

PART II

STRUCTURAL REFORM

1. THE STRUCTURE AND REFORM OF THE TAX SYSTEM

Tax reform was one of the four central elements of the strategy for economic and social development adopted by the Council in 1986. Indeed the Council went so far as to say that "tax reform may now be the most powerful instrument available to Government to promote faster growth in output and employment in the short to medium term" (NESC, 1986B, p.228). Tax reform acquired this prominent position in the Council's strategy as a result of a detailed study of the structure of the evolution of the tax system and an analysis of the tax reforms proposed by the Commission on Taxation. This revealed a system which contained many anomalies and inequities and which had deteriorated very seriously from the late seventies to the mid-eighties. This strongly suggested that tax reform should be among the central elements of an overall strategy for economic and social recovery.

(i) Principles of Tax Reform

In considering how the tax system should be reformed the Council began by setting out and commenting on the principles, recommendations and phasing proposed by the Commission on Taxation. The Council endorsed the main principles adopted by the Commission:

- (i) a comprehensive definition of income;
- (ii) equivalent tax treatment of income from different sources;
- (iii) neutrality with respect to inflation;
- (iv) minimum tax impact on individual or business choices;
- (v) general reliance on direct payments to those in need rather than assistance through the tax system,
- (vi) no earmarking of taxes;
- (vii) evaluation of compulsory social insurance contributions as taxes.

As regards recommendations the Council focused primarily on the first phase of reform proposed by the Commission rather than on the final system advocated by it. This led the Council to identify the fundamental problems of the tax system and the most pressing reforms as follows:

The Council believes that the narrowness of the existing tax base is the proximate source of the most serious problems and costs associated with the present taxation system. The Council also believes that the narrowness of the existing base is a serious constraint to developing a system which would be more equitable and which would provide greater incentives to enterprise and wealth generation...

Accordingly the Council believes that the priority of taxation policy in the coming years must be the widening of the tax base and the simultaneous reduction of tax rates. This applies not alone to personal income tax but also to capital taxation, to the taxation of corporate income, and to value added tax. This belief also extends to the taxation of property in respect of which, in Report No. 80, the Council expressed its agreement in principle with the notion of a property tax, both as a means of providing a measure of revenue autonomy to local authorities and of broadening the tax base (NESC, 1986B).

These unambiguous recommendations were one of the four central elements of the Council's strategy for economic and social development and, indeed, were considered indispensable for the full realisation of the other three.

(ii) Taxation from 1986 to 1990

In this document we undertake a survey of the evolution of the tax system since 1986. Our purpose is similar to that in *Strategy for Development 1986-1990* – to ascertain whether the changes in taxation introduced in the years 1986 to 1990 have moved the system in the right direction and whether government taxation policy in that period has followed a coherent strategy. Section 2 considers the overall composition of taxation. Changes in capital taxation are examined in Section 3. Section 4 discusses the reform of corporation tax since 1986, while Section 5 identifies and assesses the main changes in personal income tax. The Council's assessment of tax policy since 1986 is presented in Section 7. Finally, in Section 8 we outline an approach to tax reform in a new strategy for economic and social development.

2. THE OVERALL COMPOSITION OF TAXATION

An important issue which immediately arises in any analysis of the tax system is how taxes should be defined. The Council has long considered that compulsory social security contributions bear many of the characteristics of taxes and that, at least from the point of view of economic effects and incentives, the income tax and social welfare systems should be analysed jointly. This is done throughout this report – in so far as is possible. However, data limitations dictate that, on occasion, taxation be considered without reference to PRSI.

(i) The Overall Tax Burden

One example of this occurs when we seek an up to date picture of the overall tax burden. Figure 6.1 shows total tax revenue – exclusive of PRSI – as a per cent of GNP since 1975. This figure shows the steep and sustained rise in the tax burden from 1979 to 1988. Since then total taxation has fallen as a per cent of GNP – reflecting both reductions in taxation and strong growth of GNP.

(ii) The Composition of Taxation

The large changes in the overall burden of taxation since the late seventies, shown in Figure 6.1, did not occur as a result of proportional increases, and latterly

decreases, in each category of taxation. Table 6.1 shows the composition of total tax revenue – including social security contributions – in selected years from 1977 to 1987. The increase in the total tax burden was largely caused by an increase in the share of taxes on personal income. Indeed, the sharp increase in the share of income taxes was counterbalanced by a marked decline in the share of taxes on property and a slight decline in the share of taxes on corporate income.

Figure 6.1
Evolution of the Tax Burden
Per Cent of GDP

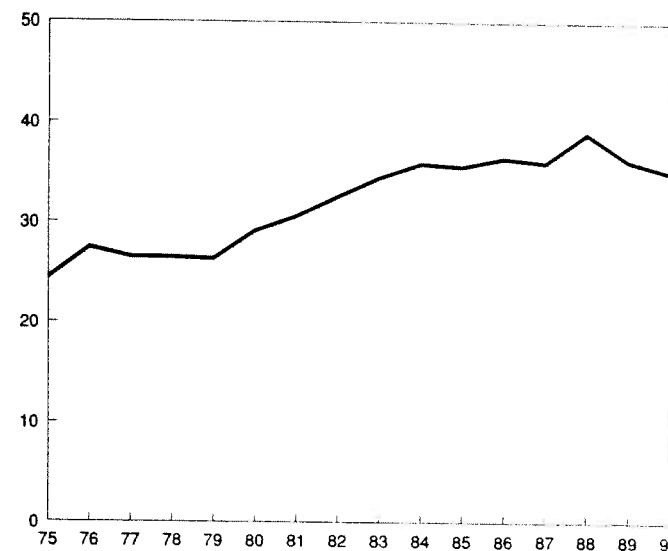


Table 6.1
Composition of Tax Revenue, 1977-87

	1977	1980	1983	1987
	– (per cent of total) –			
Taxes on Personal Income(1)	27.6	32.0	29.5	34.6
Tax on Corporate Income	4.1	4.5	3.8	3.2
Social Security Contributions(2)	13.5	14.5	16.9	14.5
Taxes on Property(3)	8.1	5.3	3.8	4.4
Taxes on Goods and Services	46.7	43.7	46.1	42.5
Total	100.0	100.0	100.0	100.0

(1) Includes Capital Gains Tax

(2) Includes Payroll Taxes

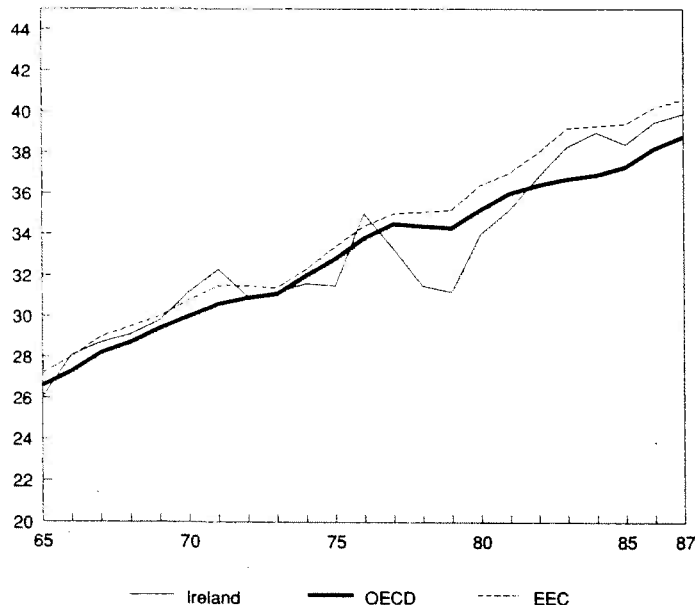
(3) Includes Rates, Stamp Duties etc.

Source: Revenue Statistics of OECD Member Countries, 1965-1988, OECD Paris, 1989.

(iii) International Comparisons

It is of considerable interest to compare taxation in Ireland with that in other EC and OECD countries. Figure 6.2 shows the evolution of the total tax burden, including social security payments, as a per cent of GDP, in Ireland, the EC and the OECD from 1965 to 1987 – the latter two calculated as unweighted averages of the member states' statistics. The total burden in Ireland in 1987 (39.9 per cent) was marginally higher than the OECD average (38.8 per cent) and marginally lower than the EC average (40.4 per cent). Although the current level of the tax burden in Ireland is broadly similar to that in other EC and OECD countries the evolution of the burden is strikingly different. The rate of increase of the tax burden as a per cent of GDP in Ireland from the late seventies to the mid-eighties was twice the EC average and three times the OECD average. This rapid increase alone explains the widespread perception of a heavy tax burden in Ireland. In addition, it should be noted that Irish GNP grew much more slowly than GDP since 1980, and this means that tax as a per cent of the resources available to Ireland increased even more rapidly than is shown in Figure 6.2.

