

NESC REPORT NO. 26
PRELUDE TO PLANNING

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NATIONAL ECONOMIC AND SOCIAL COUNCIL

Prelude to Planning

No. 26

Price: 2.00

**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

Prelude to Planning

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Chapter 1

INTRODUCTION

1.1. The Council was formally established at the end of 1973. Since then, it has presented to the Government a number of reports on the economy. Some of these reports were concerned with the current economic situation; some were designed to create a framework within which successive programmes or plans for economic and social development could be prepared.

1.2. The following reports dealt with the current economic situation :

The Economy in 1973 and Prospects for 1974, No. 1, April 1974.

The Economy in 1974 and Outlook for 1975,¹ No. 3, November 1974.

Report on Inflation, No. 9, June 1975.

Economy in 1975 and Prospects for 1976, No. 13, October 1975.

It is not easy to determine the extent to which these reports influenced Government thinking and policy. The second estimated the consequences of different fiscal policies for the economy in 1975 in greater detail than in any previous economic commentaries or official documents. Most of the detailed measures put forward in the *Report on Inflation* were incorporated in the June 1975 Budget; the main exception was that relating to the payment of no increase in the second phase of the 1975 National Pay Agreement. The

¹This was not published as a Council report but as "a document prepared by the Council's secretariat". However, it was prepared in the same way as all other reports by the Council, namely, following discussion in the relevant committee of the Council (in this case, the Economic Policy Committee) a draft was prepared by the secretariat; this draft was discussed and amended at a further meeting of the committee, and substantially amended at two meetings of the Council.

policy options for 1976 were examined in the *Economy in 1975 and Prospects for 1976*. During the past year, Government objectives seem to have corresponded closely to the main conclusions of that Report:

“If nothing is done (i.e. if pay continues to be fully linked to prices and Government policies are unchanged) the situation will deteriorate further. The main symptoms of the deterioration will be higher unemployment and greater inequities within the labour force, with those in secure employment doing well relative to those in activities subject to external competition and relative to the unemployed.

This prospect is clearly unsatisfactory. Other policy options must therefore be examined. In our view, import controls, devaluation and deflation would not be satisfactory policies. The only alternative is income restraint. If competitiveness is to be restored, pay restraint means increases in the average incomes of those in employment that are smaller than those occurring in other countries . . .”²

1.3. The second group of reports on the economy was designed to create a framework within which plans for economic and social development could be prepared. These reports can be seen as an attempt to up-date and expand the National Industrial Economic Council's *Report on Full Employment* which was published in March 1967. That report stated the problems, assessed their dimensions, suggested some of the main elements of a broad strategy by which full employment might be pursued, examined some of the main obstacles which then lay in the way of its achievement, and generally posed the choices which the community, if it wanted full employment, would have to face and make. The Third Programme for Economic and Social Development 1969-72 was drawn up against the background of the NIEC's *Report on Full Employment* and was presented as a step on the road to that goal.

²*Economy in 1975 and Prospects for 1976*, NESC, No. 13, page 40, paragraphs 79 and 80.

1.4. The following reports in this second series have been published:

Population and Employment Projections, No. 5, February 1975.

Jobs and Living Standards: Projections and Implications, No. 7, July 1975.

Population Projections 1971-86: The Implications for Social Planning-Dwelling Needs, No. 14, February 1976.

Population Projections 1971-86: The Implications for Education, No. 18, July 1976.

Rural Areas: Social Planning Problems, No. 19, July 1976.

The Future of Public Expenditures in Ireland, No. 20, July 1976.

Report on Public Expenditure, No. 21, July 1976.

Given the small size of the Council's secretariat (there have never been more than four full-time members, servicing the Council's three committees and drafting reports), much of the background work for these reports had to be commissioned from outside experts. These often worked on a part-time basis in or with the secretariat.

1.5. The latest study in this series—*The Potential for Growth in the Tax Revenues of the Irish Economy*—was prepared by Dr G E J Llewellyn, Assistant Director of Research, Faculty of Economics, University of Cambridge. Its main conclusions are that there is only limited scope for increasing tax revenues by raising tax rates and by widening the existing tax base; any substantial growth in tax revenue is dependent on faster growth in national income and output.

1.6. This report,³ which was prepared following a decision by the Council at its meeting on 6 May 1976, attempts to draw together the main threads of the Council's work to date on the economy. There is no attempt at a short-term forecast for 1976. Enough of these have

³Successive drafts of this report were discussed at meetings of the Council's Economic Policy Committee on 2, 7 and 10 September 1976 and at meetings of the full Council on 23 September 1976.

been made already by various bodies.⁴ They diverge quite widely from each other, though most of the differences are explained by the different assumptions on which they are based, and the margins of tolerance that are inherent in any short-term forecasts. In some short-term forecasts, wishes may father thoughts. This is natural and understandable and in any case there is no contraceptive procedure or device to prevent them doing so. Forecasts are particularly valuable when they can quickly be checked against the out-turn. Given the very real problems of statistical measurement and estimation, however, the differences between the first preliminary estimate of what happened to the economy in 1976 and the final figure that will appear in the historical record may be as great as the differences that exist between the forecasts for 1976 that have so far been made.

1.7. Despite all the difficulties in making them, short-term forecasts are essential for the formulation of demand-management policies. But the problems now facing the economy cannot be solved by such policies. These problems are structural rather than conjunctural. In these circumstances, demand-management policies, even if the constraints within which it seems they must now operate could be loosened, can do little more than rearrange the symptoms. What is needed is a diagnosis of the present economic difficulties and relatively poor prospects (especially for the growth of employment), and a prescription for their cure. This report attempts to make a contribution to the rational discussion of these fundamental issues.

⁴For example, by the Minister for Finance in his Financial Statement in January 1976, by the Central Bank of Ireland, by the Economic and Social Research Institute, by the Department of Finance in the "Economic Review and Outlook—July, 1976" by the Allied Irish Banks, and by independent experts.

Chapter 2

THE CURRENT ECONOMIC SITUATION

2.1. The main features of the current economic situation can be summarised briefly:

- (a) Unemployment rose through 1974 and 1975 and now (at mid-September 1976) exceeds 108,000. As a percentage of the labour force, this is the highest rate of unemployment in the EEC.
- (b) National output (GNP at constant 1970 market prices) rose by about $\frac{1}{2}\%$ ¹ in 1974 and fell by about 1% in 1975. The most optimistic estimate is a growth rate of rather more than 2% in 1976.
- (c) The current external deficit was almost £290 million in 1974 and about £15 million in 1975. The 1976 deficit could be almost ten times that of 1975.
- (d) Total Government expenditure has grown rapidly and will be more than 55% of GNP in 1976. Despite tax rates which are very widely felt to be excessive, there remains a very large overall budget deficit, financed to a large extent by heavy overseas borrowing which cannot for long be sustained.
- (e) In recent years, the Irish rate of inflation has been among the highest in the EEC. It seems likely that Irish prices and costs will rise faster than those in the UK through 1976 and 1977.

These economic problems now facing the economy are the result of Irish inflation and the severe world recession of 1974–75.

¹This figure is the average of the growth rates calculated on output and expenditure bases. The 1975 figure is an expenditure estimate prepared by the Department of Finance.

2.2. Between 1972 and early 1974, a significant part of Irish inflation was "imported"—that is, caused by price increases that occurred outside this country. If the prices of imported raw materials, materials for further production and capital goods rise, then costs of production are increased and firms must try to raise their prices if they are not to be forced out of business. If the prices of imported finished goods rise, these increases are reflected quickly in the shops. 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.

2.3. In recent years, and especially during 1972 and 1973, the prices at which exports could be sold, and the prices that had 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 oil price increases at the end of 1973. For Ireland, these price increases have been made even more severe by the fall in the value of the Irish pound (in line with sterling) in terms of other currencies.

2.4. Imported inflation has therefore been a powerful force generating inflation in Ireland. But the subsequent reactions to this imported inflation by Government,² trade unions and employers have magnified its effects on Irish prices and costs. These domestic causes of inflation (or contributions to it) have become increasingly important since early 1974.

2.5. What has happened is consistent with the view that employees seek to achieve or maintain some absolute level of real income, or perhaps some desired or expected rate of improvement in it. Price increases (caused, for example, by higher import prices) reduced the real purchasing power of earned incomes and provoked demands for increases in money incomes to compensate for them. The consequence of the compensating increase in money incomes was further price

²The role of Government in the inflationary process is discussed briefly in paragraphs 2.13 to 2.20 below.

risers, leading to further increases in incomes and prices. The result was a domestic inflationary spiral, with incomes chasing prices and prices chasing incomes.

2.6. In recent years the domestic incomes/prices spiral has received institutional support from the National Pay Agreements. These Agreements were sought and reached, not because the inflationary consequences were desired, but because they were one way of trying to ensure that real employee incomes kept pace with inflation and gave some increase in 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 were shared by both employers and employees, and the basic increases in money incomes that emerged from the Agreements were the result of free negotiations between employers and unions and were ratified by both sides.

2.7. As well as the desire to achieve or maintain some absolute level of real income, there was pressure to prevent any significant change in the pattern of differentials. If workers in a particular occupation or sector succeeded in improving their relative position, others sought increases to restore the traditional differentials. In doing so, from their viewpoint they removed an anomaly—but may have created an anomaly from the viewpoint of those who had temporarily succeeded in improving their relative positions. Another continuing process of incomes increases was therefore created.

2.8. The domestic contributions to inflation became progressively stronger after the first quarter of 1974. As this was happening, a severe world recession developed—the worst since the nineteen-thirties—following the quadrupling of oil prices towards the end of 1973. At the same time, protection against imports of manufactured products from the UK and other EEC countries was disappearing or being reduced. By itself, the world recession would have caused a deterioration in the economic situation in Ireland. Stagnation in world trade and slack (or falling) demand and more acute competition in external markets would have slowed down the growth in Irish exports. The existence of spare capacity in other economies would have caused

more severe competition from imports in the home market. The general falling-off in industrial investment would have been reflected in a smaller inflow of new foreign firms. By itself, therefore, the world recession would have caused a higher level of unemployment.

2.9. The effects of the world recession on the Irish economy were made worse by the pace of Irish inflation. During a recession, price competition becomes more severe and price more important as a determinant of sales. If the rate of inflation in this country had been slower, then exports would very probably have fared better, Irish industries would have been better placed to withstand competition from imports, and the numbers at work would have been higher. Some of the evidence for this lies in the large number of firms that have had to cease production, in statements by individual industrialists about the difficulties they encountered in meeting price competition in the home and export markets, in the experience of the overseas staff of Córas Tráchtála of business lost because of prices that were too high,³ and in the incidence of recourse to the "inability to pay" clauses of the 1974 and 1975 National Pay Agreements.

2.10. During the first half of 1976, industrial output rose, following a decline from about the second quarter of 1974 until the final quarter of 1975. The recent rise in industrial output is largely explained by the production of new foreign firms that have come on stream during the last two years. As compared with the first six months of 1975, industrial exports rose substantially during the first half of 1976. The increase in the volume of industrial exports is largely explained by the increased exports of chemicals, synthetic textiles, pharmaceutical and engineering products produced by new foreign firms that have come into operation since the spring of 1974. During the first half of 1976, in volume terms, the exports (for example) of clothing, footwear, drink, iron and steel, and fertilisers were all below their levels in the first six months of 1975. Imports of finished consumer goods that compete with the products of domestic firms rose substantially during the first half of this year. The increases were dramatic in the case of clothing, footwear, furniture and television sets. All this was happening during a period when world trade and output were recovering.

³See Annual Reports for 1974 and 1975, Córas Tráchtála.

2.11. Recent attempts to import flour and bread suggest that more Irish firms were becoming uncompetitive. It would appear that both these products can now be imported and sold, at least in some parts of the home market, at prices lower than those at which the domestic product is available. The higher prices of domestic bread and flour are partly (but not wholly) explained by higher labour costs.⁴

2.12. The severity of the recent recession means that spare capacity will continue to exist in other countries for some time as the upturn develops. This means that price competition will remain acute and that Irish products are likely to benefit significantly only if the upswing develops strongly and is sustained. This may not happen, because some of the major industrial countries may curb the expansion of their economies to prevent another inflationary upsurge in world prices. Even if a sustained expansion occurred, Irish prices and costs may rise relative to those in other countries and therefore limit any benefit that would accrue to this country. Indeed, this is what is likely to happen, for all the indications suggest that Irish costs and prices are likely to rise faster than those in the UK through 1976 and into 1977.

2.13. Inflation and the world recession 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 have been paid to those directly or indirectly employed by the public sector. Anomaly settlements have been negotiated under the National Agreements for public sector employees and these have further increased public expenditure. As well as the National Agreements, there has been continuing pressure to raise social welfare payments in line with pay increases, if not faster. Other current Government expenditure has risen in line with prices.

2.14. Rising unemployment has meant increased expenditure on unemployment benefit and assistance and pressure on Government

⁴Indeed, Irish wheat is cheaper than French or North American wheat. However, in bread production some of the harder Canadian wheat has to be used to meet Irish tastes.

to raise its spending to create jobs. There have been pressures to improve existing services and to introduce new policies. There have been substantial increases in the cost of servicing Government borrowing undertaken to finance spending in previous and current years. All these have added to the rate of increase in public spending. The net result has been that public expenditure has risen much faster than the value of national output: total Government expenditure (both current and capital) rose from just over 40% of GNP in 1972-73 to over 55% of GNP in 1976.⁵

2.15. Government revenues have not risen fast enough to match the growth in public expenditure, despite increases in prices, in money incomes and in the rates of direct and indirect taxes. As a result, the public sector borrowing requirement has grown rapidly. During the fiscal years 1971-72 to 1973-74, it lay between 8% and 9% of GNP; it rose to over 16% in 1974, was around 19% of GNP in 1975, and could be more than 20% of GNP in 1976.⁶ This overall deficit has been financed to a large extent by overseas borrowing at a rate which cannot for long be sustained. Early in 1976, conditions relating to the management of the economy were attached to an external loan to the Irish Government.⁷

⁵For a fuller discussion of public expenditure and its causes and consequences, see *Report on Public Expenditure*, NESC, No. 21, July 1976.

