reductions are suggested for coal or bottled gas (handled by the private sector and therefore difficult to subsidise). VAT cuts are suggested on bottled gas as this (unlike coal) is subject to a maximum prices order.

- (iv) subsidise the prices of town gas and turf to reduce their prices by a percentage equal to the reduction at (i) above for electricity: estimated cost, £4 million p.a., 0.2 percentage points reduction in CPI;
- (v) subsidise the price of sugar by 3p per pound: estimated cost, £12 million p.a., 0.3 percentage points reduction in CPI;†
- (vi) a consumer subsidy of 5p per 800 gram (i.e. the standard) loaf, with *pro rata* subsidies for the 400 and 1,600 gram loaves: estimated cost £10.8 million p.a., 0.7 percentage points reduction in CPI;
- (vii) a consumer subsidy of 10p per lb on butter: estimated cost, £8.3 million p.a., 0.5 percentage points reduction in CPI;
- (viii) a consumer subsidy of 2p per pint on fresh pasteurised milk: estimated cost, £11.5 million p.a., 0.7 percentage points reduction in CPI.

55. The measures listed in the previous paragraph are given merely as an example of how the rate of increase in consumer prices could be reduced. They must therefore be seen as suggestions rather than precise recommendations. In all cases, it should be possible to ensure that the full amount of the removal of VAT or of the subsidy was passed on to consumers in lower prices. If all the measures listed were applied, the rate of increase in consumer prices could be directly reduced by 3.5 percentage points below what it otherwise would have been. In addition, there would be indirect effects. For example, the reduction in the price of electricity would reduce costs in the industrial and service sectors, and the reduction in the price of sugar would reduce the costs of sugar, chocolate and flour confectionery. The total reduction in the consumer price index would be about $4\frac{1}{4}$ percentage points.

56. If, in addition, VAT were removed from clothing and footwear—industries in which redundancies are now occurring and which will

† The price of sugar is very likely to fall by this amount by end-1975 (or earlier). The cost of the subsidy on sugar would, over a full year, therefore be less than shown here.

remain particularly vulnerable over the next twelve months—the rise in consumer prices could be reduced by a further 0.6 percentage points. There would be some difficulty in ensuring that the full benefit was passed on to consumers, but this would be eased if the co-operation of major importers, wholesalers and retailers was obtained. This measure would give some encouragement to sales of clothing and footwear, and would (in conjunction, for example, with the measures listed above) reduce the rate of increase in consumer prices by over $4\frac{3}{4}$ percentage points.

57. Additional measures to help the textile, clothing and footwear industries, where the situation is very likely to deteriorate further and rapidly, may also help to avoid further unemployment. The introduction of a system of import licensing—the *fourth* element in the package—would provide a particularly flexible form of surveillance, permitted by EEC regulations and with the advantage of not adding to prices.*

58. One disadvantage of the measures so far listed is that they would tend to reduce the price of energy relative to that of other products. This undesirable change in relative prices could be offset by a change in the price of private motoring through an increase in the road tax on private cars—the *fifth* element in the package. The increase in road tax might be progressive—for example, no increase on smaller cars (which tend to be assembled in Ireland) and progressively larger increases on larger and more expensive cars (which tend to be imported fully assembled). This change would have a very small impact on the consumer price index—0.2 percentage points, bringing the net reduction in consumer prices down to $4\frac{1}{2}$ percentage points. It could yield additional revenue of the order of £7 million in a full year.

59. The net effect of these measures (i.e., no increase in pay under the second phase of the 1975 Agreement and measures to reduce the rate of increase in prices by $4\frac{1}{2}$ percentage points) would be to hold the price level at the end of twelve months (i.e. at mid-1976) about $6\frac{1}{2}$ percentage points below what it otherwise would have been. The

* The Confederation of Irish Industry has submitted detailed proposals to the Minister for Industry and Commerce for licensing imports of clothing, textiles and footwear.

6½ percentage points are made up of the initial 4½% reduction in prices plus the effects of the resultant slower rate of increase in money incomes in bringing further reductions in the rate of price increase during the year. Lower costs would have encouraged higher net exports and output, and there would be some small improvement in real incomes which would have further effects on output and imports. The impact is estimated at little change in net exports, over 1% extra on the growth of GNP and over 10,000 fewer unemployed by the middle of 1976.

60. The price implications are satisfactory enough in the short term, but by the end of the year the major impact of cuts in prices on the pay/price spiral would be weakening. Furthermore, the impact on employment of the measures so far discussed is too small—very much less than the likely rise in unemployment over the year. It is therefore desirable that more should be done in order to expand output and employment further.

61. It is therefore proposed that the *sixth* element in the package should be a rapid and sizeable increase in public capital expenditure on construction—for example, on such items as sewerage, water supply, housing and ports in major development areas. This increase in public capital expenditure should be of the order of £50 million between now and the middle of 1976.

62. The measures so far discussed would result in a net increase in public expenditure.* There are two sources from which the increase in public expenditure could be financed—reductions in public current expenditure and increases in taxes. The Estimates for 1975 showed that attempts had been made to limit the growth in public current expenditure. It is understood that on current trends the estimated current expenditure for 1975 is likely to be exceeded. The immediate target must be to keep actual current expenditure in 1975 within the limits of the Estimates on which the 1975 Budget was based. The possibility of achieving any sizeable further reduction in the immediate future is likely to be small.

63. If the public sector borrowing is to be contained and if other items of public expenditure cannot be cut, additional revenue must be raised.

* The effects of the total package on Government revenues and expenditures, and on the public sector borrowing requirement, are set out in paragraphs 71 to 75 below.

This is the *seventh* element in the package. Additional revenue to help finance the subsidies and VAT cuts could be raised by a surcharge of 10% on personal income tax liabilities in the 35% and higher bands. An increase in indirect tax rates on drink and tobacco could be used as an alternative to the surcharge on income tax liabilities. The majority of the Council believe that there are strong health and social reasons in favour of increasing the rates of indirect taxation on alcoholic drink and tobacco. If such increases were to be effective as part of an anti-inflationary package, the resulting price increases would have to be excluded from the consumer price index when calculating the increase in the index that should be applied to employee incomes. The majority of the Council believe that the possibility of excluding increases in these taxes from the consumer price index should be discussed between Government, employers and trade unions.