Figure 6.2
Evolution of the Tax Burden
Per Cent of GDP



When we compare the composition of overall tax revenue in Ireland with other member states of the European Community the following picture emerges. The share of taxes on goods and services in Ireland is considerably above the EC average and is only exceeded in Greece and Portugal (OECD, 1989C). By contrast, the share accounted for by employer's social insurance contributions is about half

the Community average – only Denmark and the UK having a lower share. Similar remarks apply to employees' social insurance. The share of taxes on corporate income continues to be significantly lower than in the Community as a whole. Indeed, the latest available data, for 1987, show Ireland having the lowest share in the EC. The importance of property taxation is only slightly lower in Ireland than on average in the Community but is very much lower than in the United Kingdom – which has the highest share in the EC or the OECD.

3. CAPITAL TAXATION

If we take capital taxation to include Capital Gains Tax (CGT), Capital Acquisitions Tax (CAT) and the Residential Property Tax (RPT), then the revenue from capital taxation has increased from £33.7m in 1986 to an estimated £64m in 1990. This near doubling of revenue reflects a number of reforms, including the increasing impact of aggregation for CAT purposes, some self-assessment and improved administration, and the buoyancy of the economy.

The important reforms in CGT and CAT, introduced in 1982 and 1984, were reviewed in some detail in *Strategy for Development 1986-1990*. There it was noted that, despite the reforms, the yield from these taxes and the RPT expanded very modestly. While this could be partly explained by the recession (which reduced the volume of capital transactions and eroded the capital tax base) it was pointed out that the poor yield also results from those features of the tax code which erode the tax base. This was particularly so in the case of the RPT. Some of the problematic features of the tax code cited in *Strategy for Development 1986-1990* remain in force in 1990. The most striking of these are the high levels at which the property value (£91,000) and income thresholds (£27,800) are set.

In relation to CGT and CAT it can still be said that the base is narrowed by the existence of exemptions and reliefs. Capital gains on a range of assets are still exempt from tax.¹ Recall the Commission on Taxation's view that "The equity and efficiency of these exemptions are not essentially different from the implications of analogous exemptions in other parts of the system of personal taxation".² In the case of Capital Acquisitions Tax most of the exemptions available in 1986 are still in force. Although the exemption thresholds have not been increased in line with inflation they remain very substantial and considerably narrow the base for the tax.

In conclusion, the period from 1986 to 1990 was not very different from the period 1982 to 1986 and there remains room for higher yields from capital taxation, not only through increased property values and improved collection and enforcement, but also through further reforms of exemptions, allowances and rates.

1. The gains exempt from CGT include the following: (i) small gains; (ii) gains on principal private residence (except where sale price reflects development potential); (iii) gains realised from life assurance policies and deferred annuities; (iv) gains realised on Irish government securities.
2. *First Report of the Commission of Taxation*, 1982.

4. CORPORATION TAX

In *Strategy for Development 1986-1990* the Council noted the long-term decline in the share of corporation tax receipts in total tax revenue. This decline has not continued during the period 1986 to 1989 – but neither has the corporation tax yielded a significantly increased share of total revenue. Early exchequer returns for 1990 indicate an increase in yield; it is difficult, as yet, to assess whether this will be a permanent increase.

In 1986 the Council noted that “the corporation tax base is diminished by the existence of reliefs, allowances and exemptions in much the same way as the personal income tax base. The most important of these have been the capital allowances and, prior to the 1986 budget, the system of stock relief”. The Council also drew attention to the possibility that the combined impact of certain instruments of industrial policy and of certain features of the tax system has been to substantially increase the ratio of labour costs to the cost of capital. It was noted that while these concerns have been acknowledged the response, between 1977 and 1986, was to introduce new tax incentives and allowances designed to encourage increased employment.

(i) Reforms Since 1986

In 1987 the government announced a major review of the entire system of corporation tax. Since then there have been some significant reforms. In the 1988 budget the Minister for Finance announced a number of measures which were “designed as an integrated package” intended to reduce the “exceptionally generous” allowances which narrow the base and force high rates on the system. The major change was the reduction of the free depreciation and initial allowance provisions from 100 per cent to 50 per cent and a simultaneous reduction of the standard rate of corporation tax from 50 to 43 per cent. In addition, the provisions allowing losses on some activities to be counted against tax liabilities on other activities were restricted.

The 1989 budget did not introduce further changes in depreciation allowances or tax rates but did announce major changes in tax administration – itself a very important part of tax reform. First, the initial steps towards self assessment for companies and businesses were taken in 1988. Second, the collection of the taxes and PRSI from the self-employed was integrated into this new system. Third, a much stiffer collection regime for non-complying taxpayers was introduced – including powers of attachment and certificates of tax compliance. Finally, to encourage taxpayers, both corporate and individual, to bring their tax affairs up to date the government introduced a once-off opportunity to settle outstanding tax liabilities without payment of certain interest or penalties.

The process of reform of corporate taxation was continued in the 1990 budget. The accelerated depreciation allowances were further reduced, from 50 per cent to 25 per cent, and will be abolished completely from 1 April 1992. The standard rate of

corporation tax was reduced from 43 to 40 per cent.³ The express intention of these reforms was to create a broader-based corporation tax system with a lower standard rate. It was hoped that reduction of the standard rate, and the consequent narrowing of the gap between that rate and the special 10 per cent rate for manufacturing, would be particularly helpful to the services sector of the economy which is an important source of job creation. In addition, the Minister argued that “the elimination of 100 per cent accelerated capital allowances will remove the bias in favour of capital intensity rather than employment” (Budget 1990, p.41).

In addition to the curtailment of depreciation allowances and the reduction of tax rates, the government, in 1989, introduced a ceiling on Section 84 loans. The cost of these loans to the exchequer was further reduced in the 1990 budget – when the ceiling on loan volume was lowered.

It is clear, therefore, that in contrast to the years 1981 to 1985, the period since 1986 has seen genuine reform of the corporation tax system – in particular, the improvements in administration, the curtailment of allowances and the reduction in the number of rates from 7, in 1987, to 2 in 1990. While these changes are evidence of a coherent strategy, the inclination towards reform has not been total. This is because, alongside the elements of reform discussed above, there has been a continuation, and indeed an extension, of measures which narrow the corporation tax base and measures which are either *ad hoc* or intended to achieve specific allocative objectives.

(ii) Base Narrowing and Ad Hoc Measures

Base Narrowing Measures

First, in both 1988 and 1989 the threshold on capital allowances and allowable running expenses in respect of motor cars required for business purposes was increased. Although this was estimated to cost £14m revenue by 1990 it was justified on the grounds that it would “reduce motoring expenses connected with business and will also *be of significant benefit to the motor industry*” (Budget 1988, p.33).

Second, the substantial and overdue reduction in capital depreciation allowances introduced in 1988 were not applied to companies in the international financial services centre, the Shannon customs-free airport, nor to the special building incentives in designated areas for urban renewal.

Third, in 1988 provisions were made whereby dividends earned abroad by Irish companies could be repatriated free of tax on certain terms.

Ad Hoc Measures

The undoubted reform of corporation tax in the period since 1986 was qualified by the introduction or continuation of the following ad hoc measures.

3. Although these new provisions were introduced in the 1990 budget they will not take effect till April 1991.

First, in 1988 the bank levy was increased from £25m to £36m on the grounds that the “tax contribution from profits in the banking sector continues to be very small in relation to such profits” (Budget 1988, p.31). The levy was renewed in 1989 and 1990. While it can be argued that the levy is justified because of the continuation of Section 84 loans this merely highlights another unjustified anomaly in the tax system.

Second, also in 1988 a tax was imposed on pension fund investment income on a once-off basis on the grounds that pension funds “have in recent years earned exceptionally high returns on their investments”.

Third, especially favourable tax provisions were extended to firms in the international financial services centre.

Summary and Conclusion

There can be no doubt that in the period since 1986 the corporation tax system has been reformed along the lines advocated by the Council. In particular, the base has been widened by the reduction of depreciation allowances and the rate of tax has been reduced. Nevertheless, several problems remain. First among these is the fact that the “yield is still very low by international standards” (Budget 1990, p.41). Second, reform of the system occurred simultaneously with the introduction and/or extension of provisions which complicate the tax code. Some of these narrow the tax base, create special incentives for certain activities and, of course, reduce the tax yield. Others, such as the bank levy and the once-off tax on pension funds raise revenue, but do so in an ad hoc way.