⁶By 1975, the public sector borrowing requirement was about 70% of the revenue from direct and indirect taxation. Given the high interest rates and the short term of the loans, the proportion of tax revenue required to service the borrowing would rise very rapidly above its 1975 level of 23%, if the 1975 ratio of borrowing to tax revenue were maintained.

⁷The following conditions (or economic targets) were attached to the loan of US \$300 million under the Community loan scheme in February 1976:

- (a) the growth in the Central Government borrowing requirement as a percentage of gross national product should be halted in 1976 and should be reduced in subsequent years;
- (b) that every effort should be made towards financing the largest possible proportion of the public sector borrowing requirement by non-monetary means (such as placing long-term securities directly with the public), and
- (c) caution should be exercised to avoid the danger that would arise from providing easy accommodation for both the Exchequer borrowing requirement and the demand for credit for the private sector were the latter to expand more rapidly than presently envisaged.

2.16. Given the importance of pay and of social payments and benefits in public expenditure, and given the present level of unemployment, it will be very difficult in the short run to reduce the rate of growth of public expenditure below the growth rate of GNP in money terms. Any *significant* reduction in the relative importance of public expenditure in total national expenditure must come mainly from a large and sustained improvement in the rate of economic growth, which would reduce unemployment and ease social problems and tensions. The higher growth would have to be achieved and maintained by means other than higher public expenditures.

2.17. At the same time, the prospects for raising tax revenues are limited. Attempts to increase revenues could be made by increasing tax rates on the existing tax base, or by widening the existing tax base by bringing more items or categories into the tax net.

2.18. However, increases in the rates of indirect taxation would raise prices and generate pressure for increases in money incomes (see paragraph 2.5. above). A significant proportion of the additional revenue from higher indirect taxation (given the present size of the public sector) would be needed to meet the consequent increases in public service remuneration and in social welfare payments. Moreover, in an inflationary period, the value in real terms of personal and dependants' allowances is reduced and increases in money incomes bring the recipients into higher direct tax brackets. As a result, the disposable 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 they have been thwarted. In these circumstances, all the pressures are for increases in tax allowances and for reductions in the tax rates. If direct tax rates are raised, further increases in money incomes may be demanded to escape the further cut in real disposable incomes, thus adding to the inflationary pressures. These consequences are the more probable if (as is the case at present) the rates of direct and indirect taxation are very widely (if not universally) felt to be excessive.

2.19. An attempt to raise more revenue by widening the present tax base is likely to have similar consequences. In 1976, Government current and capital expenditures exceed 55% of GNP, Government revenue (mainly from direct and indirect taxation) is around 35% of GNP, leaving a borrowing requirement of about 20% of GNP. To achieve any appreciable reduction in the borrowing requirement, existing tax-rates would have to be maintained and a considerable amount of additional revenue would be required from new items and categories. The inevitable result would be an increase in the proportion of personal and corporate income appropriated by Government.

2.20. In present circumstances, therefore, any attempts to reduce the public sector borrowing requirement significantly by raising additional revenues (whether by higher tax rates and/or widening the tax base) are likely to provoke a defensive reaction by tax payers, as they attempt to maintain their real disposable incomes. The reaction will take the form of demands for further increases in money incomes. This will add to the inflationary pressures and (if facilitated by monetary and credit policies) spark off a spiral of tax rise, money income rise, price and tax rise again, with continuing increases in unemployment. The additional tax revenue that is required can be obtained without inflationary consequences only if there is a significant and sustained improvement in the rate of economic growth.

2.21. There are, then, *two* crucial elements in the present problems facing the Irish economy. *First*, the level of real income demanded by employees in Ireland has always been too high to enable full employment to be approached; and the attempts to achieve the level of real income now demanded by employees will tend to generate rates of increase in costs and prices that are higher than those occurring in Ireland's main export markets and especially in the UK. Given the rate of exchange between the Irish pound and sterling, the output of still more Irish firms will not be able to compete with similar UK goods, and unemployment will worsen. To the extent that changes in the rate of exchange between sterling and other currencies reflect changes in UK prices and costs relative to those in other countries, these changes will not be sufficient to offset the relatively faster increase in Irish costs

and prices. The prospects for exported growth are therefore poor. Given the overall economic situation and the state of the public finances, there can be little scope for raising domestic demand by higher Government expenditure and/or reductions in tax revenue. Even if it were attempted, the growth in output generated by measures aimed at raising domestic demand would be small and short-lived, because of balance of payments constraints. Without significant and sustained growth in output, real income expectations cannot be met. The attempt to realise them by increases in money incomes will accelerate the rate of inflation and increase the already large foreign borrowing. The levels of real income now demanded and expected cannot be achieved in this way.

2.22. *Second*, as already stated, the present level of public expenditure (even when allowance is made for the effects of the world recession) requires a level of taxation that is widely (if not universally) felt to be excessive, but which nevertheless leaves a very large overall budget deficit and heavy overseas borrowing (which cannot for long be sustained) in order to help finance it. The overall deficit must be reduced. But, for reasons discussed in the Council's *Report on Public Expenditure*, reductions in Government spending tend to be strongly resisted. At the same time, there is increasing evidence that increases in tax rates to raise more revenue in order to reduce the overall deficit provoke a defensive reaction by taxpayers, as they attempt to maintain their real disposable incomes (if not to prevent a reduction in the rate of growth in them to which they have become accustomed). When these claims for higher money incomes are pressed, the competitiveness of Irish products (both in the home and export markets) is further eroded.

2.23. The economy can get off the horns of the dilemma on which it is now impaled only through faster economic growth. This growth must be export-led. Export-led growth is possible only if Irish products are competitive. They will be competitive only if the growth in money incomes relative to the *trend* rate of growth in productivity is more favourable here than in neighbouring countries and especially than in the UK. The trend rate of growth of productivity cannot be

raised appreciably by any action that is possible in the short-run. The maintenance of competitiveness (where it still exists) and its restoration where it has been eroded or lost therefore requires a slower rate of growth in money incomes relative to productivity here than in Ireland's main export markets and especially in the UK. This is an inescapable pre-condition for faster growth. For real income expectations this means *reculer pour mieux sauter*. Any attempt to achieve faster growth through raising the level of domestic demand by fiscal measures will inevitably mean *sauter pour mieux reculer*.

2.24. It is particularly unfortunate that the country is faced with its present economic problems at a time when the potential for growth is greater than at any time during the history of the State. This potential is discussed in the chapter which follows. Unless the present problems are resolved along the lines described in the previous paragraph, this potential for growth will not be realised.

Chapter 3

THE POTENTIAL FOR GROWTH

3.1. This chapter analyses the potential for growth in the Irish economy over the next ten years or so. The pre-conditions for realising this potential have been described in Chapter 2. This potential will not be realised unless Irish products can be sold in the home and export markets at prices which are not only competitive but which also enable the capital employed to be remunerated, renewed and expanded. If these requirements are not met, Irish people will be poorer as a result of the goods and services whose production is thwarted, unemployment will reach unprecedented levels both in absolute terms and as a percentage of the Irish labour force, and net emigration will be forced up to the numbers that ruled in the nineteen-fifties.

3.2. On the supply side, the rate at which an economy can grow depends on the availability of productive resources and on the efficiency with which they are used. The main productive resources are capital and labour. Of these, the most important is labour. Economic growth is only superficially measured by the output of things; it is concerned rather with people and their well-being. All the people who will be seeking productive work for the first time during the next ten years have already been born and are now being educated and trained. With fast enough growth they will be able to find work in Ireland. Without it, they will be unemployed (and therefore dependent on transfers from the rest of the community) or forced to emigrate and look for work in other countries.

3.3. If the pre-conditions for growth are met, there is no reason why the supply of capital should become a constraint on providing work for all who seek it. The supply of capital can be increased

dramatically in a much shorter time than that required to rear, educate and train a worker. This can happen in two ways. First, when the economy is growing and businessmen and farmers have confidence that it will continue to grow, they will expand their productive capacity. The expansion will be financed from retained profits or borrowed funds. Both will be available if the pre-conditions for growth are met. The experience of other countries whose economies have expanded rapidly shows that the expansion in productive capacity can be self-promoting: expanding sales provide both the motive for more investment and the means to carry it out. Second, the domestic flow of investible funds can be augmented by an inflow of capital from abroad. This inflow would finance the purchase of plant, machinery and equipment produced in other countries. Private capital inflows to finance new enterprises bring with them the expertise to operate them, and the market intelligence and connections which assist in exporting the output. Moreover, when the economy is growing and real incomes rising, the financing of the necessary infrastructural investment by the public authorities is unlikely to pose serious problems.

3.4. In the context of this report, it is not necessary to discuss all the implications of foreign investment in this country. However, in arriving at any decision about its desirability or otherwise, the following considerations are relevant. First, if private foreign investment is needed to provide the new jobs that are required in Ireland and if it is not permitted or if it is discouraged, Irish people will still have to work with capital that is not owned by Irishmen—but they will be working with it outside Ireland rather than at home. Second, if foreign investment is necessary, it is preferable that it should flow into the country on private account rather than through external Government borrowing. Private external investment is more likely to earn additional foreign currencies to remunerate the foreign investors; if it does not, foreign lenders lose whereas the Government cannot avoid its obligations to repay its borrowings. Given the present level of external Government debt, foreign lenders might attach to future loans conditions relating to the way in which the Irish economy should be managed, thus limiting national sovereignty. This is much less likely to happen if the

capital inflows are on private account, coming from a number of different countries and effected through a multiplicity of firms.

3.5. Growth in national output will be accompanied by increasing imports. This will occur for two reasons. First, Irish industries need substantial amounts of raw and semi-processed materials; to the extent that these are not available within Ireland they have to be imported. Investment is generally a necessary (though not a sufficient) condition for growth and almost all the plant and equipment will have to be imported also. Second, consumers spend a part of their incomes on imported goods (and especially manufactured products), and the proportion of imports in total consumption generally rises as incomes increase. Imports will therefore tend to grow faster than national output; and the growth in output will be sustainable only if the rising imports can be paid for by rising exports and an inflow of foreign capital attracted by investment opportunities in Ireland. This will only be the case if Irish costs and prices are competitive.

3.6. The final category of inputs required for growth is labour. In the paragraphs which follow, the contribution of labour to growth is discussed in terms of the numbers of workers likely to be available, and the dimension of "quality" is ignored. The "quality of the labour force" is not discussed, because by international standards the level of education and the adaptability of Irish workers is high. Moreover, those who have had to emigrate in search of work seem to have had little difficulty in finding jobs. It is therefore reasonable to proceed on the assumption that the growing numbers who will be seeking work in future will be employable or can by training be made employable.

3.7. When the Council decided to embark early in 1974 on a series of studies aimed at up-dating and extending the National Industrial Economic Council's *Report on Full Employment*, it had to commission Professor Brendan Walsh of the Economic and Social Research Institute to make demographic projections for the period 1971 to 1986, and to calculate the net increase in total employment

that would have to be achieved if full employment were to be reached by 1986, on certain assumptions about the possible behaviour of emigration, fertility, marriage and participation rates. The results of Professor Walsh's study were published, together with the Council's comments, in *Population and Employment Projections: 1971-86* (NESC, No 5, February 1975).

3.8. The projections are summarised in Table 3.1. The range of figures shown for 1986 mainly reflects variations in the assumptions made about emigration (for example, zero or 5,000 per annum in 1986), female participation rates, and participation rates for both males and females in the age group 15-19 years.

3.9. Of course, it cannot be emphasised too strongly that these projections are not forecasts of what will happen. The figures merely indicate what *could* happen over the years to 1986 to the numbers who might be seeking work and to the numbers of dependants who must be supported, on certain explicit assumptions. The assumptions were not unreasonable in the light of the best information available when they were made.

3.10. However, projecting population trends is always a hazardous exercise. Changes in the size and composition of the population will depend, for example, on whether the economy expands or stagnates. If economic growth flags, many more people may be forced to emigrate than was assumed in the initial projections. This will change many of the other assumptions, so that the position in ten years time will be radically different. Again, at the present time it is very difficult to predict changes in birth and fertility rates. If the dramatic reductions in birth rates in many other European countries were to occur in Ireland, the growth in population (and especially in the younger age-groups) could be much lower. The projections summarised in Table 3.1 assumed either zero net emigration or net emigration of 5,000 a year. But statistics which have become available since Professor Walsh made his projections indicate that there has been net immigration in recent years.

3.11. It is even more difficult to predict the numbers who will be

TABLE 3.1 Summary of projections for 1986

	1986 (projected)				
	1971 (Actual in millions)	"Low" estimates*		"High" estimates*	
		Pro- jection in millions	Annual average % growth	Pro- jection in millions	Annual average % growth
<i>Total population</i>	2.98	3.51	1.1%	3.78	1.6%
<i>Age structure of population</i>					
0-14 years	0.93	1.08	1.0%	1.28	2.1%
15-19 years	0.27	0.31	0.9%	0.31	1.1%
20-24 years	0.22	0.29	1.9%	0.32	2.6%
25-44 years	0.63	0.92	2.6%	0.94	2.8%
45-64 years	0.61	0.56	-0.6%	0.56	0.5%
65 years and over	0.33	0.36	0.7%	0.36	0.6%
<i>Numbers seeking work</i>					
Males	0.83	0.97	1.1%	1.00	1.2%
Females	0.29	0.33	1.0%	0.35	1.3%
Total	1.12	1.30	1.1%	1.35	1.3%
<i>Occupational distribution</i>					
Family farm (both sexes)	0.23	0.14	-3.5%	0.15	-3.2%
Non-family farm (both sexes)	0.88	1.16	1.9%	1.20	2.1%
Total (both sexes)	1.12	1.30	1.1%	1.35	1.3%
<i>Non-family farm employment†</i>					
Total employment (both sexes)	0.82	1.12	2.1%	1.16	2.4%
Total unemployment (both sexes)	0.06	0.05	-2.5%	0.05	-2.2%
<i>Total non-family farm labour force</i>	0.88	1.16	1.9%	1.20	2.1%

*The "high" and "low" estimates are the upper and lower bounds of the possible range of change based on the assumptions used in the projections by Professor Walsh.