64. More general assistance could be given to industry (whose cash-flow problems are one threat to employment) if the Government were to adopt the National Prices Commission's recommendations on the treatment of depreciation for price control purposes.

65. As the effects of the price reductions suggested above begin to weaken in early 1976, there would be a tendency for prices to rise at a rather faster rate. This would be the time to make further efforts to maintain real spendable incomes while curbing the growth in domestic costs. Some combination of three further steps would therefore be necessary at the turn of the year:

- (i) an increase in personal and children's allowances for income tax purposes by the same amounts as in the 1975 budget;
- (ii) a reduction by 2 percentage points in pay increases that would be due in the first quarter of 1976, based on the rise in the consumer price index between August and November 1975;
- (iii) the extension of the 10% surcharge on income tax liabilities to the 26% band of personal income taxation (or equivalent further increases in indirect taxes on drink and tobacco, if it were agreed that the resulting price increases should be excluded from the consumer price index when determining increases in incomes).

66. The first two measures would result in an appreciable increase in real spendable incomes. They would, however, involve a net loss of revenue to the Exchequer and result in an increase in public sector borrowing. The third measure would at least offset the net revenue loss from (i) and (ii). The net result of the three measures would be a smaller increase in money incomes in the first half of 1976. The slower rate of increase in domestic costs that would follow would further encourage exports, output and employment.

67. The effect that the total package would have on pay, prices and real incomes is discussed in Appendix B. The package (including the measures in paragraph 65 above) would affect the *real* income of a married man with three children, after he had paid income tax, as follows by mid-1976:

| <i>Weekly wage/salary</i> | <i>Change in real post-tax income</i> |
|---------------------------|---------------------------------------|
| £40 per week | +1.8% |
| £60 per week | +0.5% |
| £100 per week | -1.4% |
| £160 per week | -2.6% |

These figures are based on the assumption that he has no allowances other than those for a wife and three dependent children. If he has additional allowances (for example, interest payments on a mortgage, life assurance or VHI), then the increases in real post-tax income would be greater (or the reductions smaller) than those shown above.

68. The measures so far suggested have been aimed at reducing the rate of increase in prices while maintaining the real incomes of employees. The price reductions will benefit all sections of the community. It is therefore important that the growth in *money* incomes that are not covered by the 1975 National Agreement should be similarly restrained.

69. Agricultural incomes are expected to rise in 1975. It is likely that the increase this year will more than offset the decline in 1974. However, average family farm income in real terms in 1975 will probably just reach the 1972 level. New EEC decisions on agricultural prices will be made in February 1976; these may be on the moderate side because of lower price inflation in continental Europe. Government action by way

of reduction in grants or aids could, if necessary, be taken to maintain an equitable balance between agricultural and employee incomes, if the rise in the former was judged excessive.

70. For accounting years ending on or after 1 July 1975, public and private companies should not be permitted to raise rates of dividends above the levels paid in the previous accounting year by more than 15%. The National Prices Commission should extend and intensify its monitoring of professional fees. No increases in professional fees and charges should be allowed for the three months starting 1 July 1975, and thereafter any increases in fees and charges should be limited to the percentage increases under the 1975 National Agreement as modified in the manner described above.

71. The impact on the economy of the measures suggested above* can now be drawn together. This is done in some detail in technical notes which are available from the NESC Secretariat. The following paragraphs present a summary of the effects of the package.

* The suggestions were:

- June 1975 (i) measures to cut prices by 4½%;
- (ii) no payments under Phase II of the 1975 National Agreement;
- (iii) indexation of pay to prices thereafter;
- (iv) progressive increase in road tax on larger and more expensive cars;
- (v) increase of £50 million p.a. in public capital expenditure on construction;
- (vi) 10% surcharge in personal income tax liabilities in 35% and higher bands or increases in indirect tax rates on drink and tobacco with resulting price increases excluded from CPI;
- (vii) import licences for textiles, clothing and footwear;
- (viii) adoption of the National Prices Commission's recommendations on depreciation;
- (ix) dividend limitation;
- (x) professional fees to be frozen for three months and thereafter to rise in line with revised National Agreement provisions;
- End 1975 (xi) increased personal and childrens' allowances for income tax as in 1975 budget;
- (xii) reduction of 2 percentage points in pay increases due in first quarter of 1976, based on the rise in CPI between August and November 1975;
- (xiii) 10% surcharge on income tax liabilities in the 26% band, or further increases in indirect tax rates on drink and tobacco with resulting price increases excluded from CPI.

72. The initial cuts in prices were estimated at $4\frac{1}{2}\%$. The effects of these cuts in prices, with a zero second phase in the 1975 Agreement and subsequent indexation of pay, would be to lead to lower rates of pay and cost increases which would further reduce the rate of price increases. By mid-1976 it is estimated that consumer prices would be almost 7% less than would otherwise be the case, and average pay of employees in employment could be 10% less. The full impact on real living standards is complicated by the interplay of the pay, price and income tax provisions, and it will vary from one family to another. Appendix B examines the interplay more fully and gives illustrations of the impact of the package on real post-tax incomes. These can be summarised by saying that, in general, those now earning up to £60 per week (£3,000 p.a.) would be better off, those earning in the £60 to £70 per week range would see little change in their real spendable incomes, and those earning over £70 per week (£3,500 p.a.) would be worse off.

73. The effect on output and employment would come mainly from the expansion induced by lower industrial costs (pay and fuel), their impact on exports and the increase in public capital expenditure. There would be some offsetting deflationary impact from the increase in personal taxation. By the middle of 1976 it is estimated that the volume of output would be about $2\frac{1}{2}\%$ higher than would otherwise be the case and that unemployment would be some 25,000 less. These figures are not forecasts for GNP and unemployment but changes from what the position might otherwise be—probably stagnating or falling output and large increases in unemployment. There would be a large positive stimulus to the volume of exports because the deterioration in the competitive position would have been arrested, but the impact on the balance of payments position could well be negligible because of the slower rate of increase in export prices and the faster growth of imports associated with higher output.