5. PERSONAL INCOME TAX

(i) Overall Equity

In *Strategy for Development, 1986-1990* the Council said: “One aspect of the income tax system which is fundamental to perceptions of inequality is the different treatment of employees, the self-employed and farmers”. Some of the advantages conferred on self-employed persons by the tax code have been removed in the period since 1986. In fact, some of the most significant change has been in the reform of tax *administration* for employers and the self-employed. The main measures, which were introduced in 1988, were the tax amnesty and self-assessment for the self-employed. These measures allowed a large number of arrears to be cleared and will hopefully free administration resources to ensure more thorough and rapid payment in future. Secondly, the 1990 Finance Act provides that from now on the self-employed would be taxed on a current year basis. This is a major reform which should help to remove a major perceived inequity in the personal tax system.

The Farm Tax, which in 1986 the Council considered not to be a genuine income tax, was abolished in 1987. The declared intention was “that farmers should be taxed in the same manner as other sections of the community”. However, pending the assessment of farmers for income tax the abolition of the farm tax involved a

reduction of £9m in taxation from farmers in 1987. The Minister argued that “this shortfall must be made good by the farming community from another source” and accordingly he manipulated the VAT system to yield an additional £9m. Following the continued non-payment of arrears of tax-related levies by farmers, the VAT refund to unregistered farmers was further reduced in the 1988 budget. However, much of these arrears were cleared under the amnesty declared in 1988 and the VAT refund was increased in 1989 and again in 1990.

(ii) Development of the PAYE System

In *Strategy for Development, 1986-1990*, the Council documented the structure and evolution of the PAYE system in the period from 1977 to 1986. This revealed the following serious problems in the tax system

- high marginal rates at relatively low incomes;
- high average rates;
- large gaps between gross labour costs and disposable employee income;
- an enormous increase in the proportion of taxpayers paying tax above the standard rate;
- considerable erosion of the marginal rate bands due to the failure of successive budgets to index tax bands;
- erosion of the income tax base due to proliferation of allowances, exemptions and reliefs;
- an inequitable distribution of discretionary allowances.

The period since 1986 has seen three main changes in the PAYE system. First, there have been increases in the exemption limits and widening of tax bands (Budgets of 1988, 1989, 1990). Second, the standard and top rates of tax have been reduced. Third, there has been some curtailment of discretionary reliefs, in particular mortgage interest relief and relief on life assurance premiums. In this section we consider whether these changes have addressed the problems identified in *Strategy for Development 1986-1990* and listed above.

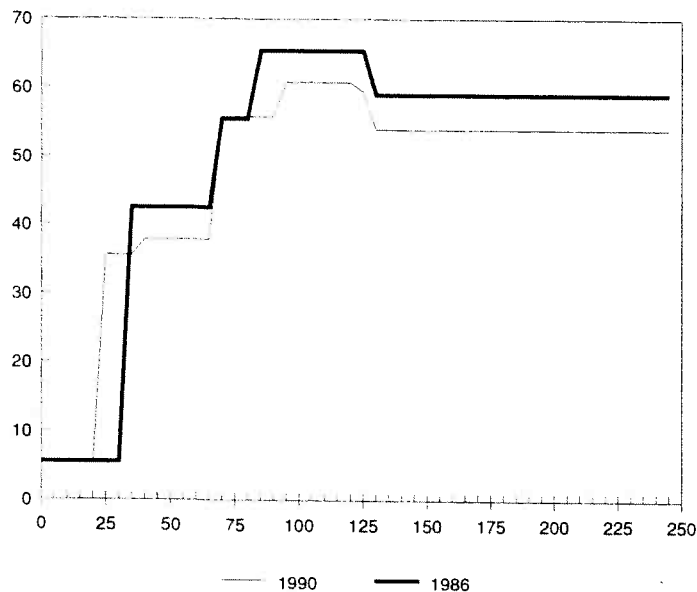
Marginal Tax Rates

The significance of marginal tax rates derives from the fact that they alter the incentives which people face and from the possible effects which this may have on decisions concerning work and work effort. This is one instance where there is a strong case for considering income tax and PRSI jointly. All our calculations of marginal and average tax rates include income taxes, employees’ PRSI and all levies. The pattern of marginal tax rates (MTRs) can be illustrated and analysed in two ways: by calculating the MTR at each level of money income or by calculating the MTR at various percentages of average industrial earnings. Each approach has its strengths and its weaknesses and care must be taken in comparing the pattern of MTRs at different dates. One of the central points made in *Strategy for Development 1986-1990* was that taxpayers reach very high marginal rates well below average industrial earnings.⁴

4. In order to maintain comparability with *Strategy for Development 1986-1990* average industrial earnings are represented by average male earnings in manufacturing industry.

Figure 6.3 shows marginal tax rates facing single workers in 1986 and 1990 at various levels of income expressed as a percentage of average industrial earnings. This shows that in 1986 single workers faced very high MTRs at well below average industrial earnings. Tax reform which unambiguously lowered marginal rates would mean that the 1990 line would be entirely inside or below the 1986 line, implying a lower marginal tax rate at each level of earnings. It is clear from Figure 6.3 that the reforms since 1986 have not entirely achieved this. Those who earn between 25 per cent and 30 per cent of average earnings face a higher marginal tax rate in 1990 than in 1986. The reduction in marginal rates at all other levels of income reflects the reductions in scheduled rates introduced in the budgets of 1989 and 1990.

Figure 6.3
Marginal Tax Rates Single Persons
Per Cent of Average Industrial Earnings

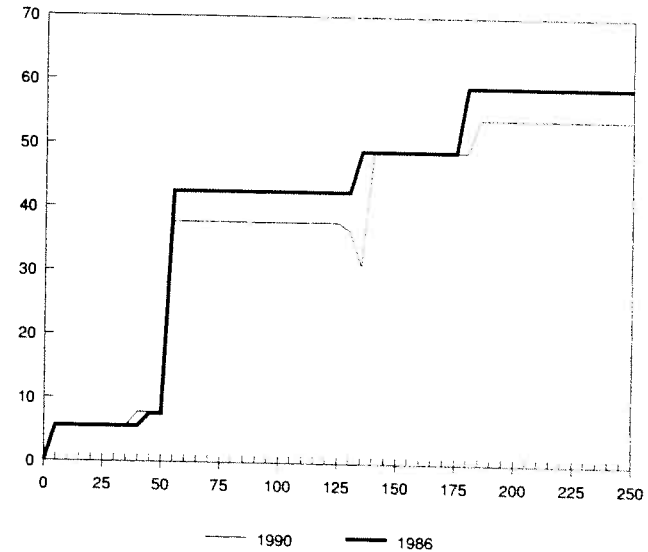


The similarity in the *shape* of the MTR curve in 1986 and 1990 reflects the continued existence of several anomalies in the structure of MTRs which, in turn, reflects the continued existence of the following tax provisions:

- (i) the existence of the general exemption limits for income tax and the system of marginal relief which these limits necessitate;
- (ii) the fact that the Youth Employment Levy and the Health contribution only become payable at income levels corresponding to the relevant Medical Card eligibility thresholds;
- (iii) the existence of income ceilings of £16,700 and £17,300 demarcating liability for the Health and PRSI contributions respectively.

These factors were criticised by the Council in 1986 because they inhibit a clear understanding of the tax system on the part of taxpayers and create difficulties for the revenue agencies.

Figure 6.4
Marginal Tax Rates – Married Persons*
Per Cent of Average Industrial Earnings



*With Non Earning Spouse

Figure 6.4 shows marginal tax rates facing married taxpayers (whose spouses do not earn) at various levels of income, expressed as a percentage of average industrial earnings. This figure shows that the MTR curve for 1990 lies almost entirely on or inside the 1986 MTR curve. However, for those who earn between 30 per cent and 50 per cent of average earnings the marginal tax rate has actually increased – though only slightly. Those on average earnings have experienced a fall in MTR.

Conclusions on Marginal Tax Rates

In summary, there has clearly been some success in reducing marginal tax rates during the period since 1986. These reductions have, in general, been somewhat larger for those with incomes approaching average industrial earnings and above.

There are a number of reasons why reductions in MTRs are desirable. Two in particular stand out – one efficiency based and one equity based. The efficiency argument is that most of the incentive and disincentive effects of taxation are related to the size of marginal rates. The equity argument is that a rising schedule of marginal rates is the source of much of the creative efforts to avoid tax by

redefining income etc. and a rising schedule of marginal rate means that discretionary allowances are of greater value to richer taxpayers. The burden of this equity argument is that it may, in fact, be easier to achieve more equity and redistribution with a flatter rate schedule – provided, of course, that progressivity is achieved in some other way. These efficiency and equity considerations allow a preliminary evaluation of the changes in MTRs achieved since 1986.