†Non-family farm employment relates to the level of employment (and hence unemployment) required to reach full employment on Professor Walsh's assumptions by 1986.

seeking work. Recent studies in other countries suggest that the proportion of the number of people of working age who will seek work—i.e., the labour force participation rate—is related to the job opportunities available (that is, to the pressure of demand for labour). While no similar studies have been published for Ireland, it is probable that participation rates would rise if full employment were approached, and that they would fall if the economy stagnated. The studies made for other countries indicate that variations in the level of demand have more marked effects on the participation rates for females than for males. This may or may not be true for Ireland, given the tradition of emigration, especially by males unable to find work at home. This provides another example of the intricate relationships between the pace of economic development and the size both of the population and of the numbers seeking work.

3.12. If full employment is accepted as a major objective of economic policy—and this is the goal that is relevant in assessing the potential for growth—then the number of new jobs required over the next ten years is likely to exceed 300,000. Indeed, this could represent the minimum requirement, when account is taken of the rise in participation rates that is likely to accompany the approach to full employment.

3.13. The argument thus far can be summarised briefly. The rate of growth in national output depends on the availability of productive resources and on how efficiently they are used. The main productive inputs are labour, capital and imports. Even on conservative assumptions, there is the potential for a very large increase in the supply of labour over the next ten years or so. Indeed, as far as the number likely to be available for employment is concerned, the potential for growth is probably greater than in any other OECD country, with the possible exception of Japan. In Ireland, this potential on the side of labour supply has existed at least since the second world war. The economic and social experience of the 1950s shows clearly what can happen if this growth potential is not realised. The 1950s demonstrated failure: economic stagnation, high emigration and a rate of increase in living standards that was among the lowest in the western world. The choice lies between reproducing that

failure in the remainder of the 1970s and in the 1980s and success. It is very doubtful whether there exists any substantial intermediate position.

3.14. The necessary condition for success is that Irish products can be sold on the home and export markets at prices which are competitive and which enable the capital employed to be remunerated, renewed and expanded. If this condition is met, progress towards full employment is unlikely to be constrained by lack of capital and the funds to finance it. Domestic savings (both personal and corporate) could easily be supplemented by capital inflows. If this condition is fulfilled, progress towards full employment will not be curbed by balance of payments constraints, because it will be possible to finance the growing requirements for imports by rising exports and capital inflows.

3.15. The growth in national output depends not only on the growth in resources but also on how productively they are used. The rate of growth in productivity in the economy as a whole is related to the rates of growth of output in the main sectors of economic activity (for example, agriculture, manufacturing, services), and on the rate of growth in productivity in each of these sectors. These are discussed in the following chapter which examines the growth process.

Chapter 4

THE GROWTH PROCESS

4.1. If the growth potential of the Irish economy is to be realised, then national output must expand at very much faster rates than have been achieved in the past. The policies that could accelerate the Irish growth rates, and the changes that are likely to be associated with the faster growth rate that is required, are more likely to be found in the experience of other countries which have grown faster than Ireland or which have reached a higher stage of development. This is done in Dr Llewellyn's study.

4.2. The total output of an economy consists of goods (that is, physical, transportable products) and services (for example, construction, insurance, banking, transport, personal services such as hairdressing, public administration and defence). The economy's output of physical products is produced by agriculture, manufacturing industry, and mining. This chapter is mainly concerned with how the experience of other countries can indicate the way in which the structure of the Irish economy will change as it develops. Since different countries have different endowments of mineral resources, the role of mining is not examined. While the mineral deposits discovered in recent years are important, their exploitation will not by itself generate full employment. Major discoveries of oil and natural gas could radically change future economic prospects. It would be imprudent to discard the pattern of development described in this chapter before these major discoveries have been made.

4.3. In the OECD countries, almost all of the output of physical goods is produced by agriculture and manufacturing industry. In the post-war period in these countries agricultural output has grown relatively slowly, and the Irish growth rate was somewhat below the average. However, until 1973, agricultural expansion was inhibited because Irish agricultural produce did not have unrestricted access to the British and West European markets. Full membership of the EEC will mean that the old barriers to trade will soon have dis-

appeared completely. However, one barrier still remains; because of the depreciation of the pound significant monetary taxes have to be paid on Irish agricultural exports covered by the Common Agricultural Policy (CAP). Unless an offsetting adjustment is made, any further depreciation of the pound against other Community currencies will result in higher monetary charges on Irish agricultural exports.¹ There is considerable potential for expanding agricultural output in this country.² Even if there is little expansion in the demand for food in EEC, this potential could be realised by increasing Ireland's share of it. In the OECD countries in the post-war period the output of manufacturing industry grew at a much faster rate than that of agriculture.

4.4. Dr Llewellyn's study shows that in other OECD countries there has been a close correspondence between the growth of goods output (that is, of agricultural and manufacturing output) and the growth in the major components of the services sector. The output of the services sector is usually classified into commerce, transport and communication, construction, public utilities, private services and public services. Good indicators exist for measuring the rate of growth of output in commerce, transport and communication, and construction.

4.5. Commerce includes wholesale and retail trade, restaurants and hotels, banking and finance, insurance, real estate and business services. In most countries, the rate of growth in output in commerce is measured by the rate of growth in the volume of sales. Dr

¹Under the Common Agricultural Policy, the common prices, import levies, export refunds etc., are fixed in units of account which are converted into national currencies at official representative rates ("green" rates). Due to currency fluctuations in recent years market exchange rates have diverged from these "green" rates. In order to maintain trade on the basis of the "green" rates and prevent the common prices from being undermined, the Community operates the monetary compensatory amount (MCA) system. Member states with depreciated currencies apply MCA's as charges on exports and subsidies on imports. At the present time a substantial gap exists between the market rate of the pound and the Irish "green" pound rate. This means that as a result of the depreciated pound, Irish farmers are paying more for imported fertilisers, fuel, oil and machinery, but Irish exporters of major agricultural products are not receiving the full benefits of a depreciating currency because of the imposition of monetary taxes.

²See *A Comparative Study of Output, Value Added and Growth in Irish and Dutch Agriculture*, NESCA, No. 24, 1976.

Llewellyn shows that over the past 25 years or so, in OECD countries the rate of growth of the commerce sub-sector has corresponded very closely with the rate of growth of output in the goods-producing sectors (namely, agriculture and manufacturing industry). A similar correspondence has existed in Ireland: over the period 1951 to 1973, the average annual growth rate in commerce was 3.2% and that of agriculture and manufacturing industry (the goods-producing sectors) 3.3%. This close correspondence is not, of course, unexpected or accidental. The assets that produce goods must be financed and insured, the productive process requires working capital, materials have to be distributed to farms and firms, and agricultural and industrial output must be distributed through wholesale and retail outlets.

4.6. There is some association between the rate of growth of transport and communication and the rate of growth of the goods-producing sectors (agriculture and manufacturing industry), but a sizeable part of the growth in the former cannot be explained (in a statistical sense) by the growth in the latter. This is not unexpected. Transport includes not only the movement of goods, but also of people whether for business or pleasure. Communication includes telephone, telegraph, telex and postal services: while some communication services are undoubtedly linked directly with the production of goods, others (such as personal telephone and postal services) are not. However, the growth in personal transport and in personal telephone and postal services is likely to be linked indirectly with growth in the goods-producing sectors: the growth in these services depends on the growth in real income which in turn depends on the growth in agricultural and manufacturing output. Nevertheless, it remains true that a large part of the output of the transport and communication sub-sector is directly related to the production of goods. While a one-for-one relationship is unlikely to appear, the output of transport and communication is likely to grow fastest when the output of the goods-producing sectors is growing rapidly.

4.7. The demand for the output of public utilities (for example, gas, electricity and water), like the demand for the output of commerce and transport and communication, is derived from the demand for goods. By contrast, the statistics for OECD countries do not show a

close correspondence between the rate of growth of output in the construction sub-sector and that of the goods-producing sector.

4.8. However, some construction output is related to the production of the goods-producing sectors, but much of it depends on demand from the personal and public sectors. This demand is likely to be stimulated by rising real incomes. Dr. Llewellyn's analysis of OECD experience shows a strong tendency for any given increase in the output of the goods-producing sectors to be accompanied by a more than proportionate increase in construction output. A similar relationship appears in the Irish statistics over the period 1955-1973. It would seem reasonable to conclude that rapid growth in construction output can be expected when there is rapid growth in agricultural and industrial output.

4.9. The experience of other OECD countries over the last 25 years or so shows, therefore, that the growth of output in commerce, transport and communication and construction is closely linked with the rate of growth in agricultural and manufacturing output.³ It would seem reasonable to expect that the Irish economy will conform quite closely with these patterns as it grows in the future. It has done so in the past. The next problem is the relative contributions to the growth in output in the different sectors that can be expected from increased employment and rising productivity. This is examined in the remainder of this chapter.

4.10. Since the early 1950s, in all the OECD countries included in Dr. Llewellyn's study, agricultural employment has declined in absolute terms, notwithstanding a steady growth in the volume of output in all the countries other than Norway. In almost all the countries, the

³In almost all OECD countries, agriculture, manufacturing industry, commerce, transport and communication and construction account for 75% or more of total civilian employment. The remaining sectors are private and public services. The sub-sectors cover a very wide variety of different activities and this makes it very difficult to measure their output and the rate at which it has grown. In practice, as Dr. Llewellyn states, the measurement of the growth in output is inextricably mixed up with the concept and measurement of productivity. For this reason, the output of these sub-sectors is examined in the context of the discussion of productivity growth later in this chapter.

rate of growth in productivity in agriculture, implied by the rising output and falling employment, has been higher than the rate of growth of productivity in manufacturing. The rates of growth in productivity in countries (such as the US and Canada) in which output per man is, and always has been, very high, and in countries (such as the UK) where output per acre is particularly high, were of the same order as those achieved in France and Italy—countries in which agriculture was generally judged inefficient, particularly in the 1950s and early 1960s.

4.11. The sources of growth in productivity in agriculture are numerous and their relative importance has almost certainly varied from country to country. They include the reduction in disguised unemployment (or "underemployment"), increase in average farm size, more mechanisation, greater use of fertilisers, improvements in agricultural technology, and a general improvement in the ability and willingness of farmers to use new methods and technologies. Many of these sources of growing productivity cannot be measured and their contribution is therefore not susceptible to statistical analysis. Given the fast rates of growth in productivity achieved in countries whose agriculture would generally be judged efficient and the benefits of EEC membership, there can be little doubt that rapid increases in both agricultural productivity and output are achievable in Ireland over the next ten years or so. If the rate of increase in Irish costs could be reduced to that of the continental EEC countries, the rate of growth in agricultural output might approach that of productivity, so that the numbers engaged in Irish agriculture could decline much more slowly than in the past.

4.12. Over the last 25 years or so, fast-growing OECD countries experienced rapid growth in manufacturing output, and slow-growing countries experienced slow growth in manufacturing output. However, during these years changes seemed to occur in the relative contributions of increases in employment and in productivity to the growth in industrial output. From the early 1950s to the mid-1960s, employment in manufacturing typically grew at about seven-tenths, and productivity at about three-tenths, of the rate of growth in manufacturing output. As between countries, this relationship varied with the rate of investment in manufacturing. Where the rate of investment

was high, slower growth in employment and faster growth in productivity were associated with any given rate of growth in manufacturing output (and *vice versa*).

4.13. Over the period from the mid-1960s until the early 1970s, almost all the OECD countries experienced some acceleration in the rate of growth in productivity in manufacturing, often accompanied by a slowing down in the rate of growth in manufacturing output. In this period, there was no statistically-significant association between the rate of growth in manufacturing output, and the rates of growth in employment and productivity. Whatever the reasons for these changes in the relationships between the growth rates in output, employment and productivity (and no convincing explanation of them seems to have emerged as yet), they make it difficult to assess what is likely to happen in the future. In Dr Llewellyn's judgment, it would seem prudent to assume that in the future, rapid growth in manufacturing output will require growing employment in much the same proportion as obtained between the early 1950s and the mid-1960s. This could be a pessimistic view of the potential for growth in manufacturing output if the higher productivity growth rates that accompanied the generally lower rates of output growth after 1965 were to continue into the future.

4.14. Earlier in this chapter, it was shown that the rate of growth in output in the commerce sub-sector was apparently closely determined by, and approximately equal to, the rate of growth in output in the goods-producing sectors (agriculture and manufacturing industry). Dr Llewellyn's study indicates a high degree of correlation between the rates of productivity growth in manufacturing and commerce from the early 1950s until the early 1970s. The figures suggest that an acceleration of 1 percentage point per year in the rate of growth of productivity in manufacturing would be accompanied by a slightly greater acceleration (1.1 percentage points) in the rate of growth of productivity in commerce.