74. The prices, employment and output results are reasonably satisfactory (the last two roughly offsetting the deterioration which might otherwise be expected, but not much more). The absence of improvement in the balance of payments prospects may not seem desirable but, considering the deterioration in output and employment

which will occur if policy measures such as those described above are not taken, it should be recalled that the balance of payments deficit is likely to fall sharply this year. Indeed, there is likely to be little difficulty in financing the external deficit this year and reserves could even rise through the remainder of 1975. The "underlying" balance of payments position would improve as a result of the package.

75. The measures would also have a considerable impact on public finance. The initial impact of the price cuts is estimated at about £80 million and £50 million additional capital expenditure was suggested. As the measures began to affect output, employment, pay and prices, however, there would be other influences on public finance. The effect on pay would in turn cut income tax receipts and expenditure on public sector pay. The income tax proposals would bring in extra revenue. The decrease in unemployment (or reductions in the increase) would bring increases in income tax, social security and redundancy fund receipts and lower expenditure on unemployment benefit. Furthermore, whatever the real increases in the rates of social welfare payments decided upon in the review due later this year, their cost will be reduced by the slower rate of price increase. Many of these effects will build up during the year. It is estimated that by mid-1976 the public sector borrowing requirement (including the cost of servicing debt built up during the year) would be very little different from what it would have been if the measures had not been introduced*—indeed, it might be running at an annual rate of £20 million less than at present. Once again this is a satisfactory result when viewed in conjunction with the price and unemployment effects. There would, however, be a temporary rise in the borrowing requirement between now and mid-1976—about £70 million could be required during 1975 and 1976 before the position comes back to what it would otherwise have been.

76. This result is viewed as satisfying the condition that the package should not lead to any increase in the rate of public sector borrowing a year from now. The public finance difficulties are not simply a short-term cash-flow problem. On current trends, the problem of financing a growing deficit will become increasingly great; yet, if the problem were eased (for example, by recourse to Central Bank credit), then the inflation

* For more details see technical notes available from NES secretariat.

problem would probably become even more difficult to tackle. If the measures outlined above were introduced, and if there were some prospect of reducing public sector borrowing in 1976 and later years, this might be sufficient justification for a temporary departure from traditional policies. A £70 million loan to the Exchequer from the Central Bank could be financed by special deposits made by the commercial banks. Alternatively, these banks could take up new government securities to the same value. The rates paid on either the special deposits or the securities could be negotiated to reflect current conditions—the heavy cost of the recession to the Exchequer, the very liquid position of the banking system and the need for a contribution from all but the weakest members of society if the economy's problems are to be solved.*

77. If, however, it was felt that even a temporary charge on the Exchequer should be avoided, this could be done by changing the nature of the proposals for extra capital expenditure made in paragraph 61 above. An increase in private sector building activity would increase domestic output and employment as effectively as additions to the public capital programme. Such an increase could be financed by the banking system—for example, by offering loans for the purchase of private houses at the lower end of the price range on reasonably

* To summarise, the measures would make the following changes to the economic situation (for full details see technical notes available from NES Secretariat):

| | |
|--|--|
| <i>Year to mid-1976</i> | |
| Public sector borrowing requirement | Increase £70 million |
| <i>Situation at mid-1976</i> | |
| Public sector borrowing requirement (including financing of temporary increase of £70 million in year to mid-1976) | Decrease £20 million (at annual rate) |
| Consumer prices | -7% |
| Real post-tax incomes | |
| —now earning less than £60 per week | increased |
| —now earning £60 to £70 per week | unchanged |
| —now earning over £70 per week | decreased |
| GNP | +2½% |
| Unemployment | -25,000 |
| Foreign balance | unchanged |
| "Underlying" foreign balance | greatly improved |

attractive terms. The banks might be asked to make available a sum of the order of £40 million in this way.

78. The advantage of substituting this proposal for a corresponding amount of the increased public capital expenditure suggested above is that the temporary increase in the public sector borrowing requirement would be correspondingly reduced—indeed, it could be virtually eliminated. The disadvantage is that this proposal could take longer to get under way—arrangements would have to be made with building societies, borrowers would have to be found who would not have been borrowing from other institutions in any case, and much of the current stock of unsold dwellings would have to be sold before new construction (i.e. the desired effect on output and employment) got under way. It is difficult to judge whether increased public capital expenditure as described above, or increased finance for low-cost private sector housing, would be the more desirable addition to the economic and social infrastructure.

79. If the full increase of £50 million in public capital expenditure proposed above were retained in the package and the temporary increase in the borrowing requirement financed from domestic sources, this would not imply that the banks could no longer devote any funds to private housing. If the package were maintained as above, and the scheme to provide bank finance for private housing were introduced (even on a smaller scale), then the overall output and employment effects would be even greater and there would be a larger decrease in the rate of public sector borrowing by the middle of next year.

VII POLICIES FOR 1976

80. The preceding section has shown that action can be taken in 1975:
- (i) to reduce the rate of inflation significantly below the 25% or more than would otherwise occur;
 - (ii) to avoid substantial further increases in unemployment;
 - (iii) to improve the competitive position of Irish exports.
81. Measures to achieve these aims would be consistent with good demand management policy during the present world depression. They would enable Ireland to emerge from the recession which followed the oil crisis with a much lower proportionate increase in unemployment (among the insured population) than in other EEC countries. They would also be the first significant step in the Irish programme to reduce the rate of inflation—an area in which Ireland has performed much worse than her EEC partners. Nor need they lead to any increase, even temporary, in public sector borrowing.
82. Any such measures would, however, be only a first step. It will still be very important next year, and in future years, to keep down the rate of inflation and promote the growth of employment. The primary target will still be to continue reducing the rate of inflation: firstly, because of its importance as a problem in itself; secondly, because reducing the rates of cost and price increase will still be the best way to further improving the competitive position and hence expanding exports, output and employment. If these aims are achieved then the necessary conditions for faster growth would have been re-established, and the revaluation of the Irish pound and the break in the link with sterling (which would further help the fight against inflation) should be seriously considered.
83. The time to influence events is before they happen. If employment and output are to grow through 1976 and 1977, and if the rate of price

increase is to be kept down to a rate that would promote exports and make possible an independent exchange rate policy, then the policies and actions that will be required in 1976 must be agreed during the second half of this year. Two of the important issues are discussed below, namely, the inter-relations between increases in money incomes and budgetary policy, and the need to reduce public sector borrowing.