It is not at all clear that the disincentive effects of marginal tax rates on labour supply are greater for those with average earnings and above. It is likely that the greatest disincentive effects arise from the interaction of the tax and welfare system and are, therefore, relevant to those whose earnings or potential earnings are well below average male earnings in manufacturing industry. A number of the specific changes introduced since 1986 have helped in this regard.

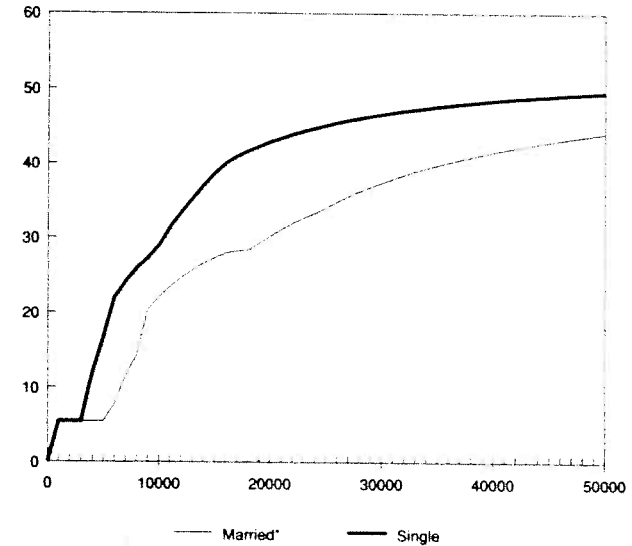
Turning to the second argument for reductions in MTRs – that related to the *flattening* of the rate schedule – we find that no definitive judgement on developments since 1986 can be made at this point. The reason is that a flattening of the rate schedule – which has been partially achieved – will only enhance the possibility of redistribution, and eliminate inequities and tax avoidance, if it is accompanied by widening of the tax base and closing of loopholes. Consequently, to decide whether the reductions in *marginal* tax rates since 1986 has been beneficial in this sense we need to consider those reductions in MTRs in conjunction with changes in average tax rates and the evolution of the tax base.

Average Tax Rates

Average tax rates are a very important element of the tax system since they strongly influence the perceived fairness or unfairness of the system, reflect the progressivity of taxation, and probably influence labour supply and migration. In documenting the evolution of the personal income tax system since 1986 it is important to consider how the reforms of 1988, 1989 and 1990 have influenced average tax rates imposed on different earners.

Figure 6.5 shows the average tax rate in 1990 at income levels from zero to £50,000 for single workers (or members of a working couple) and for those married with a non-earning spouse. This shows income tax, PRSI and special levies payable as a percentage of gross income. The income tax payable at each level of income from zero to £50,000 is calculated on the basis of *standard* tax allowances only. Figure 6.5 reveals that the average tax rate paid by single people (and working couples) is higher than that on married workers (with non-earning spouses) at all income levels above £2,000. At higher levels of income there appears to be somewhat more progressivity in the taxation of such married persons than in that of single persons. The figure also shows that average tax rates do not increase uniformly with income. Average rates increase very rapidly over the income range £2,000 to around £15,000. Thereafter, average rates increase much more slowly.

Figure 6.5
Average Tax Rates, 1990
Single Persons/Married Persons*



*Spouse Not Earning

Figure 6.6
Marginal and Average Tax Rates
Single Persons 1986 and 1990

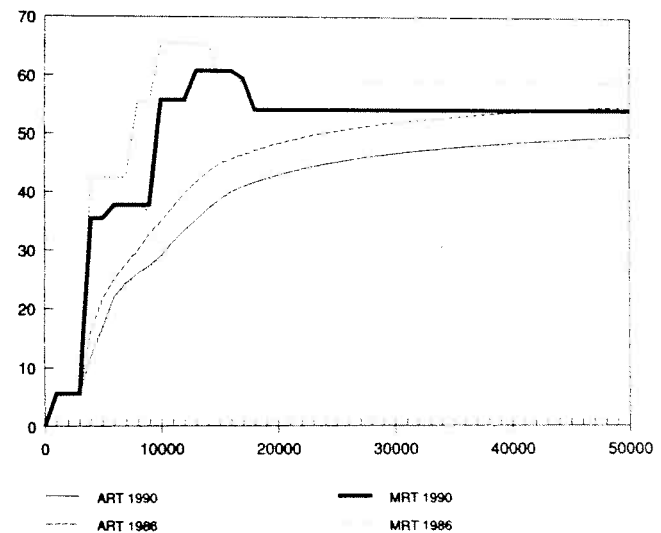
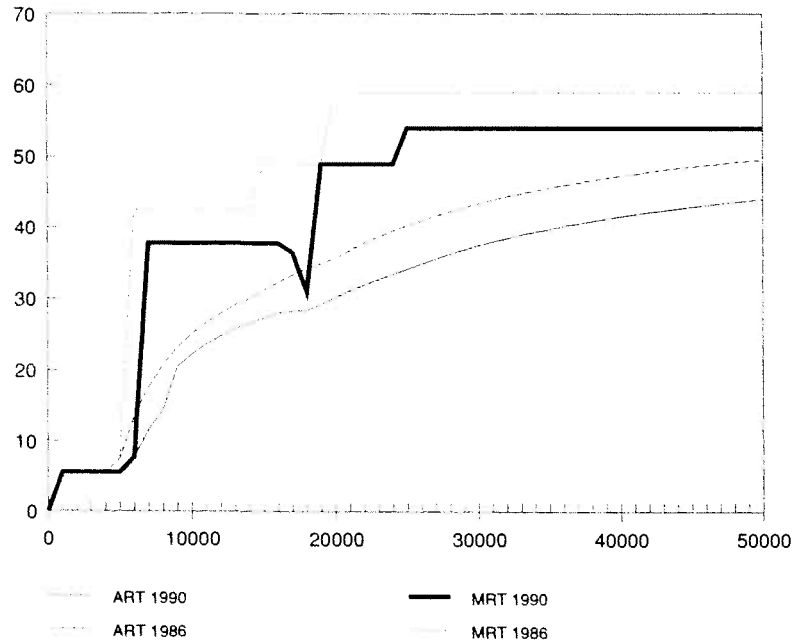


Figure 6.7
Marginal and Average Tax Rates
Married (Spouse Not Earning) 1986, 1990



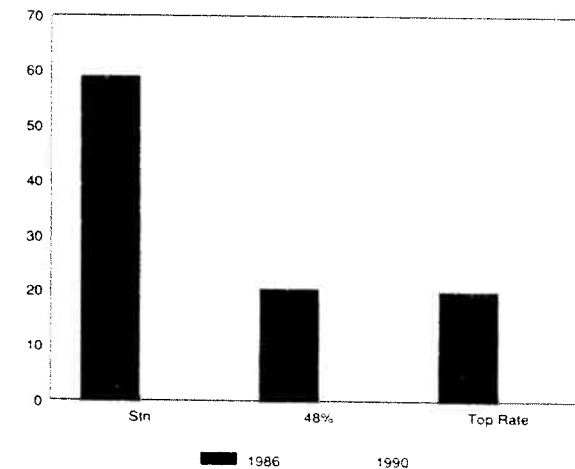
Indeed, Figure 6.5 does not give a fully accurate picture of actual tax paid by persons at different income levels since it excludes altogether the effect of discretionary allowances. Higher income groups are best positioned to take advantage of these discretionary reliefs and, when they do so, they reduce their tax liability by more. Consequently, the actual average tax rate curves are probably even flatter than those shown in Figure 6.5.

In Figures 6.6 and 6.7 we consider the change in marginal and average tax rates since 1986. Both figures show that the changes in the tax system since 1986 have tended to be most favourable to those with larger incomes. A uniform reduction in average tax rates would return more income to the rich than the poor – in the sense that a one percentage point reduction in everybody's average tax rate would return £50 to a person on an income of £5,000 and £300 to a person on £30,000. But the change in average tax rates since 1986 – as measured by the vertical distance between the average tax rate curves for 1986 and 1990 in Figures 6.6 and 6.7 – has not been uniform. In general, the reduction in average rates has been larger for those with higher incomes. Calculation of these reductions in average tax rates reveals an interesting pattern of change in tax burdens. Among married taxpayers (with non-earning spouses) those earning up to £4,000 had no reduction in their tax burden (see Figure 6.7). Those earning £5,000 had 2 per cent of their income returned, while those on £8,000 had received back over 6 per cent of their income.

Much smaller reductions in the tax burden were given to the very large number of taxpayers with incomes between £9,000 and £16,000 – whereas those above £18,000 found their tax bill reduced by almost 6 per cent of their income. In the case of single taxpayers (and taxpayers in working couples) the pattern of tax cuts is much more compressed (see Figure 6.6), such that it was only those with incomes below £9,000 who received relatively small reductions in their average tax rate. The general tendency for somewhat larger and more certain percentage average rate reductions for those on higher incomes reflects the particular pattern of changes in allowances, bands and rates chosen by government since 1986.