4.15 During 1955 to 1964, the rate of growth of productivity in the commerce sub-sector in Ireland broadly followed this pattern. However, during 1965 to 1973 the productivity growth rate in com-

merce relative to that in manufacturing industry was much higher than the experience of other countries would have suggested. This could reflect deficiencies in the data for the commerce sub-sector, much of which had to be estimated. In Dr Llewellyn's judgement, it would be plausible and sensible to assume that productivity in commerce will grow in the future at about the same rate as productivity in manufacturing. The manufacturing sector is likely to continue to grow relative to the agricultural sector,⁴ so that the growth rate in output of the goods-producing sectors will approximate to that of manufacturing. This in turn would imply that the growth rate of output in the commerce sector would approximate to that of manufacturing, so that the growth rate in employment in commerce would tend to be much the same as the rate of growth in employment in manufacturing industry.

4.16. The relationship between the rate of growth in transport and communication and the rate of output growth of the goods-producing sector was discussed in paragraph 4.6 above. Dr Llewellyn's analysis of what happened in some OECD countries between the early 1950s and the early 1970s suggests that employment in transport and communication typically grew at about six-tenths of the rate of growth of output in that sub-sector. When allowance is made for economies of scale and for continued improvement in technology, his analysis suggests that if (for example) the output of the transport and communication sub-sector in Ireland were to grow at 5% a year, employment in it would grow by about 1% a year.

4.17. No direct measure of output in the "other services"⁵ sub-sector of the services sector is possible, because no physical output is produced. Statisticians therefore usually infer the rate of growth of output from the rate of growth of input, and the input most often used is employment. In many parts of the other services sub-sector, it is likely that productivity growth has occurred as a result of the substitution of capital for labour and of better organisation. This may have

⁴A significant part of the relatively faster growth in manufacturing output may be the result of processing increases in agricultural outputs.

⁵"Other services" consist of private services and public services. See footnote to paragraph 4.9 above.

happened, for example, in laundries and dry-cleaning, in hospitals, in dentistry and in education. However, it is in the nature of many other service activities that what is being bought is the services of a man or woman for an hour. The most reasonable conclusion is that there has been productivity growth in some of the large service activities, but that in the other services sub-sector as a whole the rate of productivity growth has been a good deal lower than in agriculture, manufacturing, commerce, and transport and communication. In assessing how high the rate of growth in productivity in the other services sub-sector is likely to be, cross-country evidence gives little help. But there seems to be a tendency for productivity in this sub-sector to rise rather faster in countries that have experienced rapid productivity growth in industry.

4.18. The discussion so far can be summed up briefly. The growth in national output depends on the growth in productive resources (labour and capital) and on how efficiently these resources are used. The necessary condition for growth is that Irish products can be sold on the home and export markets at prices which are competitive and which enable the capital employed to be remunerated, renewed and expanded. If the precondition is met, the expansion of national output is unlikely to be constrained by lack of capital to expand productive capacity or by inability to pay for rising imports. If the pre-condition is met, the potential for economic growth over the next ten to fifteen years is greater than in almost all other OECD countries, because of the projected growth in the supply of labour.

4.19. If this potential is to be realised, national output must grow at very much faster rates than have been achieved in the past. The structural changes in the economy that would accompany such growth are therefore more likely to be found in the past experience of other countries which have grown faster than Ireland and which have already reached a higher stage of development. Their experience may give some indication of the changes in the Irish economy that will be associated with faster growth.

4.20. In the growth process, the key sectors are agriculture and manufacturing industry—the sectors which produce physical goods. Given the small size of the Irish market, the growth in the goods-

producing sectors must be export-led. This means that their outputs must be available at prices which are competitive and which enable the capital employed to be remunerated, renewed and expanded. The growth in agricultural and manufacturing output will (both directly and indirectly) increase the demand for the outputs of major parts of the services sector (namely commerce, transport and communication, construction and public utilities). On the basis of the past experience of other countries, it is likely that the output of these major service activities will grow at least as fast as the output of the goods-producing sectors.

4.21. There is great potential for expansion in agriculture. The growth in agricultural output is likely to be associated with high rates of productivity growth and some reduction in the numbers employed—but at a slower rate than in the past. In manufacturing industry, the growth in employment and productivity will depend on the rate of growth in manufacturing output. The growth in the major service activities (such as commerce, transport and communication, construction), which would be generated by the growth in agriculture and manufacturing, is likely to be accompanied by similar relative contributions from growth in employment and growth in productivity.

4.22. No attempt has been made to draw together, in a formal model of the economy, the projected growth in the labour force and the pattern of growth rates in output, employment and productivity in the main sectors that is likely to occur if the growth potential is realised. An exercise of that kind is not possible within the Council's resources. In any case, a model of the economy is now being formulated in the Department of Finance and the Central Bank in co-operation with other interested bodies and particularly the Central Statistics Office and the Economic and Social Research Institute.⁶

4.23. In the discussion in this chapter of the growth process, it has been assumed that rapid growth in Ireland would follow the same broad pattern as that which occurred in other OECD countries which have grown rapidly over the last 25 years or so. The justification for

⁶See *Report on Public Expenditure*, NESc No. 21, July 1976, paragraph 6.14, pages 55 and 56.

this assumption is that in the past, growth in Ireland has been accompanied by structural changes similar to those which occurred elsewhere. However, other growth processes are conceivable. For example, it might be argued that growth in Ireland could be initiated and led, not by the goods-producing sectors and the sectors whose outputs depend, directly or indirectly, on the growth in the goods sectors, but by the expansion of public services such as education, health and welfare.⁷ But this argument has not been developed and articulated. Nor are there any historical examples of fast growth being started and maintained by policies of this kind. Indeed, the discussion in Chapter 5 below confirms that in present circumstances economic growth cannot be initiated and sustained by an expansion of public expenditures.

⁷The National Industrial Economic Council expressed its views on this possibility quite clearly in its *Report on Full Employment* (see paragraph 148, pages 111 and 112):
". . . an expansion in non-productive Government expenditure . . . could by itself bring about a fairly large increase in the level of employment, but it would inevitably be associated with domestic inflation and with deficits in the balance of payments which grew far too rapidly. These might for a very short while be financed by an inflow of foreign capital but this would soon cease as falling exports reduced the prospects of repayment. The tendency for external deficits to rise could be controlled only by a reversion to tariff and quota protection, by direct exchange controls or by periodic (and increasingly frequent) devaluations in the external value of the currency; but these measures would only limit imports while rising prices eroded the capacity to export. If this path were followed, inevitably a time would come when radical corrective measures would have to be applied, and one of their inescapable consequences would be a cut-back in employment. This approach to full employment might be likened to buying ice on hire-purchase in a hot climate where there is no refrigeration."

CHAPTER 5

THE KEY SECTORS

5.1. In the discussion so far, the activities that generate national output have been broadly classified as either goods or services. The key sectors are those which produce goods—namely, agriculture and manufacturing industry. Growth in these sectors generates growth in some of the major service activities (such as commerce, transport and communication, construction). The key to faster growth therefore lies in creating the conditions in which the goods-producing sectors can expand as rapidly as possible. Some of the major obstacles to growth which now inhibit the expansion of these sectors are examined in Chapter 6 below. To identify these obstacles to growth, a different (though related) classification of economic activities is useful.

5.2. No activity that uses economic resources can continue in existence unless its costs or money outgoings (including the cost of using, maintaining and renewing whatever capital it employs) are, at the least, covered by receipts. No activity can expand unless it earns or receives a surplus of receipts over costs. This applies to *all* activities—to farms, business firms, banks, hospitals, universities, voluntary bodies engaged in social work, trade unions, business and professional associations. All these activities use economic resources—that is, workers, capital in some form or another, goods and a variety of services. All the activities that use economic resources can be classified into two categories, depending on the source of their receipts: first, those in which the receipts come from (are earned by) sales through markets; second, those activities in which the receipts come from “grants”.

5.3. In the activities in the first category, the goods and services are sold directly for money. The receipts which accrue depend on decisions voluntarily made by persons, households, firms or other

agencies to buy what the activity produces and to pay for the purchases out of the money at their disposal. The activities in this first category constitute the *market sector* of the economy. The private sector falls within the market sector to the extent that the receipts from sales cover costs. To the extent that private firms receive “grants” from the Government to help cover current costs or assist in financing investment, they would fall into the second category—the *non-market sector* (see paras 5.6 *et seq* below). The same applies to Government trading activities. If semi-State bodies (such as the Electricity Supply Board or Comhlucht Siúicre Éireann) earn all their revenues from sales, they would fall wholly within the market sector. Córas Iompair Éireann would fall within the market sector only to the degree to which its revenues came from the rates and fares it charges. Though an oversimplification, it would be justifiable to treat the market sector as being virtually the same as the private sector of the economy.

5.4. The activities in the second category obtain their receipts—the money needed to finance them, to cover their costs—from grants. A grant means a one-way transfer—a change in the ownership of (or command over) economic resources from a donor to a recipient. What the donor pays reduces his command over goods and services. In return for what he pays he does not receive goods and services of equivalent value. If his payment is used to finance a public service such as education or health, he may, of course, have access to the service provided, but there need not be (and usually is not) any correspondence between the payments he makes and the benefits he receives. A grant, therefore, differs from an exchange, which is a two-way transfer. With exchange, the payment voluntarily made is matched by the receipt of equivalent value. In the market sector, goods and services change hands through exchange: they are bought through decisions voluntarily made by buyers; the same goods and services are sold as a result of decisions voluntarily made by sellers.

5.5. The grants made by persons, households and firms may be voluntary or involuntary. Examples of a voluntary grant would be a gift to a relative or a contribution to charity. A voluntary grant may approximate towards an exchange: a contributor to a charity, for example, may enjoy some psychic satisfaction that he deems equiva-

lent. However, in the Irish economy these voluntary grants are relatively unimportant—in total they amount to a small fraction of the gross national product. By far the most important example of an involuntary grant is taxation. In the case of direct taxation, the tax payments cannot legally be evaded. The same largely applies for the community as a whole to indirect taxation: if the Government is to obtain revenue, the indirect taxes must be imposed on goods and services that people feel they must buy; if they are not imposed on these goods and services no revenue, or not enough revenue, will flow to Government.

5.6. The activities that are financed by grants constitute the *non-market* sector of the economy. It would not be a gross oversimplification to regard the non-market sector as being virtually the same as the public sector. It would include State trading activities to the extent that they received current or capital subsidies from the Government or local authorities. It would include firms and agencies in the private sector to the extent that they received similar grants. In the simplest case, all activities in the non-market (mainly the public) sector must be financed sooner or later by transfers from the market (mainly private) sector. This, of course, is an oversimplification, because those employed in the public sector are subject to the same direct and indirect taxes as those employed in the private sector. But the taxes they pay fall far short of meeting their cost; while reducing the net transfer required from the market sector, it does not eliminate it. If it did (as will be seen later) no problem would arise and no obstacle to economic growth would exist.

5.7. This distinction between the non-market and market sectors carries with it no implication that the outputs of the former are less (or for that matter more) desirable from a social viewpoint than those of the latter or that the market sector could function effectively without at least some of the services provided by the non-market sector. The goods and services needed to satisfy public (or social or collective) wants can be provided only through the non-market sector. An example is law and order: since no-one can be excluded from the benefits, there exists no incentive to pay for them voluntarily; they cannot therefore be provided through the market and must be made

available by Government. Some goods and services which are provided through the non-market sector (such as education, health, a good deal of housing) could be provided through the market. The fact that they are not, reflects a judgement that the provision through the market would be inadequate or inequitable in the access it offered to these services. The fact that such services confer benefits not only on those who enjoy or use them, but on the community as a whole is a further argument for their provision through the non-market sector. The disadvantaged and the needy must be supported through the non-market sector. There is therefore no implication that one sector is inherently more important on social grounds than the other. The main concern in this chapter is with their relative importance in the context of achieving faster and sustained economic growth.

5.8. The distinction between the non-market and market sectors of the economy is the first necessary step in any attempt to identify the major obstacles that now exist to faster economic growth. The conclusion that the non-market sector consists mainly of the public sector, and that the market sector is largely the same as the private sector is based on fact, and does not reflect preferences, ideologies, hopes or fears. The second step that is needed to identify the obstacles to growth requires a closer look at the market sector.

5.9. The activities that fall within the market sector can be divided into two broad categories: first, those which are not sheltered from external competition, and second, those which are sheltered from such competition. The unsheltered, or exposed, activities are those which are exporting and/or which have to face competition from imports in the home market. With the freeing of trade over the past ten years or so, under the Anglo-Irish Free Trade Area Agreement and the transitional arrangements attached to EEC membership, more of the activities in the market sector have moved into the unsheltered category. All exports of goods and services, and all goods and services which have to meet competition from imports, are produced in the unsheltered part of the market sector.

5.10. The prices of the goods and services produced by the unsheltered activities are determined externally. If Irish wages and other

costs rise faster than those in other countries (and especially in the UK), firms which are exporting or which have to compete with imports cannot pass on the full increases in higher prices. Their profits and profit margins are therefore squeezed. At best, the funds available for new investment are reduced, so that less investment will occur. At worst, the prices at which they can export or at which they have to sell to compete with imports no longer cover costs, and the firms become unprofitable, can employ fewer workers and may be forced out of business.

5.11. This is true not only for industrial products, but also for agricultural products. Under the CAP, increases in the support prices for major agricultural products are determined, *inter alia*, by reference to what has been happening to costs of production and earnings in other sectors in the EEC as a whole. The increases agreed upon will be less remunerative for Irish farmers to the extent that their costs have risen faster than those in other countries in the Community. Full membership of the EEC will also mean the freeing of trade in agricultural products generally. These therefore face given prices in export markets and increasingly have to compete with imports in the home market. If agricultural costs in Ireland rise faster than those in the other countries, farm incomes will be squeezed (or will increase at a slower rate), so that the incentive to expand output will be reduced.