84. The inter-relations between increases in money incomes and budgetary policy can be illustrated by what happened in 1974–75. It was estimated that the December 1974 and the 1975 Budget increases in the indirect tax rates on petrol, drink and tobacco would raise about £60 million in 1975 (or about £65 million in a full year), and add 2½ to 3 percentage points to the increase in the consumer price index. These estimates were upset in two ways by the 1975 Agreement. First, the indexation clauses of the 1975 Agreement meant that the total direct and indirect effects of these tax increases would add about 4 percentage points to the rise in consumer prices. Second, once these price increases and the associated indexation of pay come through in full, the net additional revenue accruing to the Exchequer from the higher taxes on petrol, drink and tobacco would be reduced by about £25 million to £35 to £40 million, because of the need to meet the increases in public sector pay and pensions and social welfare payments resulting from the price increases caused by the higher indirect taxes.

85. All this happened because there was no *explicit* recognition of how pay and fiscal policies are related to each other. The absence of prior agreement on priorities had the effect of adding to the rate of price increase. The absence of prior agreement on priorities was not the result of any wide disagreement on goals among Government, trade unions and employers. All parties had goals which included the provision of public services, the promotion of employment, the control of inflation, and the level and distribution of income among the employed and unemployed and among employees in employment. The goals to which trade unions and employers attach importance cannot be attained without detailed consultation with, and assistance from, the Government. The goals to which the Government gives priority cannot be achieved without detailed consultation with, and assistance from, trade unions and employers.

86. The avoidable contribution to inflation arose, not because there was any basic disagreement on objectives (or even on priorities), but because of deficiencies in present institutional arrangements. The Budget was introduced in January 1975 when the negotiations on the 1975 Agreement were at a preliminary stage. It was presumably based on some assumption about the terms that might ultimately be agreed. When the proposals for the 1975 Agreement were being finalised, the budgetary measures were known to the participants in the negotiations. The fact that negotiations followed the budget meant that there was no occasion on which possible budgetary measures and increases in money incomes could be examined in order to explore the possibility of a package that would protect real incomes as far as possible while minimising the inflationary consequences for prices and costs.

87. It is therefore proposed that there should be consultation between Government and trade unions, employers and farmers in the early autumn of 1975. The purpose of these detailed consultations and negotiations would be to bring the development of incomes, employment, output, and fiscal and monetary policies into a consistent framework for 1976. The objective would be to avoid conflicting actions which added to inflationary pressures (see paragraphs 84 and 85 above).

88. Total public expenditure has risen very rapidly in recent years and is now approaching half of gross national expenditure. A counterpart of this increase in public expenditure has been a steady fall in the proportion of output going to private consumption—one of the sharpest among OECD countries. If attention is focussed on "pure" private consumption—that is, that part which is not paid for by transfers through the public sector—the decline has been even more marked. These changes reflect efforts to promote social justice and welfare and the role of the public sector in maintaining economic expansion.

89. However, it is becoming increasingly difficult to finance increases in public expenditure from increases in current revenues—indeed, on present trends public sector borrowing will grow at an alarming rate. Increases in indirect tax rates raise prices and (under present arrangements) rates of pay in the economy as a whole. Given the importance of pay, pensions and social welfare payments in current public spending,

the net revenue from higher indirect tax rates is about 60% of the gross proceeds. Higher direct taxes reduce real disposable incomes and may lead to demands for higher incomes. The result has been a dramatic increase in the borrowing requirement, which has added significantly to the inflationary pressures in the economy.

90. The Council has commissioned studies of public expenditure and revenue and their likely development over the medium-term. These will provide a useful background for the elaboration of plans to bring together the growth of the economy's productive capacity and public spending and receipts, in a way which avoids large borrowing requirements adding to inflationary pressures. The Council will be discussing these studies during the summer and early autumn of this year.

91. Meanwhile, it seems clear that little can be done to stop the borrowing requirement growing again in 1976 if public expenditure plans cannot be cut or tax rates increased. Given the increases in personal income taxation suggested above for 1975–76 and the undesirability of adding to indirect tax rates in 1976, the burden should fall on public expenditure. It is very difficult to reduce public expenditure in the short run, so decisions relating to 1976 should be taken now. It is suggested, therefore, that there should be an urgent and critical review of public expenditure to cut out programmes which were designed to contribute to the expansion of output and employment, but which are no longer doing so. In addition, a specific target should be set for the reduction in the rate of increase in public expenditure to be achieved in 1976.

VIII SUMMARY

92. The principal objectives of policy in the medium term are to provide increased employment at increasing real living standards. It is clear that something has gone amiss in the progress towards these objectives over the last few years. Prices have been rising faster here than overseas, the competitiveness of Irish products has been eroded, investment has not grown sufficiently, and unemployment remains a serious and growing economic and social problem. In Ireland, inflation has accelerated at a time when other countries have already gone a long way towards reducing their inflation rates. Ireland is therefore approaching 1976 with poorer prospects of being able to benefit from the upswing in world economic activity that is expected next year.

93. If inflation continues to accelerate and if the competitive position continues to deteriorate, then there will be a reduction in the demand for Irish goods and more increases in unemployment in Ireland. If the Government, in the interests of preserving employment, were to increase the level of total demand in order to raise the demand for Irish goods, the balance of payments position would deteriorate further. A steadily increasing deficit in the Irish balance of payments would eventually lead to loss of confidence in Ireland's ability to repay the money it has been borrowing overseas.