It is clear that the reforms since 1986 have achieved one very important thing – a reduction in the burden of income tax on all PAYE earners. However, this is only one of the aims of tax reform as proposed by both the Commission on Taxation and by the Council in *Strategy for Development 1986-1990*. Analysis of the tax system, and its likely economic effects, led both these bodies to place great emphasis on the widening of the tax base (by elimination of numerous reliefs, allowances and exemptions and introduction of a property tax) and led them to link this base widening, which increases the progressivity of the system, to reductions in tax rates. The changes in marginal and average rates shown in Figures 6.6 and 6.7 derive mainly from the reduction in schedule rates and the widening of the tax bands.

Figure 6.8
Distribution of Taxpayers by Rate Band
Single Persons

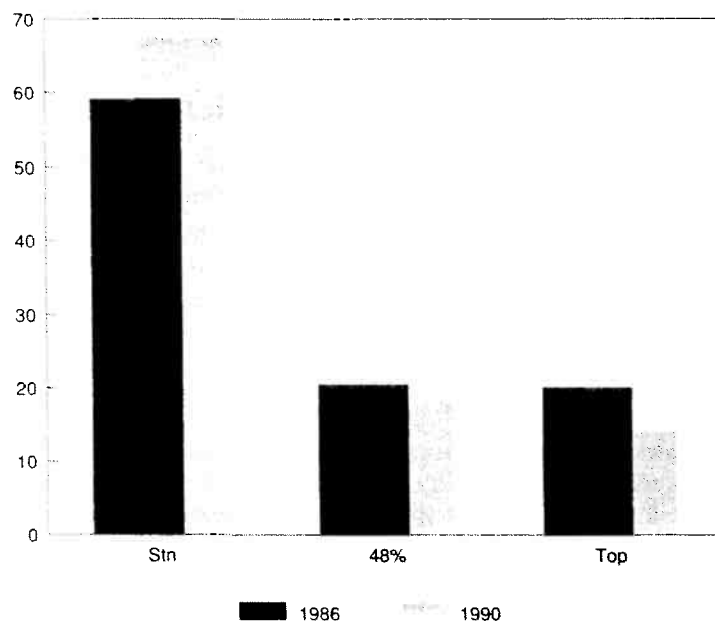


Distribution of Taxpayers by Marginal Rate Band

One of the most striking developments in the tax system noted by the Council in *Strategy for Development 1986-1990* was the increase in the number of taxpayers paying tax at rates above the standard rate. In 1973, 8,000 taxpayers, or 1 per cent of the total, were in this position. This percentage had risen to almost 45 per cent by 1986, with a particularly high proportion of single taxpayers liable at rates in excess of the standard rate. One declared objective of taxation policy since 1986 has been to bring at least two-thirds of taxpayers back to the standard rate.

Figure 6.8 illustrates the extent to which this objective had been reached by 1989-1990. The proportion of single taxpayers on the standard rate has increased by almost 10 percentage points, while the proportion on the 48 per cent rate has fallen by almost 7 percentage points. Among married taxpayers the proportion on the standard rate has increased by over 8 percentage points – an increase largely accounted for by a fall in the proportion on the top rate (see Figure 6.9).

Figure 6.9
Distribution of Taxpayers by Rate Band
Married Persons (Spouse Not Earning)



Taking taxpayers as a whole the proportion on the standard rate had increased from 54.2 per cent to 63.8 per cent by 1989-90. This has occurred as a result of an equal fall in the percentage liable at the middle and top rates. Recall that the strategy of reform devised by the Commission on Taxation and endorsed by the Council (spelt out in Section 1 above) implied two priorities for structural reform, one of which was: securing a situation whereby the maximum possible proportion of taxpayers

are liable at the standard rate. Back in 1986 the Council considered that the achievement of this objective was “critically dependent on the degree of progress attained in extending the income tax base”. We have seen that the proportion on the standard rate has been increased but, as will be confirmed below, *without* much progress in extending the tax base. This means one of two things: either the target (two thirds on the standard rate) was really a very unambitious one and securing a situation with “the maximum possible proportion” of taxpayers on the standard rate would still depend on a significant widening of the base, or, it was not really correct to say that increasing the proportion on the standard rate, and reducing rates generally, *required* an extension of the base (because the buoyancy of revenues could ‘pay for’ the reduction in tax rates). The latter possibility means that the set of tax policy options was wider than the Council imagined in 1986 and, contrary to what the Council believed, included the option of income tax *cuts* with limited tax reform.

Table 6.2
Evolution of Marginal Rate Bands 1985-1991 – Single

Marginal Tax Rate	1977-78	1985-86	1986-87	1987-88	1988-89	1989-90	1990-91
20	1710	–	–	–	–	–	–
25	2995	–	–	–	–	–	–
30	–	–	–	–	–	–	2660
32	–	–	–	–	–	2753	–
35	5566	2786	2874	2788	2867	–	–
45	13278	–	–	–	–	–	–
48	–	7286	7397	7176	8077	8109	8173
50	17134	–	–	–	–	–	–
53	–	–	–	–	–	–	10802
56	–	–	–	–	–	10831	–
58	–	–	10092	9791	10728	–	–
60	19704	10086	–	–	–	–	–
Exemption Limit	–	2650	2551	2474	2514	2634	2757
Allowances	1650	2786	2874	2788	2867	2753	2660

Evolution of Income Tax Rate Bands

The dramatic increase in the proportion of taxpayers liable at rates above the standard rate during the period from 1977 to 1986 was largely explained by the erosion of the marginal rate thresholds in real terms. This was tellingly illustrated in *Strategy for Development 1986-1990* by means of a table akin to Table 6.2. This table shows the income level at which the relevant tax rate becomes applicable, calculated in terms of 1985-86 purchasing power. For example, in 1977-78 the 35 per cent rate became applicable at an income of £5,566 (calculated in 1985-86 purchasing power). By 1985-86 the real income at which tax became payable at the standard rate was only half as large, i.e. £2,786. A similar erosion occurred in the real value of the higher rate bands, though, as can be seen in Table 6.3, in the case of married taxpayers (whose spouses do not earn) there was a somewhat less dramatic erosion in the real value of tax thresholds.

Table 6.3
Evolution of Marginal Rate Bands 1985-1991 – Married

Marginal Tax Rate	1977-78	1985-86	1986-87	1987-88	1988-89	1989-90	1990-91
20	1710	—	—	—	—	—	—
25	2995	—	—	—	—	—	—
30	—	—	—	—	—	—	4399
32	—	—	—	—	—	4553	—
35	5566	4686	4799	4655	4740	—	—
45	13278	—	—	—	—	—	—
48	—	13686	13846	13432	15161	15264	15425
50	17134	—	—	—	—	—	—
53	—	—	—	—	—	—	20684
56	—	0	0	0	0	20708	—
58	—	—	19236	18661	20463	—	—
60	19704	19286	—	—	—	—	—
Exemption Limits	—	5300	5101	4949	5027	5268	5513
Allowances	2729	4686	4799	4655	4740	4553	4399

Tables 6.2 and 6.3 show this erosion between 1977 and 1986 and report the evolution of the rate bands from 1986 to the present – all calculated in terms of 1985-86 purchasing power. The main point to be derived from these two tables is that the dramatic erosion in the real value of tax thresholds, which was a major feature of the evolution of the tax system from 1977 to 1986, did not continue after 1986. For example, while the real value of the standard rate thresholds for single taxpayers was halved between 1977 and 1986 (from £5,566 to £2,786), it fell by only 4.5 per cent in real terms between 1985-86 and 1990-91.⁵ Indeed, in the latter period both the 48 per cent threshold and the top rate threshold *increased* in real terms (see Tables 6.2 and 6.3).

In its earlier review of the tax system the Council noted that since their introduction, exemption limits declined only modestly in real terms up to 1986. It can be seen from Tables 6.4 and 6.5 that the real value of the exemption limits has subsequently increased by about 4 per cent. In 1989 an additional exemption limit was introduced for those with children and in 1990 this additional allowance was increased. This measure, which was intended to improve the tax treatment of low-paid married couples with children, is not reflected in Table 6.3.

In contrast with tax rate thresholds (and, to a lesser extent, exemption limits) the real value of personal allowances had increased substantially between 1977 and 1986. This meant that the rapid increase in the number of taxpayers liable to tax at higher rates in that period was not due to the failure of personal tax allowances to keep pace with inflation. From the bottom row of Tables 6.2 and 6.3 it can be seen that since 1986 the real value of personal allowances has declined somewhat.