5.12. The unsheltered activities in the market sector now consist mainly of agriculture and manufacturing industry. By comparison with agricultural and industrial exports, "pure" tourism (as measured by expenditure by foreigners visiting Ireland for non-business reasons) is relatively small, though both value-added and the potential for growth are considerable. Exports and imports of commercial and financial services are relatively small as well. The sale of transport services (and especially air transport) to foreigners may be somewhat more important. At present, exports of professional services are very small, though there is undoubtedly considerable scope for architects and quantity surveyors to do work abroad, especially in the oil-producing countries. The development of those exports would be likely to generate some exports of goods (for example, building materials). However, at the

present time, the unsheltered activities in the market sector of the economy can be broadly equated with the goods-producing sectors—that is, with those economic activities which must play the leading role in initiating and sustaining economic growth.

5.13. The unsheltered market activities can be further sub-divided into "old" and "new". The former consist mainly of firms and industries which were established as a result of tariff protection in the 1920s and later decades. It was with the adaptation of these industries in preparation for freer trade that the Committee on Industrial Organisation, and later the Committee on Industrial Progress, were mainly concerned. In these industries, labour productivity was, for a variety of reasons, generally relatively low and costs relatively high. These industries have suffered especially from increases in costs in recent years, exacerbated by the recent world recession. The new industries consist of those set up since the 1950s with the assistance of industrial grants and export profits tax relief. These new firms have generally been subsidiaries or associates of foreign companies, and since their establishment have been wholly or mainly orientated towards exports. They have generally been more capital intensive than the older firms and industries, using technologies similar to those employed by their parent companies. They therefore had the potential for levels of productivity similar to those being achieved in more developed countries, and in fact this potential has often been realised here. These new firms have not in general suffered to the same extent from the relatively faster increase in Irish costs in recent years. The importance of this subdivision of the unsheltered market sector into "old" and "new" firms and industries is discussed further below.¹

5.14. A small economy like Ireland cannot escape the effects of a world recession. The effects of a recession are felt first by the unsheltered activities in the market sector of the economy. The demand for exports falls and the competition from imports in the home market

¹A distinction between industries established before 1970 and those set up since then might be more relevant. The effects on profitability and cash flow of industrial grants may diminish or wear off after about five years, so that new firms which received grants could suffer in much the same way as the older firms established under tariff protection.

becomes more acute. As a result, output in the unsheltered activities falls and redundancies occur. This directly causes reductions in purchasing power. There will be further reductions in real spending because of the fall in the derived demand for services such as commerce, transport and communication, construction, electricity, etc. It is in this way that the recession enters and spreads through the Irish economy. At existing tax rates, tax revenues will fall (at least in real terms), but Government expenditure will tend to rise because of the rising unemployment and the pressure for Government action to reduce it. Conversely, the benefits of an upturn in world trade and output can "enter" the Irish economy only through the unsheltered market sector. The extent to which the unsheltered activities will benefit will depend on the competitiveness of their output. If their products are competitive, then exports will expand faster and imports will rise less quickly, so that output and employment in the unsheltered activities will expand more rapidly. This will cause an increase in the derived demand for the output of those service activities whose growth depends on that of the goods-producing sectors. This is the only way in which a world recovery can enter and spread through the Irish economy.

5.15. The *sheltered* activities in the market sector consist of those which do not export and which do not have to meet competition from imports in the home market. In this sense the whole of the non-market sector is sheltered: public services are not exported, nor are they imported. The sheltered activities in the market sector all lie within the services sector of the economy. They include building and construction, the repair and maintenance of vehicles, hairdressing and all personal services, professional services, wholesale and retail distribution, rail and road transport, all public utilities, and most of banking and finance. The prices of the services provided by these sub-sectors are not determined externally. Nor are they in any direct way constrained by the level or behaviour of external prices: a person wanting a haircut or a house, for example, must buy it in Ireland. Within many of these sub-sectors, there may be intense competition in Ireland: for example, this may be the case in retail distribution, especially in the larger urban centres. External firms may enter retail distribution here, but since they will incur the same domestic costs as the firms already established in the trade, the price they charge for their services will approximate

towards that already ruling in Ireland. In some of these sub-sectors, competition may be absent or limited: this is the case in almost all the professions where price competition is not generally permitted. In such cases, the price charged for the service may be higher than it would be with competition. However, there would still be no external constraint on the charges that could be made.

5.16. Sheltered activities in the market sector are therefore in a quite different position from the unsheltered activities. The latter have little or no scope for raising their prices to compensate for a higher rate of increase in costs than is occurring elsewhere, because the prices obtainable in export markets and the prices of competing imports are externally determined. By contrast, the former (the sheltered market activities) suffer from no such constraint. Increases in their costs can be passed on in higher prices and their profit margins can usually be maintained. Those who are engaged in these sheltered activities, or who manage them, are aware of their power to pass on cost increases in higher prices. They have grown accustomed to acting in this way and react strongly to any attempts (for example, by the National Prices Commission) to restrain them from doing so.

5.17 The argument thus far can be summarised briefly as follows. All activities which use economic resources can be classified into two categories. First, the market sector in which sellers obtain revenues as a result of voluntary decisions by buyers about how they will spend the money at their disposal. The market sector consists mainly of the private sector, though these are important publicly owned trading activities (such as the Electricity Supply Board, Irish Shipping, Irish Life, Irish Sugar Company and the Industrial Credit Company). It includes the goods-producing sectors (agriculture and manufacturing industry). These are key sectors because the growth in them will generate growth in the major service activities. Second, the non-market sector consists mainly of public sector activities. Those who produce non-marketed output receive their reward from net compulsory transfers from those engaged in the market sector of the economy. The market sector can be further sub-divided into unsheltered and sheltered activities. All exports and all import substitutes are produced by the unsheltered activities. They have therefore little or no control over

their selling prices, and if Irish costs rise faster than those elsewhere their profits are squeezed, investment and employment fall and firms are forced out of business. The sheltered market activities neither export nor have to meet competition from imports, so that they are not subject to the same tight constraints in passing on cost increases in higher prices. They share this insulation from external constraints with the non-market (mainly public) sector. The economy therefore consists of an unsheltered market and a sheltered market sector (in both of which private enterprise predominates in Ireland) and a non-market sector (which consists mainly of the public sector). The key to faster and sustained economic growth lies in the health of the first of these sectors, namely, in the unsheltered market sector whose main components at this stage in Ireland are agriculture and manufacturing industry.

CHAPTER 6

THE MAIN OBSTACLES TO GROWTH

6.1. There are two major obstacles to the rapid growth of the unsheltered (or exposed) market sector, and therefore to the growth of output and employment in the whole economy. The first lies in the relative strength of sectors other than the exposed market sector in the negotiating procedures through which increases in money incomes are determined. The second obstacle is raised by the efforts that must be made to reduce the public sector deficit. These obstacles are discussed in the paragraphs which follow.

6.2. The relative strength in pay negotiations of the main sectors of the economy that were distinguished in the previous chapter reflects the distribution of workers and employees among them. Of the total number at work outside agriculture of 790,000 in 1975, about 25 per cent (at most) were engaged in the unsheltered (or exposed) market sector (that is, in manufacturing industry): about 55 per cent were in the sheltered market sector, and about 20 per cent in the non-market sector. Those in activities that were exposed to external competition (whether in the home or export markets) were therefore in a minority. As trade unions and their officers see it as their duty to further the interests of their members, it should not be surprising if the settlements negotiated were determined mainly by some compromise between employers representing the sheltered market and non-market sectors and trade unions representing the workers engaged in them. It should not surprise anyone if the settlements determined in this way were not conducive to the expansion of the market sector.

6.3. It is worth exploring the reasons why this can happen. Until the mid-1960s, virtually all economic activities were sheltered—certainly the unsheltered market sector was very small. Most manufacturing industries enjoyed substantial protection from tariffs and/or import quotas; the exports of major agricultural products were subsidised and

imports of products that competed with domestic agriculture were prohibited or limited. Over the 40 years ending in the middle of the last decade, increases in wages and other domestic costs could be passed on in higher prices (even if these made necessary still higher protection or resulted in higher export subsidies and higher taxes). With the freeing of trade in industrial and agricultural products, the situation has changed radically—but attitudes and the conception of economic realities have changed much more slowly. In the sheltered market sector and in the non-market sector (at least until recently when the public sector deficit reached an unsustainable level), it is and always has been the case that increases in wages and other domestic costs can be passed on in higher prices or in higher taxes. In the sheltered market activities, there can be a long lag between an increase in prices and the falling off in demand that results in unemployment. The latter occurs only when the exposed sectors suffer and the demand for the output of the sheltered activities falls. Moreover, both employers and employees in the major sheltered market activities are generally in a strong bargaining position relative to the rest of the community. Little suffering is inflicted immediately on the community (though much on those who work in it) if a firm or industry that exported most of its output is closed by a dispute or put out of business. The same is true of firms and industries whose output competes with imports, because in free trade conditions their output can be replaced by imports. However, this does not apply to major activities in the sheltered market sector: a dispute which closes down the Electricity Supply Board or the Associated Banks can inflict widespread and serious damage on the community.

6.4. The general increases that have been negotiated have therefore tended to reflect the capacity (or the ability to get the money) to pay in the sheltered market and non-market sectors. "Inability to pay" provisions have recognised that the increases negotiated may not be capable of being paid in all sectors—in fact these clauses have been used most frequently by firms in manufacturing industry. However, the existence and use of these provisions do not solve the problem. If an increase in employee incomes negotiated at national level is not paid, or not paid in full, there is the danger that such "unpaid" increases would tend to become a prior claim on the future profits of the firms

involved. If this were to happen it could have major implications for new investment and therefore for the future growth in employment and output.¹

6.5. It might be argued that the problems posed for manufacturing industry by the increases that have been negotiated could have been avoided or resolved by increases in productivity (that is, in output per man). The exposed market sector produces physical goods; productivity has grown much faster historically in the activities that produce goods than in those which produce services, and the potential for faster growth in productivity in the goods sector is likely to continue for the foreseeable future. Despite the historical experience, there are at least three reasons why in present circumstances the increases in money incomes are unlikely to be offset by productivity growth. First, if the competitiveness of manufacturing industry—and especially of the older industries—is to be maintained or improved, what is required is higher productivity at the *existing* gross money wage. But there now seems to be a firmly established expectation that additional increases in money incomes must be offered in compensation for higher productivity. The experience of the National Prices Commission has shown that the additional increases generally have to be paid in advance of the increase in productivity. Restrictive practices are, in effect, a new form of property, and they will be removed only to the extent that they are bought by employers. What is being bought is the prospect but not necessarily the reality of higher output per man. As a result, productivity agreements tend to raise rather than lower unit costs in the short-run. Second, increased productivity often requires an increase in the amount of capital employed per worker. If profits are already being squeezed by the increases in money incomes, firms will not be able to finance the new investment that is required. Third, in the exposed manufacturing sector, margins have been squeezed between the prices that can be charged in the home and export markets and rising domestic costs. The squeeze has been tightened by the more acute price competition associated with the recent world recession. At the same time, there appears to be a fairly widespread belief in manufacturing industry that the importance of its role in economic

¹The relationship between profits and investment is discussed in paragraph 6.7 below.

growth is not understood and its problems are ignored by Government. These conditions are not conducive to action to raise productivity and investment in Ireland—they are more likely to encourage firms to invest elsewhere.

6.6. The discussion in the previous paragraph relates mainly to the manufacturing firms and industries that were established before 1970. It does not generally apply to the new firms that have been attracted to Ireland over the last five years or so with the aid of industrial grants and export profits tax relief. These firms generally use more up-to-date technologies, employ more capital per worker than the older firms, operate in growth industries, and have at least the potential for levels of productivity approaching those of their parent companies for similar activities in highly developed countries such as the US and West Germany. These new firms and industries once fully established are more likely to be able to pay the increases in line with the national norm, without profits being depressed to unremunerative levels (especially when account is taken of export profits tax relief). Indeed, the introduction of a new firm in which the levels of productivity and wages are high into a region may tend to pull up wages in other activities in the region, and in that way generate a localised "incomes inflation", with resulting pressure on margins in already existing activities.

6.7. The effects of the institutional arrangements through which increases in incomes are determined may therefore be summarised briefly as follows. Over the past fifteen years and more, the size of the negotiated increases in money incomes have been determined mainly by reference to what the sheltered market sector could pay. The strong pressures to maintain the existing traditional differentials between different activities and occupations meant that these increases tend to be generalised throughout the economy. Indeed, almost all employees regard any increase negotiated at national level as their minimum entitlement. In the sheltered market activities, employers could recoup the higher labour costs through price increases. In the non-market sector, the Government and local authorities (the main employers) were able to get the money to pay the higher wages and salaries through increases in taxation or in borrowing. But in the exposed market sector, selling prices are externally determined. If, in firms in this sector, incomes are rising faster relative to productivity than in other countries, profits in

these firms will be reduced and some may be driven out of business. These effects are likely to be particularly severe in the older industries that were established under protection. The exposed industries suffer further as a result of the higher prices they have to pay for the services they buy from the sheltered market sector—for example, their costs rise further as a result of the higher charges for electricity and transport. The result is unemployment and a lower rate of investment by manufacturing firms. External firms in manufacturing industry may find Ireland less attractive as a location for new plants, because of the relatively higher costs and lower profits, so that new foreign investment in industry will also tend to fall. As a result, future growth in industrial output and employment will be slower. Farm profits will also be squeezed because of the higher prices farmers have to pay for the output of the sheltered market sector, so that investment in agriculture is likely to be reduced as well. But since the exposed sectors (industry and agriculture) that suffer in this way are the key sectors whose rate of growth largely determines the rate of growth in the economy as a whole, the future growth in national output and in total employment will suffer also.