94. These developments could force the Irish Government into one or other or both of two policies—first, deflation; second, devaluation. Deflation means cutting demand and therefore expenditure by cutting government expenditure or raising taxes. The inevitable result would be more unemployment. Devaluation would merely recognise the fact that real incomes were higher than could be sustained by domestic output. A devaluation would succeed only if average real incomes were reduced. Any beneficial effects that might follow devaluation would not occur immediately. Furthermore, if devaluation were the only measure used to combat the combination of inflation, balance of payments

deficit and unemployment the economy would get into a "vicious circle" of accelerating inflation and a depreciating exchange rate, both being continuously aggravated by erosion of confidence in the country's ability to solve its problems and in its currency. Sooner or later severe deflation would become the only way out. *This would imply a prolonged period of greatly increased unemployment, perhaps even major social or political crises.*

95. The easiest course is to convince ourselves that what has been happening is inevitable. The hardest course is to face the logic of a continuation of past trends and to take steps that will re-establish the conditions in which significant progress can again be achieved towards increasing employment and raising living standards. *The most important single step is to slow down the rate of inflation.*

96. There has been controversy about the relative importance of the various causes of inflation in this country. There is general agreement that in recent years a significant part of Irish inflation has been "imported"—that is, caused by price increases that have occurred outside this country. This imported inflation was particularly important between 1972 and early 1974, but is relatively much less important in 1975. Some part of Irish inflation has been the result of domestic causes. The strength of these has varied from one year to another, but they have become relatively more important in 1975.

97. The reactions by Government, trade unions and employers have magnified the effects of imported inflation on the Irish price level. Increases in money incomes have been sought to compensate for these price increases. The consequence of the compensating increase in money incomes is a price rise, leading to further income and price increases. This incomes/prices spiral has been an important domestic source of inflation. In recent years the spiral has received institutional support from the National Pay Agreements. The pay increases can be passed on in higher prices by firms whose activities are sheltered from external competition. Exporters or firms subject to competition from abroad may not be able to raise their prices, so that profits are reduced (or, in the case of farmers, net incomes are lowered).

98. The National Agreements have had important implications for public expenditure. Anomaly settlements for public servants, negotiated under the National Agreements, have further increased public spending. As well as the National Agreements, there has been continuing pressure to raise social welfare payments (such as old age pensions, children's allowances and unemployment benefit and assistance) in line with pay increases, if not faster. This increased expenditure has been needed merely to maintain the level of public spending in real terms. In addition, there have been pressures to improve existing services (such as education and health) and to introduce new policies. Moreover, there have been substantial increases in the cost of servicing Government borrowing undertaken to finance spending in previous and current years. The net result has been that public expenditure has risen faster than the value of national output.

99. Despite the rise in prices and in money incomes, the revenue from direct and indirect taxes (at the existing rates) has not risen fast enough to match the growth in public spending. In their attempt to bridge the growing gap between revenue and expenditure by increases in tax rates, Governments have faced real constraints. If tax rates are raised, further increases in money incomes may be demanded to escape the cut in real incomes, thus adding to the inflationary pressures and (when facilitated by monetary and credit policies) sparking off a spiral of tax rise, money income rise, price and tax rise again.

100. The net result has been that public expenditure has risen much faster than tax revenues. As a consequence, the net borrowing requirement of the Government has risen dramatically. These requirements have been met from a net expansion of bank credit and from State and State-guaranteed external borrowing. The increased level of national spending that results creates an environment that is favourable to inflation.

101. Revaluation of the currency could be a very powerful once-for-all means of moderating the effect on the economy of price increases emanating from abroad. However, revaluation could not be contemplated in present circumstances. The immediate aim must be to avoid devalua-

tion and to create the conditions in which the Irish pound could be revalued if strong inflationary trends continue outside Ireland (notably in the United Kingdom). The only way to do this is to bring the rate of inflation in Ireland down below that obtaining in the United Kingdom. This would restore the competitive advantage of Irish goods, making revaluation (and therefore better insulation of the economy against external inflationary pressures) a feasible step.

102. Given the terms of the 1975 National Agreement, existing policies and likely developments in the world economy, the prospects for 1975 are as follows:

- (i) A fall in national output of 1% to 2%, and a further rise in unemployment to 20,000 to 30,000 in the course of the year.
- (ii) A rise in the consumer price index of 25% or more.
- (iii) Public sector borrowing which will be much larger than was expected at the time of the budget and which may be difficult to finance.
- (iv) The current external deficit will be considerably lower in 1975 than in 1974, but only as a result of the low levels of demand, output and employment. The erosion of the competitiveness of Irish goods means that any attempt to expand output and employment would cause a large increase in the external deficit—so large that the attempts to correct it would force the application of deflationary policies.
- (v) Inequality and inequity in the distribution of job-security and rewards.

103. If the growth in money incomes in 1975 cannot be reduced, there is little or no prospect of any improvement in the economic situation in 1976. Competitiveness will probably have deteriorated to an extent that will inhibit the growth in industrial exports as the world economy starts improving in 1976. It would be very difficult to avoid a deflationary budget in 1976, and it is likely that there would be a further reduction in output and a further rise in unemployment.

104. Corrective action is urgently required, but the options are limited. If the rate of growth in money incomes cannot be reduced, then deflation is inescapable and devaluation may become unavoidable. If the rate of growth in money incomes can be reduced, then deflation can be largely avoided and growth in output and employment restored as world trade starts expanding (as is generally expected) during 1976.

105. If the detailed terms of the 1975 Agreement can be modified (while still safeguarding both its spirit and objectives), the following steps could be taken:

June 1975:

- (i) measures to cut prices by 4½%;
- (ii) no payments under Phase II of the 1975 National Agreement;
- (iii) indexation of pay to prices thereafter;
- (iv) progressive increase in road tax on larger and more expensive cars;
- (v) increase of £50 million p.a. in public capital expenditure on construction;
- (vi) 10% surcharge in personal income tax liabilities in 35% band and higher, or increases in indirect tax rates on drink and tobacco with resulting price increases excluded from CPI;
- (vii) import licences for textiles, clothing and footwear;
- (viii) adoption of the National Prices Commission's recommendations on depreciation;
- (ix) dividend limitation;
- (x) professional fees to be frozen for three months and thereafter to rise in line with revised National Agreement provisions;

End 1975:

- (xi) increase in personal and childrens' allowances for income tax as in 1975 budget;

(xii) reduction of 2 percentage points in pay increases due in first quarter of 1976, based on the rise in the CPI between August and November 1975;

(xiii) 10% surcharge on income tax liabilities in the 26% band, or further increases in indirect tax rates on drink and tobacco with resulting price increases excluded from CPI.