Overall then, the performance on rate bands in the years since 1986 has been close to that advocated by the Commission on Taxation, i.e. they have been more or less indexed. This contrasts sharply with the period 1981 to 1986, when rate bands declined dramatically in real value and allowances increased ahead of inflation. We will analyse the evolution of allowances presently.

Evolution of the Income Tax Base

The Council has previously documented the wide array of allowances, exemptions and reliefs which narrow the base for personal income tax. These can be allocated to four categories

- (i) Basic Allowances, i.e. single, married and widowed persons allowances;
- (ii) Secondary Allowances and Exemptions, i.e. income exempted because of the recipient's dependency obligations, age, or physical incapacity, or because of the operation of the exemption limits;
- (iii) Discretionary Reliefs, i.e. income exempted because of the way in which income is earned or disposed of; and
- (iv) Other allowances, i.e. income exempted in order to explicitly compensate the recipients for the way in which other aspects of the taxation system operate.

5. The standard rate threshold for married taxpayers (with non earning spouses) fell by 6.1 per cent in real terms during the same period.

The review of the evolution of the tax base undertaken in *Strategy for Development 1986-1990* highlighted three points. First, in 1985-86 basic personal allowances accounted for about half the diminution of the income tax base; secondary allowances and other reliefs accounted for about 16 per cent each. Second, while the amount of income excluded from the tax base increased under all four headings between 1981 and 1986, much the greatest increase occurred in *discretionary* reliefs. This results from the very rapid increase in the amount of income exempt because of interest relief, medical insurance relief and life assurance premium relief. Third, in the decade to 1986 many new categories of exempt income were created and many existing reliefs were extended and increased.

This plethora of reliefs and allowances was identified by both the Commission on Taxation and the Council as the source of many of the major problems of the Irish tax system; recall from Section 1 that the Council was emphatic that "the priority of taxation policy in the coming years must be the widening of the tax base and the simultaneous reduction of rates". Two things are necessary to inform our judgement on whether the reforms since 1986 have reversed the erosion of the tax base which was so significant from the late seventies to the early eighties. First, we need to consider changes in the schedule of allowances as stated in the tax code. Second, we must ascertain the amount of income actually exempted under various headings, since this incorporates the response of individuals and companies to the provisions of the tax code.

We begin by reporting the evolution of some of the basic and secondary allowances in the period since 1986, and compare this with developments in the first half of the 1980s. Table 6.4 shows the percentage change in the real value of basic and secondary allowances and exemption limits in the two periods 1981 to 1986 and 1986 to 1990. The table reveals that the nominal value of all the basic personal allowances increased faster than consumer prices in the period 1981 to 1986. Thus the real value of the married and single persons allowances increased by 21 per cent; but the real value of the exemption limits declined. By contrast, in the later period, 1986 to 1990, the real value of most basic and secondary allowances declined, whereas the real value of the exemption limits increased slightly.

In some respects the evolution of the basic and secondary allowances in recent years accords much more closely with the principles adopted by the Council than did developments in the period 1981 to 1986.

In contrast to the earlier period these allowances are no longer eroding the tax base and inflation is no longer eroding the real value of the exemption limits for those on low pay. Indeed, the decline in the real value of the single persons allowance, married persons allowance, widows allowances, widowed parents allowances, single parents allowance, age allowance, dependent relatives allowance, blind

persons allowance and the allowance for those who employ someone to take care of an incapacitated individual, all constitute an *unambiguous widening of the tax base*. Does this conform with the changes advocated by the Commission and the Council? The answer must be that they do not. In the case of personal allowances the Commission proposed *indexation* not reduction. In the case of all the other allowances listed above (and quantified in Table 6.4) the Commission proposed abolition *with provision for compensatory payments*.

Table 6.4
Evolution of Basic and Secondary Allowances
and Exemption Limits, 1986-90

	Change in Real Terms 1981-82 to 1986-87 %	Change in Real Terms 1986-87 to 1990-91 %
Married Person's Allowance	+21.3	-9.7
Single Person's Allowance	+21.3	-9.7
Widowed Person's Allowance	+42.7	-10.1
Widowed Parent Allowance	+56.2	-9.0
Single Parent Allowance	+108.2	-10.0
Age Allowance - Single	+68.8	-11.9
- Married	+50.6	-11.9
Dependent Relative Allowance	-22.0	-11.9
Blind Person's Allowance	+1.5	-11.9
Person Employed to take care of Incapacitated Individual	+238.2	-11.9
Age Exemption Limit(3) - 65+	-7.3	+4.9
- 75+	-11.2	+4.3
General Exemption Limit(3)	-10.3	+8.1

In general, however, the base widening that we have identified here is the opposite to that proposed by the Commission and the Council. Base widening which reduces *discretionary* allowances and reliefs, tends to *increase* the progressivity of

the tax system and this, as argued by the Commission and the Council, provides a rationale for rate reductions in order to restore the original degree of progressivity. Base widening which reduces basic and secondary allowances tends to *decrease* the progressivity of the system and would, from the point of view of equity at least, warrant *increases* in rates – especially higher rates. Where reductions in basic and secondary allowances (without compensating direct payments) are combined with rate reductions the progressivity of the system will tend to be reduced from both ends, as it were.

We must next consider what has happened to those discretionary allowances which narrow the tax base, undermine the progressivity of the system and create opportunities for tax avoidance. These are mortgage interest relief, medical insurance relief, life assurance premium relief, permanent health insurance premiums, covenants, the business expansion scheme, Section 23 provisions, fringe benefits and business expenses.⁶ Since *Strategy for Development 1986-1990* there have been a number of changes in these provisions. In 1987 mortgage interest relief was reduced to 90 per cent of interest (subject to a ceiling of £2,000 for single and £4,000 for married taxpayers). In 1989 this was further reduced to 80 per cent of interest. The ceilings were not increased in nominal terms from 1986 to 1990.

In 1989 the tax relief on life assurance premiums was reduced to 80 per cent of the amount relieved previously and in 1990 to 50 per cent. These measures raised over £70m in full-year terms. Against these modest base-widening measures must be weighed the following base-narrowing changes. In 1988 Section 23 provisions were re-introduced. In 1987 the Business Expansion Scheme was extended.

Given the modest scale and the ambiguity of these changes in the tax base it is not surprising to find that the income tax base continues to be severely diminished by a wide range of allowances, reliefs and exemptions. Table 6.5 sets out the income exempted under each individual allowance, exemption and relief for the years 1985-86 and 1989-90 and provides an estimate of the amount of tax forgone under each heading. Table 6.6 aggregates the estimates of exempt income under the four categories identified above. In 1981-82 total exempt income amounted to 62.4 per cent of the actual tax base. By 1985-86 this had risen to 76.8 per cent, as shown at the bottom of Table 6.5. The changes in the tax code and in economic activity since 1986 have reduced this percentage to 68.4 in 1989-90. Although this constitutes change in right direction it is clear that the personal income tax base is still severely diminished by the wide array of allowances, exemptions and reliefs in place. Indeed, it is likely that this slight fall in income exempted as a proportion of the tax base results mainly from the buoyancy of the economy (i.e. *increase* in the base) rather than from reform of the tax code (i.e. *widening* of the base).

6. This is not a comprehensive list of allowances and reliefs which narrow the tax base.

Table 6.5
Estimates of Income Under Various Headings for 1989-90
(except where otherwise stated)

	1985-86 Diminution of Base £m	1985-86 Tax Foregone £m	1989-90 Diminution of Base £m(1)	1989-90 Tax Foregone £m
Married Persons Allowance	1,341	553	1835.6	717.1
Single Persons Allowance	810	355	991.1	406.2
Widowed Persons Allowance	89	36	159.4	59.9
Single Parent Allowance	18	7	24.8	9.9
Widowed Parent Allowance	11	4	11.4	4.2
Child Allowance	77	31	—	—
Age Allowance	5	2	14.8	5.7
Dependent Relative Allowance	4.5	2	3.4	1.3
Blind Persons Allowance	0.4	0.2	0.4	0.2
Person Employed to care for Incapacitated Person	1.3	0.5	0.3	0.2
Age Exemption	121	42	24.5	5.6
General Exemption	412	144	61.9	14.0
Child Exemption			30.6	7.1
Interest Relief	337	132	434.7	171.8
Medical Insurance	71	30	127.5	50.4
Life Assurance	66	28	85.0	33.6
Health Expenses	4	2	n.a.	n.a.
PAYE Allowance	489	214	651.1	259.4
PRSI Allowance	192	82	194.0	77.4
Premiums under Permanent Health Benefit Schemes	0.7	0.3	3.2	1.2
Preferential Loans	11	5	14.0	5.5
Artists Relief	1.5	0.7	2.3	0.9
Convenanted Subscriptions	4	2	32.6	16.3
Deposit Interest	20	9	n.a.	n.a.
Totals	4086.4		4702.6	1847.9
Income Tax Base	5321.6		6869.9	
Exempt Income as a Proportion of Base (%)	76.8		68.4	

Source: Department of Finance.