6.8. The second obstacle to the faster growth in the exposed market sector of the economy (see paragraph 6.1 above) is raised by the efforts that must be made to reduce the very large overall budget deficit that now exists. These efforts must be made because deficits on the present scale will soon lead to an unsustainable accumulation of borrowings that are largely in foreign currencies. These efforts are also necessary to meet two of the three conditions attached to the February 1976 loan of \$300 million under the European Economic Community loan scheme. These are :

- (a) The growth in the Central Government borrowing requirement as a percentage of gross national product should be halted in 1976 and should be reduced in subsequent years.
- (b) every effort should be made towards financing the largest possible proportion of the public sector borrowing requirement by non-monetary means (such as placing long-term securities directly with the public).

The Government's stated intention to phase out the present current deficit over a three-year period is consistent with these conditions. The current budget deficit in 1976 was estimated at £327 million in the January Budget. The elimination of a current deficit of this size within a three-year period will require a significant transfer of resources from the private sector through taxation, unless there are reductions in real current public expenditures or a dramatic increase in the rate of growth in national output and employment.

6.9. The present state of the public finances, its implications and the steps that should be taken to improve it, were discussed in the Council's *Report on Public Expenditure* (NESC, No. 21, July 1976). The present level of public expenditure (even when allowance is made for the recent world recession) requires a level of taxation that is very widely (if not universally) felt to be excessive, but which nevertheless still leaves a very large overall budget deficit and a heavy borrowing requirement. The borrowing requirement has been met to a large extent in recent years by external borrowing denominated in strong currencies that have been appreciating in value against the Irish pound. The foreign borrowings have been running at a level which cannot for long be sustained, and the servicing and repayment¹ of even the existing borrowings are likely (unless a much faster rate of economic expansion is soon achieved) to create balance of payments problems. The present size of the current budget deficit and the amount and terms of public sector borrowing—the high interest rates and the relatively short periods within which loans must be repaid—provide no grounds for hope that the tax burden can be lightened in the foreseeable future. It is very difficult to reduce public expenditure in real terms: these expenditures pay the incomes, directly and indirectly, of individuals and groups and therefore create strong vested interests in their maintenance and expansion. If the deficit is to be reduced, then tax revenues must be raised to the extent that public expenditures cannot be reduced.

6.10. In its *Report on Public Expenditure*, the Council concluded that the rate of growth in public expenditure must be reduced. The relatively poor prospects for growth in the economy in the short-term hold

¹If refinancing on satisfactory terms cannot be arranged.

little promise of buoyancy in tax revenue. If the public sector deficit is to be contained, it may be difficult to avoid increases in tax rates. Increasingly, however, there is evidence that increases in tax rates to raise more revenue, in order to reduce the overall deficit, provoke a defensive reaction by taxpayers, as they attempt to maintain their real disposable incomes (if not to prevent a reduction in the rate of growth in them to which they have become accustomed). The relationship between higher tax rates and increases in money incomes is clear as far as indirect taxation is concerned: increases in the rates of indirect taxes raise prices, and compensation for these increases was accepted in the 1974 and 1975 National Agreements. There was no acceptance of the argument of the Minister for Finance that the measure of the rate of increase in prices that was relevant in wage negotiations was an index which excluded the effects of increases in the rates of indirect taxation. The response to increases in the rates of personal income tax tends to be similar. Such increases mean that a higher proportion of income is taken in income tax, and this in turn means a slower rate of growth in disposable incomes than in incomes before tax. Further increases in money incomes may be demanded to escape this cut in real spendable income. Firms may also react defensively to increases in the rates of corporate taxation by attempting to raise prices to maintain their post-tax margins.

6.11. The demands for increases in money incomes, following action by Government to take a larger proportion of personal income in taxation, are likely to be met in the sheltered market sector of the economy, because the firms in this sector can generally pass on increases in incomes in higher prices. In this sector, firms may also try to pass on increases in corporate taxation. If granted in the sheltered market sector, the increases in incomes will probably be (and in the past always have been) paid by the non-market (public) sector. This means that the difficulties being faced by the exposed market sector will be intensified. The firms in this sector will be under pressure to pay the same increases as those granted elsewhere. At the same time they will have to pay higher prices for services bought from the sheltered market sector and any increase in corporate taxation will squeeze their margins still tighter.

6.12. The main conclusions of this chapter can be summarised briefly as follows. Increases in money incomes are determined mainly by reference to what the sectors of the economy that are sheltered from external competition can pay. The strong pressures to maintain the existing traditional differentials between different activities and occupations means that these increases tend to be generalised throughout the economy. In the sheltered market sector, employers can generally recoup the higher labour costs through price increases. But in the exposed market sector, selling prices are determined externally. As a result, the profitability of the exposed market sector is reduced, some workers are paid off and some firms are driven out of business, because of the rise in incomes and the higher cost of the services bought from the sheltered market sector. This applies throughout the exposed market sector—both in agriculture and manufacturing industry. This has serious implications for economic growth. The exposed market sector is the key one in the growth process. If the profitability of the firms and farms in it is reduced, there will be less investment and a slower growth in employment. This means slower growth in the sheltered market activities and therefore in the whole economy. This largely explains the domestic contribution to the problems that the economy now faces. These problems could be made more serious still. To the extent that the rate of growth in public expenditure is not curbed, the rate of growth in tax revenue must be raised. Given the relatively poor prospects for economic growth in the short-term, it may not be practicable to avoid increases in taxes. These are likely to precipitate demands for further increases in money incomes as employees attempt to maintain their living standards. These demands will in all probability be granted in the sheltered sectors and similar increases will be expected in the exposed sector. This will exacerbate the problems of the exposed sector and thereby further reduce the prospects for growth in the economy as a whole.

CHAPTER 7

THE POLICY OPTIONS

7.1. The primary objective must be to realise the full potential for growth of the Irish economy over the next ten to fifteen years. If this is done, then work will be available for those who seek it, and at rising standards of living, the most urgent social needs of the community can be met and the problems of financing public sector activities will be eased. In the achievement of faster growth in output and employment, the key sectors of the economy are manufacturing industry and agriculture—if they grow, so will the whole economy. There are two main obstacles in the way of faster growth in the exposed market sector. The first exists because the level of money wages (as determined mainly by employers and workers in the non-market and sheltered market sectors) is too high relative to the wages that can be paid in the exposed sector, if its competitiveness is to be maintained. As a result, profitability is squeezed, more firms are finding it difficult to sell in export markets and compete with imports at prices which cover costs, investment is reduced and the prospects for expansion in output and employment have suffered. The second will become important if attempts are made to reduce significantly the public sector deficit by increased taxation. This could provoke demands for increases in incomes that the sheltered sectors are likely on past experience to concede. But these increases would intensify the problems facing the exposed sectors and further reduce the prospects for their growth and therefore for the growth in national output and total employment. In this chapter the policy options are considered. It will be seen that both the range of choice and the room for manoeuvre are limited.

No policy changes—first option

7.2. The first option is the continuation of existing policies. Given the

legacy of 1975 and of 1976 so far, the outlook for 1977 for the Irish economy will depend mainly on the following :

- (a) what happens in the world outside Ireland, and especially in Britain;
- (b) what happens in Ireland during 1977 and especially the economic policies that are applied to reduce the public sector borrowing requirement and to restrain the growth in money incomes.

To get a clearer picture of what could happen in 1977, it is necessary to make specific assumptions about (a) and (b) above.

7.3. A recovery in world output and trade has occurred over the past twelve months, led by expansion in the major industrial countries. It seems probable that the upswing will be weaker and will develop at a slower pace than that which occurred during 1971 to 1973. It is probable also that in the economies that are leading the recovery, action will be taken to curb growth rates if there appears to be any danger of a repetition of the very large increases in world commodity prices which occurred during 1972 and 1973. In the largest industrial countries, growth seems likely to be sacrificed to avoid inflation. And by inflation in those countries is meant a rate of increase in prices that (in the light of recent experience) would be regarded here as being near to price stability.

7.4. The main external influence on the Irish economy is what happens in Britain. In the second year of Britain's anti-inflationary policy—the twelve months ending in July of 1977—pay increases are likely to be limited successfully to 5 per cent on total earnings, with a cash minimum of £2.50 and a cash maximum of £4.00 per week. It would be prudent to assume that Britain will succeed in restraining pay increases below the rate of increase in prices for a third year, starting in the middle of 1977. If Irish policies are based on this assumption, and if present British policies are not successfully extended, the relative competitiveness of Irish products will deteriorate less quickly or improve more quickly. If Irish policies were based on the assumption that British policies would not be successful, and if in the event they were,

a further and rapid deterioration in the economic situation would be unavoidable. Given the assumption about what will happen in 1977 in Britain and in the world in general, the economic situation in Ireland will depend mainly on what happens to money incomes and on what economic policies are applied.

7.5. The final phase of the 1975 National Agreement related to a period of 3 months and was paid to all workers (with the exception of those employers who successfully pleaded "inability to pay") as from some date between 1 January 1976 and 1 March 1976. This was followed by a two month's pause. Following a proposal from the Irish Employers' Confederation, an increase of between £3 and £5 per week was accepted for a 5-month period. This was the same as the first phase of the draft 1976 National Agreement, which was rejected by a delegate conference of the Irish Congress of Trade Unions in July 1976. These increases are related to basic rates, but in many employments the increases actually paid will exceed £5 per week. The increases which will be paid following the expiry of the 5 months will be negotiated in the National Employer Labour Conference following tri-partite discussions between Government, employers and trade unions (or in bi-partite discussions between Government and trade unions and Government and employers) which began in September 1976. Any assumption about the outcome of these discussions and negotiations must be purely speculative. If a similar increase were granted for a further period of 7 months, after the 5 months have expired, this would almost certainly mean a faster increase in money incomes in Ireland through the first half of 1977 than would be occurring in Britain. If this should happen, it would have serious effects on competitiveness. As far as budgetary policy is concerned, if an attempt were made in 1977 to reduce the current budget deficit to two-thirds of the current deficit in 1976, and if the public capital programme were maintained in real terms, this would mean a reduction in current public expenditure or an increase in taxation (or some combination of both of these) equal to about 2½ per cent of the gross national product. This would require new taxation and/or reductions in current expenditure in excess of £100 million.

7.6. The continuing evolution of Government policy makes it difficult

to define precisely what is meant by the continuation of existing policies. If existing policies are (even approximately) as described in the preceding paragraph, then the following conclusions seem inescapable. Money incomes and prices would rise in 1977 at rates faster than those likely to occur in the British economy. Given the maintenance of parity between the Irish pound and sterling, the competitiveness of Irish goods would decline relative to those produced in Britain. If any further depreciation in sterling merely reflected changes in the relationship between the rate of increase in British prices and the rates of increase occurring elsewhere, then the competitiveness of Irish products in markets other than Britain would decline also. There would therefore be little growth in national output and a further rise in unemployment. By any standards (international, past performance, current requirements or potential for growth) this would represent failure. It would be a waste of effort to attempt to quantify a forecast for 1977 on these assumptions; all available energies should be directed to achieving (or at least laying the foundation for) increases in output and employment in 1977 and the following years.

Protection—a second option

7.7. Over the past year or so, some trade unions and employer organisations have argued that some form of protection (for example, import controls) would help solve at least some of the present economic problems. Import duties or controls would make imports dearer and therefore help to maintain employment in firms producing for the domestic market. In achieving this aim, they would work faster than other policies—such as some of the options discussed below—which have the same objective of reducing unemployment. In theory, protection against imports might achieve its aims without the adverse movements in the terms of trade (that is, a rise in import prices relative to export prices) which are associated with some of the other policy options, but at the cost of more rapid increases in the prices of the domestic products being substituted for imports.

7.8. However, in Irish circumstances the arguments against the protection of home production from imports—other than measures to counteract dumping—are overwhelming. In this report, it has been

consistently argued that the key to faster growth lies in the exposed market sector of the economy—in the activities which export and which have to meet competition from imports in the home market. Major primary and processed agricultural products are already protected—not in the home market but in the much larger EEC market. Protection for industrial products would give no help to export industries; it would be more likely to increase their costs and make them less competitive. If protection were nonetheless imposed, it would give some temporary help to industries suffering from competition from imports. There may be cases where selective controls to help industries that are severely depressed would be justified. However, such action by itself would do nothing to make the protected firms more efficient and competitive. Indeed, by shifting more activities into the sheltered market sector it would strengthen the processes that have reduced competitiveness in the exposed sector of the economy. Selective controls should therefore be strictly temporary and accompanied by action to improve the competitiveness of the firms and industries to which they gave protection. Apart altogether from the above arguments, there remains the fact that import controls could provoke retaliatory action, and thus cut off markets for Irish exports. Moreover, they would be contrary to the rules of the GATT and the EEC.

7.9. In Ireland, as in every other economy, the real standard of living that can be enjoyed depends on real productivity per worker. Output per worker reflects the efficiency of agriculture and industry. Protection featherbeds inefficiency. Moreover, in most industrial and agricultural activities, efficiency is related to the size of the enterprise—greater productivity is frequently one of the economies of scale. The Irish market is too small to absorb the output of plants of the most efficient size in many activities, so that part of output (and often the greater part) has to be exported. It was the gradual recognition of this fact that was the main reason for the growing emphasis on industrial exports through the 1950s and the movement towards freer trade in the 1960s. A return to protection might temporarily maintain employment in the protected industries, but it would work towards reducing competitiveness in the activities that remained unprotected, and almost certainly to lower the growth rates in national output and in overall employment in the longer term. The only way in which employment

can be protected in the industries that have to compete with imports is by producing goods in Ireland that are more attractive to Irish consumers (in terms of price and quality) than the corresponding goods from other countries. This is the necessary condition for maintaining and expanding exports. There is no other way in which rising employment at rising real wages can be achieved.