106. The effect on output and employment would come mainly from the expansion induced by lower industrial costs (pay and fuel), their impact on exports and the increase in public capital expenditure. There would be some offsetting deflationary impact from the increase in personal taxation. By the middle of 1976 it is estimated that the volume of output would be about 2½% higher than would otherwise be the case and that unemployment would be some 25,000 less. These figures are not forecasts for GNP and unemployment but changes from what the position might otherwise be—probably stagnating or falling output and large increases in unemployment. There would be a large positive stimulus to the volume of exports because the deterioration in the competitive position would have been arrested, but the impact on the balance of payments position could well be negligible because of the slower rate of increase in export prices and the faster growth of imports associated with higher output.

107. The measures would also have a considerable impact on public finance. The initial impact of the price cuts is estimated at about £80 million and £50 million additional capital expenditure was suggested. As the measures began to affect output, employment, pay and prices, however, there would be other influences on public finance. The effect on pay would in turn cut income tax receipts and expenditure on public sector pay. The income tax proposals would bring in extra revenue. The decrease in unemployment (or reductions in the increase) would bring increases in income tax, social security and redundancy fund receipts and lower expenditure on unemployment benefit. Furthermore, whatever the real increases in the rates of social welfare payments decided upon in the review due later this year, their cost will be reduced by the slower rate of price increase. Many of these effects will build up during the year. It is estimated that by mid-1976 the rate of public sector borrowing

(including the cost of servicing debt built up during the year) would be lower than it would have been if the measures had not been introduced. Once again this is a satisfactory result when viewed in conjunction with the price and unemployment effects. There would, however, be a temporary rise in the borrowing requirement between now and mid-1976—about £70 million could be required during 1975 and 1976 before the position comes back to what it would otherwise have been.

108. If this package of measures were applied, the following changes in the economic situation could be achieved by the middle of 1976:

| | |
|--|-----------|
| consumer prices | -7% |
| real post-tax income (income of £3,000 p.a.) | No change |
| (income less than £3,000 p.a.) | Increased |
| (income over £3,000 p.a.) | Reduced |
| unemployment | -25,000 |
| GNP | +2½% |
| foreign balance | Unchanged |
| public sector borrowing | Reduction |

109. If the measures proposed are applied now, the economy will be in a position to benefit from the upturn in world economic activity that is expected in 1976 and 1977. The extent to which the Irish economy will actually benefit will also depend on what happens in Ireland in 1976. Next year, the aims must be to maintain the improvement in competitiveness achieved in 1975 and to make significant progress towards reducing the rate of increase in public expenditure and lowering the public sector deficit. If these aims are achieved, then the necessary conditions for faster growth would have been re-established (indeed, this will be happening in 1976) and revaluation would then be a step which should seriously be considered.

110. The time to influence events is before they happen. If employment and output are to grow through 1976 and 1977, and if inflation is to be kept down to a rate that would make possible a revaluation of the Irish pound, then the policies and actions that will be required in 1975 must

be agreed during the second half of this year. In particular, there should be detailed consultations between Government and trade unions and employers in the early autumn of 1975 to bring the development of income, employment, output and fiscal and monetary policies into a consistent framework for 1976. In addition, plans must be made now to reduce significantly the rate of growth in public expenditure in 1976 and later years.

APPENDIX A

Effects of Changes in Exchange-rates on Agricultural Prices and Incomes

1. In examining the impact of either devaluation or revaluation on agricultural incomes and prices, account has to be taken of the common price arrangements made under the EEC Common Agricultural Policy (CAP). Such price arrangements are made in terms of the EEC monetary unit—the unit of account (UA). The UAs are converted into the national currencies of member states by the use of the official representative rates* for each of the Community currencies. As the underlying aim of the CAP is for agricultural support prices to be uniform throughout the Community, any divergence of actual market exchange rates of Community currencies from the CAP representative conversion rates brings into play a currency adjustment mechanism. This mechanism is operated by monetary compensatory amounts (MCAs) which are levied on agricultural exports and refunded on imports of a member state whose currency is floating downwards. In the case of a member state whose currency is floating upwards, the MCAs are refunded on agricultural exports and levied on agricultural imports. Broadly speaking, the amount of the MCA is based on the percentage depreciation or appreciation in the market value of the currency vis-a-vis the CAP representative rate. Accordingly, the MCAs work towards maintaining the common pricing arrangements of the CAP.

2. Since Ireland's accession to the EEC the actual market exchange rate of the Irish £ has continued to depreciate through its par relationship with sterling. Accordingly, MCAs are being levied on Irish agricultural exports and refunded on Irish agricultural imports. Thus Ireland has had to pay a tax on exports while receiving a subsidy on imports of

* On Ireland's accession to the EEC the representative conversion rate for the Irish £ (and the £ sterling) was fixed at £1 = 2.1644 UAs.

most CAP products in trade with member states (other than the UK*) and with third countries. Because Ireland is heavily dependent on agricultural exports, the payment of MCAs has had an adverse effect on the economy. In addition to the payment of MCAs on exports, the prices for agricultural products in Ireland and farmers' incomes have been below what they would have been if a conversion rate closer to the actual market exchange rate was used. Under the CAP, common prices were fixed in UAs converted into pounds at the representative rate fixed for Ireland in January 1973. This situation has been ameliorated to some extent by the new representative rate fixed for the Irish £ in October 1974 at only 3% above the actual market exchange rate for the £ at that date. A further change in the representative rate took place in February 1975. The new representative rate for the Irish £ (referred to as the Green £) has helped to improve the competitive position of Irish agricultural exports, as well as improving farm income and the balance of payments. The prices of some food items have been increased, but the overall effect on the Consumer Price Index is relatively small. However, the rate of the MCAs has increased since February 1975 because of the further depreciation of sterling.