(1) In costing the allowances and reliefs for 1989-90, personal allowances are given priority over the exemption limits. For example, a married taxpayer with an income of say £4,800 who is entitled to the PAYE allowance pays no income tax and the cost of this relief is attributed to the allowances concerned NOT to the exemption. This change in methodology would seem to account for most of the increase in the share of basic allowances and the fall in the share of secondary allowances from 1985-86 to 1989-90 (see Table 8).

It can be seen from Table 6.6 that throughout the period since 1981 the most rapid increase has occurred in Discretionary Reliefs; the amount of income exempt under this heading more than doubled between 1981 and 1986 and has increased by over forty per cent since then. To see why this should be so we can consult the more detailed information in Table 6.5. This reveals that the increase in Discretionary Reliefs is due to increased uptake of mortgage interest relief, medical insurance relief and life assurance relief, despite the curtailment of mortgage interest relief introduced in the budgets of 1987 and 1989. Over £250m of tax revenue was forgone in 1989-90 as a result of the operation of these three reliefs. Indeed, Discretionary Reliefs account for an increasing share of the total income removed from the tax base, 9.2 per cent in 1981-82, 12.2 per cent in 1985-86 and almost 15 per cent in 1989-90.

Table 6.6
Estimates of Income Exempted by Category
of Exemption 1981-82 and 1989-90

	1981-82		1985-86		1989-90(6)	
	£m	%	£m	%	£m	%
Basic Allowances (1)	1385	56.3	2240	55.1	2986	63.5
Secondary Allowances and Exemptions (2)	330.2	13.4	650.2	16.0	172	3.7
Discretionary Reliefs (3)	227	9.2	495.2	12.2	699.3	14.9
Other (4)	520	21.1	681	16.7	845	18.0
Total (5)	2462.2	100.0	4066.4	100.0	4702.6	100.0

Source: Table 6.5

(1) Married, Single and Widowed Parent's Allowances.

(2) Allowances in respect of Single Parent, Widowed Parent, Child, Age, Housekeeper, Dependent Relative, Blind Persons, and Employed person taking care of Incapacitated Individual, Nuptial Allowance, Age Exemption Limit, General Exemption Limit.

(3) Reliefs in respect of Interest, Medical Insurance, Life Assurance, Permanent Health Insurance, Health Expenses, Residence-related Expenses and Artists Earnings, exemption in respect of Preferential Loan and Covenanted Subscriptions.

(4) PAYE and PRSI Allowances.

(5) Excluding deposit interest exemption.

(6) See Note 1 to Table 7.

6. INDIRECT TAX

(i) VAT

We have seen in Table 6.1 that taxes on goods and services account for a very large proportion of total tax revenue in Ireland. The vast bulk of taxes on expenditure arise from Value Added Tax (VAT) and excise duties. Table 6.7 shows the evolution of receipts from taxes on expenditure from 1986 to 1990. In

1990 VAT is estimated to yield 47 per cent of total indirect tax revenue while customs and excise is expected to yield 42 per cent.

Table 6.7
Growth of Tax Revenue from Taxes on Expenditure

	1986	1987	1988	1989	1990
Taxes on Expenditure	3278	3372	3732	4140	4281
Customs and Excise	1462	1479	1589	1770	1831
VAT	1527	1585	1805	1943	2015
Stamp Duty	159	169	198	279	286
Motor Vehicle Duties	131	139	140	148	149

Source: Budget Booklets.

Analytical studies of the Irish tax system indicate that the base for value added tax does not include many expenditures which could be taxed and which are, indeed, taxed in other Community countries. Accordingly, when the Council said in 1986 that "the priority of taxation in the coming years must be the widening of the tax base and the simultaneous reduction of tax rates" it stressed that this applied to value added tax as well as to income and other taxes.

Since 1986 there have been a number of changes in the VAT system, all of which have reformed the system along the lines advocated by the Council. The 1988 budget imposed VAT of 5 per cent on electricity, which had been zero rated since 1975. This was increased to 10 per cent in 1990. The 1990 budget also brought telecommunications within the VAT system – imposing a rate of 10 per cent, similar to that in other Community countries. Finally, in 1990 the process of approximation of VAT rates in the European Community was begun by reducing the standard rate from 25 to 23 per cent.

(ii) Excise

The justification for excise duties, over and above VAT, lies in the nature of certain goods. In general, economic principles suggest that all expenditure should be taxed at a uniform rate. However, there are strong arguments for special taxes or subsidies on certain commodities. These arguments revolve around the concept of "externalities". Externalities arise when consumption of a product gives rise to costs or benefits which are not fully covered by the market price of a product. It follows that goods which should have excise duties upon them are exceptions to general principles of indirect taxation. In this sense it is difficult to assess changes in excise duties by reference to principles of tax reform.

In general, there have been only modest increases in excises on alcohol, tobacco and fuels over the period since 1986. In 1990 excise charges on televisions, video-recorders, gramophone records, matches and lighters, lead free petrol and auto-liquid petroleum gas were reduced or abolished.

7. CONCLUSIONS ON TAX CHANGES SINCE 1986

We have now surveyed the main changes in capital taxation, corporate taxation, personal taxation and indirect taxation since 1986. The primary purpose of this review has been to ascertain whether government taxation policy in the last four years has followed a coherent strategy and to assess the extent to which the improvements which have taken place have moved the overall taxation system, or elements of it, in the direction recommended by the Commission on Taxation and the Council.

(i) Capital and Corporation Taxes

In the case of capital taxation we found few changes since 1986. By contrast, there have been significant changes in the system of corporation tax. Most of these changes – in particular, the reduction in accelerated depreciation allowances and tax rates – constitute genuine reform along the lines advocated by the Council. However, alongside the elements of reform discussed above there has been a continuation and, indeed, an extension of measures which narrow the corporation tax base and measures which are either *ad hoc* or intended to achieve specific allocative objectives.

(ii) Income Tax

Turning to personal income tax we found changes in tax administration, marginal tax rates, average tax rates, the distribution of taxpayers by rate bands, the real value of rate bands, and the tax base. Several of these changes are consistent with the programme of reform advocated by the Council. First, improvements in tax administration were recognised as central to any reform package in Ireland. Second, we have seen above that the changes since 1986 have brought about reductions in marginal and average tax rates. Reductions in both marginal and average rates were an important part of the reform proposals of both the Commission on Taxation and the Council. Third, the drift of larger and larger numbers of taxpayers on to higher rate bands has begun to be reversed since 1986. Fourth, the movement to a current year assessment for the self-employed, combined with improved administration, will help to remove one of the widely perceived inequities in the Irish tax system – the differential treatment of PAYE and self-employed taxpayers. In these four respects the Council welcomes the changes in income tax since 1986.

However, the Council has reservations about two related aspects of tax reform since 1986. First, it is concerned that the changes may have undermined the overall progressivity of the system. Second, it considers that the base has not been

significantly broadened. Both of these relate to a contrast between the context of tax reform envisaged by the Council, in 1986, and the economic policy situation which actually transpired. To see this contrast recall the argument spelt out in *Strategy for Development, 1986-1990*: that a rationale for flattening of the rate structure would arise when significant widening of the tax base had been achieved – since base widening on its own would tend to *increase* the progressivity of the system. What has occurred since 1986 has been rate reductions, financed, not by base widening, but by the buoyancy of tax revenues. It is this which gives rise to the two reservations mentioned above.

Consider first the issue of progressivity. What has occurred since 1986 has been rate reductions (which reduce progressivity) accompanied, not by measures which increase progressivity, but by measures which tend to further reduce it (reduction in the real value of basic and secondary allowances). It can, of course, be argued that the Council's 1986 analysis (that one of the most serious problems was the fact that taxpayers reached high marginal and average rates well below average earnings) implied that the income tax system was *too progressive*. This is correct, so long as it is clear that it meant too progressive *from the bottom to the mean of the income distribution*. The changes since 1986 have indeed reduced progressivity, but this reduction has not been greatest where progressivity was (and is) greatest (from lower to middle incomes). Instead, the larger average tax rate reductions have tended to accrue to those in the range of incomes where the tax system is least progressive (see Figures 6 and 7).