Monetary and Fiscal Policies—a third option

7.10. The third option is to use the “appropriate” monetary and fiscal policies. These policies are important instruments for managing the level of total demand in the economy. They can be used to smooth out fluctuations in the level of total spending and in that way to reduce fluctuations in the levels of employment and output. Fiscal policies involve tax reductions and/or increases in public expenditure to expand total domestic demand, or raising taxes and/or reducing public expenditure in order to reduce it. Monetary policy is concerned with controlling the volume and price of money with a view to influencing domestic expenditure.

7.11. In Ireland, the Government, employers and trade unions have all clearly indicated that a main policy goal must be to reduce unemployment. At the present level of unemployment, the economy is clearly not suffering from excess demand. Reflationary (expansionary) monetary and fiscal policies might therefore seem desirable. In present Irish circumstances there is little or no scope for reflating domestic demand by fiscal action. Such action would mean raising Government expenditures relative to tax revenues, and therefore increasing the overall budget deficit. But it is already very difficult to finance the public sector deficit at its present level. Even if it were possible to finance a bigger deficit, however, a reflationary fiscal policy would be unlikely to be successful. Increased domestic demand cannot fill the gap left by the fall in foreign demand caused by the erosion of competitiveness. And it would strengthen rather than weaken the forces that have been at work to reduce competitiveness. It would therefore provide no basis for a sound recovery in employment. In a small open economy such as Ireland, a pre-condition for achieving a significant and lasting reduction in unemployment is an improvement in competitiveness.

7.12. Disinflationary monetary and fiscal policies might be used (and are sometimes advocated) to improve competitiveness. A disinflationary monetary policy means restricting the rate of growth in the money supply relative to the demand for money, so that it may become more difficult for borrowers to obtain bank loans. A disinflationary fiscal policy means cutting government expenditure and/or increasing tax revenues. These policies will reduce the level (or the rate of growth) of domestic demand.

7.13. In Ireland, the aim of monetary policy has generally been to accommodate and validate the increase in prices that seemed inescapable (given the behaviour of money incomes and import prices) and to finance any increase that was forecast in real national output. The objective has been to avoid any rise in money supply beyond this amount, because any such further increase might become a cause of further inflation rather than a consequence of the inflation that is already there. Monetary policy is obviously constrained by the freedom of movement of funds, both current and capital, between Ireland and the UK. This free movement of funds means that Irish interest rates cannot diverge appreciably from comparable UK rates, and that the target increase in the money supply can be enforced only if inflows or outflows of money (to the extent that these are not already taken into account) are neutralised or offset by Central Bank action.

7.14. If monetary policy is to counteract domestic inflationary pressures, then the permissible increase in the money supply must be less than that required to accommodate the expected increase in prices plus the expected increase in real national output. Such a policy will for a time result in higher unemployment by reducing real domestic demand. It is argued that this further rise in unemployment will lower inflationary expectations and create a disposition to accept smaller increases in incomes. It is difficult to give any precise indication of the time that will elapse between the introduction of a restrictive monetary policy and the resulting reduction in inflationary pressures.

7.15. Even assuming that a restrictive monetary policy is feasible and that it would succeed in its objective at the level of the economy as a

whole, its effects are unlikely to be spread evenly over the different sectors. The demands of the public sector (which dominates the non-market sector) for funds to finance its activities must be met. If they are met within the target increase in the money supply, there will be that much less available to meet the needs of the private sector. If the demands of the public sector are not fully met from the domestic banking system, as a result of an attempt to preserve an appropriate share for the private sector, then the public sector will raise the balance of its needs externally. To maintain the existing target increase in the money supply, this foreign borrowing must be offset and this will cause the same restriction in the funds available for lending to the private sector. If foreign firms are able to meet that part of their needs which is not met in Ireland by borrowing from their parent companies, similar consequences will follow. The result will be that the brunt of the credit restriction will ultimately fall on the sheltered market sector and on older firms in the exposed market sector. Since the sheltered market sector has scope for maintaining its profits, and therefore its credit-worthiness, by raising its prices to pay the increases in incomes, its needs are more likely to be met. The exposed market sector—and especially the older established firms in it—is likely to suffer most. Its profit margins will be squeezed by the increases in money incomes that precipitated the restrictive monetary policy. And with falling profits and the erosion of competitiveness, it will appear less credit-worthy to prudent bankers.¹

7.16. The total bank lending advised or authorised by the Central Bank is allocated mainly by the Associated Banks. The Central Bank may indicate the general criteria that should be used in allocating the total among the different sectors, but the translation of these criteria into operational directions is done by the banks' boards, and the actual allocation is made by bank managers. The Associated Banks are retailers of bank credit. However, they differ from other retailers in one important respect. In other retail activities, the products on offer are allocated by price. In retail banking, the price of credit is the rate of interest that has to be paid. For a variety of reasons, interest rates are

¹It is regrettable that no studies have been made in Ireland of the relative impact of monetary (and of fiscal) policies on the different sectors of the economy—and indeed of their general distributive effects.

not determined by the domestic demand for and supply of bank credit. As a result, during a recession (or when monetary policy is accommodating) all the credit available to the private sector may not be taken up at the existing interest rates, and during a recovery (or when monetary policy is restrictive) more may be demanded at the existing interest rates than is available for lending. In these latter circumstances, credit has to be rationed, and the criteria used in rationing are of vital importance to the economy. Rationing means that credit is being allocated by administrative decisions rather than through normal market processes. Wherever rationing is necessary, it is important that the criteria being used are clearly stated and widely publicised, so that informed judgments can be made about the extent to which administrative decisions are consistent with major economic objectives.

7.17. Within the existing institutional framework, a restrictive monetary policy would have to be associated with a disinflationary fiscal policy—that is, with a reduction in the public sector's residual borrowing requirement (from new domestic bank credit and external borrowing). There is at present very little scope for an independent interest rates policy in Ireland. This limits the range of measures that can be used to make lending to the public sector more attractive to the non-bank public. In these circumstances, a disinflationary policy must mean a reduction in overall public sector deficit. In the past in Ireland (as indeed in other countries) there may have been a preference when formulating disinflationary policies for tax increases rather than reductions in public expenditure. Increases in the rates of indirect and of direct taxation (both personal and corporate) may provoke a defensive reaction by personal taxpayers as they try to maintain their real disposable incomes,² and by firms as they attempt to maintain their post-tax margins. In the non-market (public) sector and in the sheltered market sector these demands are likely to be met, and firms in the latter sector may try to pass on the increases in corporate taxation in higher prices.³ Again, the burden of the disinflationary policy will tend to fall more heavily on the unsheltered market sector, where the pres-

²This reaction and its effects were discussed in more detail in paragraph 6.10 in Chapter 6 above.

³Studies made in other countries suggest that profits taxes are often passed on in higher prices. No similar studies have been made in Ireland.

sure to pay the same increases as those granted elsewhere, the higher cost of the services bought from the sheltered market sector, and the higher corporate taxes will tend to squeeze profitability.

7.18. It is therefore difficult to escape the conclusions that excessive increases in incomes will depress profits, reduce investment and increase unemployment in the exposed market sector, and that attempts to curb the growth in money incomes in the economy by restrictive monetary and disinflationary fiscal policies will exacerbate the difficulties of the exposed market sector during the period required for such policies to achieve their objectives. Since it is unlikely that these objectives will be achieved quickly, the damage to the exposed market sector may be considerable and lasting, and the real costs in terms of lost output and higher unemployment unacceptable.

Devaluation—a fourth option

7.19. A fourth option would be a devaluation of the Irish pound relative to sterling, in order to improve the competitiveness of Irish industrial products. Devaluation would be the "textbook" way of achieving a quick reduction in export prices (in terms of foreign currencies) and of increasing the prices of imported products (in terms of Irish pounds). To the extent that export prices did not need to be reduced in terms of foreign currencies by the full amount made possible by a devaluation, export prices measured in Irish pounds would be increased. The size of the devaluation required to achieve any given improvement in competitiveness will be the greater, the larger is the import content of the products being exported. The import content of Irish manufactured exports (in the form of imported capital goods and materials for further production) is considerable. The "textbook" analysis would argue that devaluation (accompanied by the appropriate monetary and fiscal policies) would have a favourable effect on employment in the industries producing goods for export and for sale in competition with imports in the home market. Output would tend to rise towards the capacity of the plants already in existence. By increasing the profitability of exports and import substitutes, the profitability of the exposed industrial market sector would increase, and there would be an

incentive for it to grow larger. Within EEC arrangements, the price of agricultural exports covered by the CAP would not necessarily rise as a result of devaluation against sterling, unless it was accompanied by an offsetting adjustment in monetary compensatory amounts. This would be the case because a devaluation against sterling would lead to a corresponding increase in the monetary taxes on the agricultural products covered by the CAP system.

7.20. The Irish economy has experienced the effects of a devaluation of the Irish pound relative to major currencies other than sterling. The value of sterling, for example, has fallen from \$2.80 in the Autumn of 1967 to less than \$1.75 in mid-September 1976. Since parity has been maintained with sterling, Irish industrial exports have enjoyed the benefits of a devaluation in markets other than the UK (and their competitiveness relative to "third country" imports into the UK has improved), and the prices of imports from these countries have risen in Irish pounds. However, if prices and costs in Ireland were to rise faster than in the UK between now and the end of 1977, changes in the external value of sterling would not be enough to keep Irish products competitive in external markets. The depreciation that has occurred in the value of sterling increased the inflation which Ireland had to import and, therefore, contributed to the rate of increases in money incomes that occurred as employees attempted to maintain their living standards.

7.21. If past experience of how money incomes have been raised to compensate for price increases is taken as a guide, the potentially favourable effects of a devaluation of the Irish pound against sterling would be neutralised by domestic developments. Costs of production consist mainly of import prices and domestic wage and salary costs. In the exposed market sector, at any given exchange rate, selling prices and import prices are given. If the difference between the price at which a firm can sell its output and the cost of the materials it must buy in (that is, the value added by the enterprise) is not sufficient to pay the ruling money-wage rates and leave enough for the capital employed to be maintained and renewed, the firm's problem will be survival and not expansion. A devaluation will generally increase the value-added by enterprises in the exposed sector. If money incomes relative to

productivity remain the same, funds will be generated to finance expansion. If money incomes are raised to compensate for the increase in prices following the devaluation, this will not happen. Devaluation, therefore, recognises the fact that the level of real incomes being demanded is too high to enable exposed enterprises to cover their costs. It can succeed only if real incomes are reduced below what they would otherwise have been—that is, if prices are allowed to rise faster than money incomes. If the Irish community were to offset the higher prices caused by the devaluation by paying itself higher money incomes, the devaluation would bring no benefit. There would be no change in output and employment, but money incomes and prices would be higher than before. The economy would be back to where it started, requiring another devaluation. If devaluation is to succeed, therefore, an agreement that the percentage rise in money incomes would be kept well below the percentage increases in prices following the devaluation would be required. But the devaluation became necessary because it was not possible to achieve this degree of restraint in the growth of money incomes. There could therefore be no grounds for confidence that the policies needed to make a devaluation successful would be applied.

7.22. 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. In the meantime, overseas creditors might lose patience or confidence, and increasing unwillingness to hold Irish pounds (both by residents and foreigners) or to lend foreign currency to cover the budgetary or external deficits, could lead to another devaluation. Another (and similar) problem is that the increased volume of exports required if the devaluation is to work would 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 were devalued further might dissuade potential investors from investing in Ireland, making another devaluation all the more likely.

7.23. All this *could* happen even if a fall in real incomes were accepted following the initial devaluation. It certainly would happen if

real incomes were not reduced, because that would be interpreted as making a further devaluation inevitable. Exporters would postpone converting their receipts in foreign currencies into Irish pounds; importers would pay for the goods they bought as speedily as possible. Every statement that real incomes must be maintained, every major dispute by a group in a strong bargaining position, and every pessimistic statement by a banker or businessman, would help to generate more speculation against the Irish pound. The relationship between confidence and the behaviour of the exchange rate was amply demonstrated by what happened in Britain during 1976.

7.24. The Council therefore does not believe that the answer to current Irish economic problems is to be found in a devaluation of the Irish pound relative to sterling. Its economic effects are uncertain and, even if beneficial, would in all probability be transient. It would have serious effects on confidence. It would be a pure act of faith to believe that the shock effect of a devaluation would miraculously change attitudes and expectations. It would add another complication to the relations between the Republic and Northern Ireland. The current problems facing the Irish economy could be resolved in other ways which are less unpalatable and certainly less risky, and which in any case would be a necessary part of the strategy needed to make a devaluation successful.

Pay Restraint—a fifth option

7.25. This report has repeatedly emphasised the importance of the exposed market sector. If this sector expands, so will the rest of the economy. A pre-condition for its expansion is competitiveness. Industrial competitiveness can be improved if pay rises more slowly than in competing countries. This could be achieved by restraint on the growth in money incomes in this country. Indeed, Ireland is such a very small part of the world economy that there is no reason why there should not be continuing growth in output and employment—no there should not be continuing markets—if pay increases are such as to keep Irish products competitive, because Irish exports account for only a minute proportion of world trade in similar products. The greater the restraint in the growth of money incomes the faster the

growth in output and employment that can be achieved. By strengthening the industrial sector and industrial profits, and by moderating the increase in agricultural costs, pay restraint would encourage the investment that is needed in new machinery and jobs and also enable employees in the exposed market sector to achieve the same security of employment as those engaged in the non-market and sheltered market sectors of the economy. It is only in this way that the economy can find the path that leads towards full employment with a manageable balance of payments deficit.