3. The foregoing paragraphs have shown what the effective depreciation of the Irish £ has meant for agricultural products under the CAP as operating at present. If the Irish £ were to be revalued to a level above the CAP representative rate, then agricultural products would be affected through MCAs having to be refunded on exports and levied on imports. Accordingly, revaluation should ensure that farmers, incomes, at least in the short run, would be compensated for the effects of revaluation on the price of their exports. In the medium term, however, adjustments might well be made to the representative rate for the Irish £, or even changes made in the CAP itself, which might reduce the compensation which farmers would receive under any revaluation of the currency.

* Up to October 1974, Ireland and the UK had the same market exchange rate and CAP representative rate. Hence MCAs were not applicable in trade between the two States. However, since 1 October 1974 separate representative rates for the purposes of CAP have been in operation and MCAs are now applied to agricultural trade between the UK and Ireland.

4. In short, what happens to support prices for agricultural products depends on whether or not the representative rate (i.e. the Green Pound) is adjusted in line with the actual change in the exchange rate. If it is, then devaluation will increase the support prices, and a revaluation will reduce them, in terms of Irish pounds. If the representative rate is not changed in line with the actual rate, then (as a result of the MCA,s) support prices will remain the same in terms of Irish pounds, whether or not the Irish pound is devalued or revalued.

APPENDIX B

Effects of Policy Package on Pay and Prices

1. This appendix shows the effects of the package described in the main text on:—

(a) aggregate pay and price movements;

(b) on the real incomes of people at different levels of pay.

(a) Overall effects on pay and prices

2. This section shows the effects of the package by examining the differences between two sets of figures; the first representing an illustration of likely pay and price movements without any measures being taken, the second an illustration of pay and price movements after the measures have been taken. The figures are illustrations, not forecasts, since they leave out the effects of such developments as the introduction of equal pay and wage drift and the pay figures are timed as if all employees were "early starters" under the National Agreement. Nonetheless, the *differences* between the illustrations give a reasonably accurate indication of the differences between estimates of actual developments with or without the measures.

3. The upper section of Table 1 illustrates likely pay and price movements over the next twelve months without any measures being taken.

Prices are assumed to have risen by 6% in the 3 months to May and to rise by 6, 5, 4 and 4% over the next four quarters (possibly a pessimistic view, possibly not). Under the terms of the 1975 National Agreement, and assuming similar arrangements continued under a 1976 Agreement average pay should rise by 5, 5, 5 and 4% over the next four quarters (beginning with the July-September quarter of 1975). But since many employees are not covered by the 1975 Agreement and others may not receive all the increases normally due under the Agreement (inability to pay) average pay is assumed to rise by 4% each quarter. No allowance is made for any final threshold increase under the 1975 Agreement: such an allowance would not alter differences between the two sets of calculations if corresponding arrangements were made under the new proposals.

4. The lower section of Table 1 illustrates corresponding pay and price movements if the package were introduced. It is assumed that any percentage reduction in pay increases in one quarter leads to a consequential reduction in price increases in the next quarter of one third of the reduction in the rate of pay increases (i.e., labour accounts for one third of costs, and price increases in one quarter reflect cost increases in the previous quarter). This is a simplification of actual behaviour, but still gives fairly accurate results. Pay is assumed to rise fully in line with prices in the previous quarter (i.e., no allowance is made for inability to pay or those not covered by the 1975 Agreement receiving less than those covered) except for the 2% reduction in the pay increases in 1976 Q1 associated with the fiscal changes outlined in the text.

5. The right hand column gives total figures for the year to the second quarter of 1976. It shows average pay for those in employment rising by 6½% after the measures instead of 17% before, and prices rising by 12½% after measures instead of 20½% before. The differences between these figures are reasonably accurate assessments of the impact of the measures on labour costs and the rate of inflation. *They do not give any indication of what happens to real, post-tax pay, because they do not allow for changes in tax liabilities.* The second section of this appendix illustrates the full effects of measures on a range of incomes.

TABLE 1
Aggregate Pay and Price Movements

| | Percentage change from previous quarter | | | | % change 1975 Q2 to 1976 Q2 |
|------------------------|---|----|------|----|-----------------------------|
| | 1975 | | 1976 | | |
| | Q3 | Q4 | Q1 | Q2 | |
| <i>Without package</i> | | | | | |
| Average pay* | 4 | 4 | 4 | 4 | 17 |
| Consumer prices | 6 | 5 | 4 | 4 | 20½ |
| <i>With package</i> | | | | | |
| Average pay* | 0 | 1½ | 1¾† | 3¼ | 6½ |
| Consumer prices | 1½ | 3¾ | 3¼ | 3¼ | 12½ |

* Employees in employment.

† 3¼ - 2 = 1¾ (2% reduction reflecting direct tax changes—see main text).

(b) Effects on a sample of real incomes

6. Table 2 shows the effects of the measures on a person earning £2,000 p.a., £3,000 p.a., £5,000 p.a. and £8,000 p.a., in the second quarter of 1975. In each case the person is assumed to receive tax allowances for a married man with 3 children, but no other allowances. Anyone with smaller tax allowances on a given income would do less well from the changes, anyone with larger allowances (insurance premia, VHI, or interest payments on mortgages or overdrafts) would generally do better.

7. Each example shows 3 columns of figures: the first the 1975 Q2 position; the second the 1976 Q2 position with no policy changes, a pay increase of 17% and a price increase of 20½% (c.f. Table 1 above); the third the 1975 Q2 position after the package, a pay increase of 6½% and a price increase of 12½%.