7.26. Pay increases for 1976 have already been determined by the fourth phase of the 1975 National Pay Agreement and by the general acceptance of further increases in the range £3 to £5 per week for a five month period starting during 1 June 1976 to 1 August 1976. In general, these increases in Ireland will exceed those occurring in the UK during 1976. The degree of pay restraint required could not therefore be introduced earlier than the end of 1976. If it were introduced then, a month or two could elapse before its effects worked through to ex-factory prices and perhaps three to four months before they were reflected in the behaviour of retail prices. The effects on the volume of manufactured exports might not be visible until the early summer of 1977. By that time the recovery in world trade and output could be levelling-off. For some products, the restraint might not have restored competitiveness in international markets (or in the Irish market) until the third quarter of 1977 or even later.

7.27. The majority of the Council recommended pay restraint as part of the package (the non-payment of the second phase of the 1975 National Agreement together with measures to reduce the rate of increase in the consumer price index by 4 percentage points) put forward in the *Report on Inflation* (NESC, No. 9, June 1975). It is the view of the majority of the Council that the non-payment of the second phase of the 1975 National Agreement would have been accepted by the majority of employees as part of the package proposed in the *Report on Inflation*. The Council recommended pay restraint in its report on the *Economy in 1975 and Prospects for 1976* (NESC, No. 13, October 1975). The representatives of the Irish Congress of Trade Unions, in a reservation to that report, stated

that they could not commit themselves to any view on it or its implications and must therefore reserve their position. It is, however, the view of the majority of the Council that the recommendations in the report on the *Economy in 1975 and Prospects for 1976* represented an implicit consensus, but for obvious reasons there was no explicit consensus and none could (or should) have been expected.

7.28. The increases proposed in the draft 1976 National Agreement showed some degree of restraint, in that the percentage increase in pay was somewhat smaller than the expected percentage increase in prices. This draft agreement, however, was rejected by a delegate conference of the Irish Congress of Trade Unions in July 1976. The longer the time that elapses before enough restraint is applied, the greater will be the reduction in real incomes that will be needed to improve competitiveness to the required extent.

Conclusions

7.29. The over-riding objective must be to realise the full potential for growth of the Irish economy over the next ten to fifteen years. In realising this potential, the key sectors of the economy are manufacturing industry and agriculture—if they grow, so will national output and employment.⁴ The main obstacle to achieving the growth rate that is required in manufacturing industry, if progress is to be made towards full employment, is that high rates of pay are too high in relation to the value of output per person employed. As a result, investment is reduced because profitability is squeezed, more firms are finding it difficult to sell in export markets and compete with imports at prices which cover costs, and the prospects for expansion in output and employment have suffered. The inescapable precondition for faster growth is an improvement in industrial competitiveness. This will not be achieved by the maintenance of existing policies, by protection or by monetary and fiscal policies. Nor will a permanent improvement in competitiveness be achieved by a devaluation relative to sterling.

⁴For example, an average increase of about 15,000 new industrial jobs a year would be required if industry was to make its contribution towards achieving full employment. This would require annual average increases in manufacturing output very much higher than any achieved in the past.

7.30. The quickest and surest way to improve competitiveness is pay restraint. The vital importance of pay restraint was emphasised in the Council's *Report on Inflation* (NESC, No. 9, June 1975) and *Economy in 1975 and Prospects for 1976* (NESC, No. 13, October 1975). The earliest date at which restraint can now be applied is when the present interim agreement ends towards the end of 1976. The size of any further increases in money incomes for 1977⁵ must not exceed what manufacturing industry can pay *while still improving its competitiveness* (especially relative to UK products). It is only in that way that Irish industry can benefit from the upturn in world trade and output that is likely to continue through 1977. It is very unlikely that a more favourable external environment will exist in the years which follow.

7.31. The possibility of restraining pay increases could be jeopardised by budgetary policy. Indeed, it could be argued that the increases in indirect taxes in the 1975 and 1976 budgets resulted in higher pay increases than would otherwise have occurred. The Government's requests that increases in indirect taxes should be ignored in pay negotiations were not accepted, and the increases in direct tax allowances in the 1975 and 1976 budgets were not directly related to pay restraint and seemed to be largely ignored. Two probable but related features of the 1977 budget are already known from statements by the Minister for Finance and the conditions attached to the EEC loan.⁶ First, a step will be taken towards eliminating the current budget deficit by 1979. Second, there will be some reduction in the Central Government borrowing requirement as a percentage of gross national product in 1977 as compared with 1976. This condition would be met if the borrowing requirement rose at a slower rate than GNP in 1977. If, within that constraint, the current budget deficit was reduced, a corresponding increase in the public capital programme would be possible.

⁵If there were *no* general increases in money incomes after the interim agreement has expired, average money incomes would still be 4% higher in 1977 than in 1976. This figure excludes the effects of additional increases (for example, relating to equal pay or "special increases" negotiated in 1976).

⁶See footnote to paragraph 2.15 above.

7.32. The main aim of the 1977 budget should be to achieve an improvement in the competitiveness of the exposed market sector of the economy, and especially of manufacturing industry. However, this would not necessarily be achieved by a shift from current to capital expenditure: the effect on competitiveness would depend on which current expenditures were reduced and on which capital expenditures were raised.

7.33. In 1977 the phased approach towards reducing the borrowing requirement must take the form of moderating the growth in public expenditure or increasing tax rates, or some combination of both. Increases in the rates of direct and indirect taxation should be avoided, because they would make the required degree of pay restraint more difficult to achieve. There is a growing body of evidence that employees are interested mainly in the behaviour of their real disposable incomes—that is, in the quantity of real goods and services they can buy with their earning after direct taxes have been deducted. An increase in tax rates is therefore likely to provoke a demand for compensating increases in money incomes—or for larger increases than would otherwise have been sought.

7.34. It could be argued that employees should think of the "real social wage" accruing to them rather than of their real personal disposable incomes. In broad terms, the social wage is the gross income earned *less* direct and indirect taxes paid *plus* all benefits received both in cash and in kind from social and other public services. However, when measuring their standard of living and how it is changing employees do not identify the social wage, and the concept appears to have had little effect on their pay expectations.

7.35. In 1977, the containment of the Central Government borrowing requirement must therefore be achieved by moderating the growth in public expenditure. Unpalatable and unpleasant decisions will be necessary, and the Council does not under-estimate the difficulties that will arise in making them. However, to the extent that the community will not accept increases in taxation without seeking compensation in higher money incomes, the burden must fall on the level of public services provided for the community. The choice lies between a re-

duction in real personal disposable incomes and a reduction in volume of services provided by the State.

7.36. If increases in tax rates provoke demands for larger pay increases than would otherwise have occurred, it might be expected that a reduction in tax rates which increased real disposable income would result in employees accepting a greater degree of pay restraint. Indeed, the use of tax concessions in the 1976 UK budget to "buy" smaller pay increases may have led to expectations for a similar approach here.⁷ However, within the limit set to the public sector borrowing requirement in 1977, there is no scope for similar measures here, unless they are matched by corresponding reductions in the growth in current expenditure (over and above those needed to reduce the current budget deficit), or by reductions in the planned growth in the Public Capital Programme (if these further restrictions on current expenditure are not applied). The same constraints would apply to any other budgetary measures aimed directly at lowering costs in manufacturing industry.

7.37. The main aim of the 1977 budget should be to make the maximum contribution towards an increase in industrial competitiveness. This means that increases in tax rates should be avoided, and some reduction in the burden of personal taxation achieved, these being directly related to pay restraint. Further budgetary steps to improve industrial competitiveness by directly reducing industrial costs would indeed be desirable. Given the limit set to the Central Government's borrowing requirement, tax increases can be avoided and any concessions financed only by a larger reduction in the growth of public expenditure than would otherwise have been necessary. To the extent that the growth in current expenditure cannot be sufficiently reduced, the growth of the Public Capital Programme must be curbed. However, it cannot be emphasised too strongly that the scope for using fiscal policy to improve the competitiveness of the exposed sector is very limited. The limit is set by the need to contain (and then significantly reduce) the public sector borrowing requirement, by the extent to which public expenditure can be (further) reduced to make

⁷Tax allowances were increased in the 1975 and 1976 budgets in Ireland, but the increases were not directly related to discussions on pay changes.

possible at least the avoidance of tax increases and at best some tax concessions, and by the possibility of shifting the emphasis within public expenditures towards those which will improve competitiveness.

7.38. Recent experience has shown that attempts to increase domestic demand by fiscal action cannot succeed in filling the gap left by a fall in foreign demand caused by the erosion of competitiveness. Such attempts provide no lasting basis for a sustained expansion in employment. In a small open economy such as Ireland, a precondition for achieving a significant and lasting reduction in unemployment is an improvement in the competitiveness in the exposed market sector of the economy.

7.39. In this chapter, the emphasis has been on the policies available for creating the necessary conditions for faster growth. That is why the report as a whole has been entitled *Prelude to Planning*. If sufficient pay restraint to improve competitiveness is assured, then the first stride towards full employment in ten to fifteen years can be planned. If competitiveness cannot be assured, then the plan must be concerned with how a declining population can learn to live with stagnation and inflation, and with how those who will not be able to find work in Ireland can be trained and helped to find it elsewhere.

7.40. When the basic conditions for growth have been established, it will be possible to articulate the structural policies required to facilitate and accelerate it. The policies were described in general terms by the National Industrial Economic Council in its *Report on Full Employment*. If costs and prices are competitive these policies will have more prospect of success. If costs and prices are not competitive, these policies will be able to contribute little towards growth in the economy, and more will be expected of them than they can possibly achieve.

**ADDENDUM BY THE CONFEDERATION OF IRISH INDUSTRY AND
THE IRISH EMPLOYERS' CONFEDERATION**

The Confederation of Irish Industry and the Irish Employers' Confederation consider that the first priority for 1977 must be to create the conditions within which industrial output get on to a growth path, which will create the demand for 15,000 net new jobs annually in the manufacturing sector. If this growth is to be achieved, with minimum disruption, it must take place in a balanced way throughout all the major sectors of manufacturing industry. The jobs must be provided at a level of skill and technology which enables products manufactured in Ireland to be internationally competitive. The productivity of industry in Ireland must improve at a rate which is, at least, as fast as international competition, making full use of changes in technology. Whereas about 15,000 net new jobs represent an increase of 8% in the employment of the manufacturing sector, additional increases in output must be achieved in order to keep up with international trends in productivity and technology; and also to make some preparations for the move towards higher productivity which will be essential if Ireland is to close the gap between wage rates in this country and elsewhere in the Community, and to overcome the handicaps which our geographical position imposes. The output of manufacturing industry must, therefore, be assisted to grow at a rate close to 15% per annum, if these dual objectives of increased productivity and increased employment are to be achieved.

The CII and IEC consider that this output target is achievable if the following conditions obtain:

- (a) The rate of growth in production costs for Irish industry, taking 1976 and 1977 together must be lower than that in Britain. The main element in domestically generated production cost is wages, whether direct or indirect. If the rate of growth in wage levels is contained, Irish production is likely to

grow at a rate at least as fast as the growth of European trade.

- (b) Additional growth must be achieved by reducing the cost of production. The CII and IEC recommend three approaches :

- (i) A reduction of manufacturing employers' social security tax. This would have the effect of reducing labour costs. Labour intensive firms would be the main beneficiaries from the reduction of this tax. A reduction should, therefore, help to maintain employment in the firms which are now particularly vulnerable. The reduction in production costs could be expected to generate an increase in demand for Irish made products within a year.

- (ii) Reduction of company tax on retained earnings in the manufacturing sector. This would have four advantages:

1. It would recognise the crucial role of the manufacturing sector in generating growth in the economy, would make investment in manufacturing more attractive than in the services sector, and would generate confidence in investing in the manufacturing sector.

2. It would reduce the distinction between profits attributable to exports and profits attributable to home sales. The contribution made to the development of the economy by the firm which successfully exports is no greater than that made by a firm which successfully competes with imports. The extension of tax relief would remove an inequity and an anomaly in the present system of company taxation.

3. The extent to which a firm would benefit from the relief would depend on the size of the profits it was earning. Since the whole of manufacturing industry

is now fully exposed to external competition, a high rate of profit is an indication of greater efficiency, and a low rate of profit of lower efficiency. This measure would, therefore, help those companies with inherent strength, and enable those to expand.

4. The cost of granting this relief would be relatively small.
- (iii) Eliminating the recently imposed hydrocarbon tax which made even the efficient users of oil based energy, including electricity and gas, less competitive.

The CII and IEC consider that some combination of these measures would be adequate to ensure that the output of Irish manufacturing industry would be growing at an annual rate close to the 15% growth output required within twelve months, if no further indirect taxes were imposed on the manufacturing sector.

Finally, the CII and IEC stress the urgent need to take these actions in order to provide the necessary stimulus for the growth of the manufacturing sector and, therefore, of the whole economy.

RESERVATION BY THE IRISH CONGRESS OF TRADE UNIONS

In view of the tripartite discussions between Government, Irish Congress of Trade Unions and Employer Organisations, the representatives of the Congress cannot commit themselves to any view on this Report or on its implications, and must therefore reserve their position.

Rush

NATIONAL ECONOMIC AND SOCIAL COUNCIL PUBLICATIONS

<i>Title</i>	<i>Date</i>
1. Report on the Economy in 1973 and the Prospects for 1974	April 1974
2. Comments on Capital Taxation Proposals	July 1974
3. The Economy in 1974 and Outlook for 1975	Nov. 1974
4. Regional Policy in Ireland: A Review	Jan. 1975
5. Population and Employment Projections: 1971-86	Feb. 1975
6. Comments on the OECD Report on Manpower Policy in Ireland	July 1975
7. Jobs and Living Standards: Projections and Implications	June 1975
8. An Approach to Social Policy	June 1975
9. Report on Inflation	June 1975
10. Causes and Effects of Inflation in Ireland	Oct. 1975
11. Income Distribution: A Preliminary Report	Sept. 1975
12. Educational Expenditure in Ireland	Jan. 1976
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