TABLE 2

Effects of Package on Real Incomes
(Married man with 3 children and no other allowances)

| Initial earnings | £40/week (£2,000 p.a.) | | | £60/week (£3,000 p.a.) | | |
|---|---------------------------|---------------|---------------|---------------------------|---------------|---------------|
| | 1975 Q2 | 1976 Q2(1) | 1976 Q2(2) | 1975 Q2 | 1976 Q2(1) | 1976 Q2(2) |
| Income | 2,000 | 2,340 | 2,130 | 3,000 | 3,510 | 3,195 |
| Income tax | 100 | 190 | 90 | 360 | 520 | 395 |
| Post-tax income | 1,900 | 2,150 | 2,040 | 2,640 | 2,990 | 2,800 |
| Post-tax income (3) | 100 | 113.2 | 107.4 | 100 | 113.3 | 106.1 |
| Prices (3) | 100 | 120.4 | 112.2 | 100 | 120.4 | 112.2 |
| Real post-tax income (3) | 100 | 94.0 | 95.8 | 100 | 94.1 | 94.6 |
| % change in real post-tax income due to package | | | +1.8 | | | +0.5 |

| Initial earnings | £100/week (£5,000 p.a.) | | | £160/week (£8,000 p.a.) | | |
|---|----------------------------|---------------|---------------|----------------------------|---------------|---------------|
| | 1975 Q2 | 1976 Q2(1) | 1976 Q2(2) | 1975 Q2 | 1976 Q2(1) | 1976 Q2(2) |
| Income | 5,000 | 5,850 | 5,325 | 8,000 | 9,360 | 8,520 |
| Income tax | 1,040 | 1,340 | 1,190 | 2,300 | 2,910 | 2,680 |
| Post-tax income | 3,960 | 4,510 | 4,135 | 5,700 | 6,450 | 5,840 |
| Post-tax income (3) | 100 | 113.9 | 104.4 | 100 | 113.2 | 102.5 |
| Prices (3) | 100 | 120.4 | 112.2 | 100 | 120.4 | 112.2 |
| Real post-tax income (3) | 100 | 94.6 | 93.2 | 100 | 94.0 | 91.4 |
| % change in real post-tax income due to package | | | -1.4 | | | -2.6 |

- (1) Without package—17% pay, 20½% prices, no change in personal taxation.
 (2) After package—6½% pay, 12¼% prices, personal tax changes as in main text.
 (3) 1975 Q2 = 100.

8. The results suggest that those earning up to £3,000 p.a., would be better off in real terms as a result of the measures, those earning more would be worse off. The figures make no allowance for the increased job security which would be brought about by the package.

ADDENDUM BY

IRISH EMPLOYERS' CONFEDERATION

1. If it is deemed desirable within the context of a national programme to combat inflation and unemployment, IEC would be prepared to discuss with the Irish Congress of Trade Unions within the framework of the Employer-Labour Conference any modifications to the 1975 National Agreement which are felt to be necessary to make the Agreement consistent with a national programme designed to improve economic and social conditions in the country.

2. The IEC consider that it is essential, as part of a general economic programme, for the Government to postpone the introduction of equal pay legislation until such time as there is a significant improvement in the economy.

3. We do not favour the proposal in paragraph 51 that there should be a 10% surcharge on personal income tax liabilities in the 35% and higher bands, for the following reasons:

- (a) The current percentage bands of income tax are already progressively steep.
- (b) Income differentials would be further compressed by the imposition of the suggested surcharge.
- (c) Such an imposition would be likely to create a base for increased income demands and as such, would be self-defeating.

4. We would like to see the following additional options included among the proposals:

- (a) a three month postponement of all or some of the projected improvements in social welfare benefits scheduled for the autumn of 1975;
- (b) a reduction in the level of employer contributions to social insurance, with special reference to the position of industries and firms facing exceptional economic difficulties.

RESERVATION BY THE CONFEDERATION OF IRISH INDUSTRY

The Confederation of Irish Industry considers that the essential components of a counter inflation programme which will restore industrial competitiveness and reduce unemployment are as follows:

1. A reduction in the real standard of living for those at work. The Confederation favours extension of phase 1 of the 16th Wage Agreement by 3 months, and 90% indexation thereafter.
2. A reduction of 5% over the next twelve months in the current public expenditure at constant prices.
3. Maximum achievable increases in public capital expenditure for productive purposes and for the development of the industrial infrastructure in the major centres e.g. sewage, water supply, industrial housing, ports; and also Government action to accelerate the development of natural resources, onshore and offshore.

Reservations:

1. The Confederation has no objection to short term subsidies or reduction in indirect taxes, *provided* these can be funded within a planned programme for the reduction of the current public deficit. Price reductions should not be achieved by increasing subsidies to semi state bodies.
2. The Confederation opposes the proposals to increase direct taxation, since this would lead to increased pressure to restore net pay after tax.
3. The Confederation notes that no comment has been made about the effect on inflation of the implementation on 1 January 1976 of *equal pay* and *transport legislation*.

✎ The Confederation stresses that the introduction of *equal pay* legislation should be postponed until economic conditions improve.

The Confederation opposes the proposed introduction of EEC Transport legislation on 1 January 1976, because of its effects on industrial costs. It urges also that current restrictions on road freight licensing should be liberalised as a matter of urgency, in order to reduce the present inefficient use of lorries, which would result in a consequential fall in vehicle imports.

**RESERVATION BY THE
IRISH CONGRESS OF TRADE UNIONS**

The Irish Congress of Trade Unions does not accept the proposals contained in the National Economic and Social Council Report on Inflation.

In the first place we have reservations concerning both the anticipated future developments in the event of action such as that proposed in the Report not being taken, and secondly, we have reservations as to whether the particular package of proposals set out in the Report would have the anticipated effect.

We therefore reject both the proposals and the basis for the proposals and, in particular, we reject the implication in the Report that it is necessary or desirable to make changes in the 1975 National Agreement as a part of any steps to improve the present economic position.

RESERVATION BY

IRISH CREAMERY MILK SUPPLIERS ASSOCIATION

Adequate recognition has not been given to the contribution that increased agricultural output can make towards:—

- (a) reducing unemployment;
- (b) generating buoyancy, and
- (c) favourable effects on the national balance of payments.