This tendency for rate reductions (which are desirable) to reduce progressivity, is directly related to the second point – the very limited amount of base-widening achieved since 1986. Despite some limitation of mortgage interest and life assurance relief, the wide range of discretionary allowances, reliefs and exemptions have remained substantially in place and have, in a few cases, been extended. The case against the existence of exemptions, discretionary allowances and reliefs does not depend on the desire to retain progressivity in the face of rate reductions – though base-widening would achieve that. The case derives mainly from the economic distortions and inequities which result from having a non-comprehensive definition of income for income tax purposes. The Council's criticism of the failure to widen the base – by abolishing reliefs, allowances and exemptions – and its proposal that this must now be done are, on occasion, countered by the argument that abolition of any given tax relief, such as the business expansion scheme, relief of covenants or Section 23, would yield only a modest amount of revenue and, consequently, would fund very little by way of tax rate reductions. The Council does not accept this argument. Although the *tax forgone* as a result of a given indefensible relief may be "small", the amount of money and economic activity diverted, and ultimately wasted from an economic and social point of view, in order to cash in on the tax relief, can be much larger. Furthermore, the existence of discretionary reliefs, which some can take advantage of but others cannot, represents an inequity which, like any other, should be

removed regardless of its size. Finally, the relatively small amount of revenue foregone by any individual relief shows that its abolition is feasible.

These points having been made, the Council is aware that the most significant measure of base-widening – from the point of view of funding reduced rates of tax on earned income – involves extension beyond the income tax system, i.e. the introduction of a comprehensive property tax. If policy makers are serious about reforming the Irish tax system, so as to reduce the burden on earned income, then they must widen the base in this way.

(iii) Indirect Tax

The changes in indirect tax since 1986 have, in general, been desirable measures of tax reform. We have in mind the broadening of the VAT base to include electricity and telecommunications and the reduction in the standard VAT rate from 25 to 23 per cent.

8. TAX REFORM IN A NEW STRATEGY FOR ECONOMIC AND SOCIAL DEVELOPMENT

(i) Introduction

In this section we consider tax reform in a new strategy for economic and social development. The discussion is shaped by a number of major constraints. First, it is clear that macroeconomic and public finance considerations constrain the tax reform possibilities in such a way that some options, which would be desirable if we were designing a system from scratch, need not be considered in great detail. Second, in considering tax reform, note must be taken of the impact of taxation on labour supply, migration and saving; yet adequate research findings on these effects are not available.

In relation to the public finance constraint the Council believes that this increases the urgency of undertaking those reforms which are feasible in the short-term. In relation to the lack of knowledge of the effects of taxation we attempt, in what follows, to identify some principles which can help in choosing a strategy of reform.

(ii) Principles for Reform of Indirect Tax

The Council has examined indirect taxation, and its reform, in two recent reports. In *Strategy for Development 1986-1990* the Council developed its response to the Commission on Taxation and presented a package of interim tax reforms. In *Ireland in the European Community: Performance Prospects and Strategy* the Council considered the question of indirect taxation in European integration. From these two documents the following three principles can be derived.

First, in general, it is advisable to apply a single VAT rate to all goods. There are few advantages and many disadvantages to be obtained by departures from this

general principle of uniform commodity taxation. While different rates of VAT are frequently used to achieve distribution objectives, this entails efficiency losses, and adjustments to income tax and social welfare can achieve these distributional objectives more sensitively. However, despite the general principle, that all commodities should be taxed in the same way, there are strong arguments for special taxes and subsidies on particular commodities. This provides a basis for excise duties.

Second, while indirect taxes are an inappropriate vehicle with which to pursue equity objectives, movement towards a uniform system of commodity taxation in Ireland would have undesirable distributional effects. The Council is in no doubt that movement towards such a system must be accompanied by a set of compensatory measures. In 1989 the Council considered a variety of possible compensating responses. The thrust of that analysis was that a 'mechanical' approach to the issue – such as a generalised small increase in social welfare – is inappropriate. A more thorough identification of the low income 'losers' and a correspondingly more targeted and equitable set of measures is necessary.

Third, the Council accepts the European Commission's argument that removal of physical frontiers is a necessary step in the process of integration. Furthermore, the Council agrees with the Commission's view that approximation of VAT rates and, to a lesser extent excise duties, is necessary for the removal of obstacles to trade in the Community. This requires not only the removal of physical barriers but also of trade barriers, or artificial stimulants to trade, arising from differences in VAT or excise rates across member states.

(iii) Applying the Principles to Reform of Indirect Tax

The ability of the Irish government to apply the principles outlined above is limited in the case of indirect tax. This is so because decisions on tax harmonisation at the Community level are still subject to unanimity, and agreement at the Council of Ministers was not forthcoming. Although the final outcome is uncertain the following are the main elements of what is likely to emerge in the case of VAT. First, all member states will be obliged to apply a normal VAT rate between 14 and 20 per cent, or perhaps just a minimum rate of at least 14 per cent. Second, reduced rates, or zero rates, will be reserved for essential goods and services meeting a social or cultural policy objective, and these will be jointly defined.

Given the ease of movement between the UK and Ireland large VAT rate differences would give rise to substantial cross-border shopping with a consequent loss of revenue and decline of border regions. It is clear, therefore, that Ireland will have to adopt a set of rates close to those which will prevail in the UK after the negotiations are completed. Should the UK retain its standard rate at 15 per cent, Ireland must have a standard rate no higher than 18 per cent. Likewise, if the UK retains a zero rate on certain items, then Ireland can impose rates of up to 3 per cent on these items. Indeed, given the principles discussed above, the Council

favours this approach. The distributional implications of broadening the VAT base and reducing the standard rate must be considered. The indirect tax approximation process, taken as a whole, is likely to be regressive in its effect, i.e. to favour the better off most and the worst off least. In this context, the Council wishes to stress that measures to compensate the least well-off must accompany these changes. The Council has indicated the possible mechanisms to achieve this in a recent report (NESC, 1989B). The main conclusion is that a generalised small increase in social welfare would not be an appropriate response. A targeted set of compensation measures is necessary.

In the case of excise duties the outcome is even more uncertain. However, two things can be said with some confidence. First, some degree of approximation of excise duties is likely; second, this is unlikely to bring excise duties so close together that all systems of administrative control can be abandoned. It is likely that the final agreement will imply a reduction in some of Ireland's excise duties.

It seems logical that these changes should be introduced gradually and, therefore, that they be incorporated into a tax reform strategy covering the period 1991 to 1993. It is clear that changes in VAT and excise, arising from EC approximation, will involve loss of revenue to the Irish authorities. This will be a major contributor to budgetary pressure in the coming years.

(iv) Principles for Reform of Income and Social Security Taxes

Our discussion of the reform of income and social security taxes must be based on the principles which should be applied. First, in Section 1 (ii) of this chapter we listed seven principles upon which the Council bases its proposals for tax reform:

- (i) a comprehensive definition of income;
- (ii) equivalent tax treatment of income from different sources;
- (iii) neutrality with respect to inflation;
- (iv) minimum tax impact on individual or business choices;
- (v) general reliance on direct payments to those in need rather than assistance through the tax system,
- (vi) no earmarking of taxes; and finally,
- (vii) evaluation of compulsory social insurance contributions as taxes.

These principles, and other objectives of the Council, can be encapsulated in three general guidelines which can help in identifying the next stages of Irish tax reform.

First, compulsory social security contributions bear some of the characteristics of taxes and, consequently, it is essential to evaluate their structure and impact in the context of the tax system. *Second*, reform of income tax should, as far as possible, widen the base and reduce the rates of taxation. We can add a *third* guideline to these two: that certain inequities in the tax system should be reduced and the tax system should be consistent with the reduction in the inequalities in Irish society.

It may be useful to briefly restate the arguments which lie behind each of these principles.

Unified Analysis of Income and Social Security

Although the Council rejects wholesale integration of the taxation and social welfare systems it fully accepts the need to analyse the systems jointly and to identify specific aspects of the systems requiring integration. The Council also accepts that this joint analysis must be consistent; if social security contributions bear the characteristics of taxes, then social security payments must be viewed as income and must, logically, be incorporated in the definition of income for tax purposes.

Base Broadening and Rate Reduction

The case for reforming the tax system in such a way as to broaden the base and reduce the rates of tax derives from the central principles stated above. For example, the case for a broad base derives from the principles that income should be defined comprehensively, that direct payments are the best form of support for citizens in need, and that the tax system should not be used to achieve complicated allocative objectives.

As a matter of mere arithmetic a broader tax base implies lower tax rates – for a given level of revenue. However, the case for lower tax rates is more than just a by-product of the case for a broad tax base. First, it is frequently argued that the 'distortionary' or 'dead weight' effect of taxation is associated with the magnitude of the marginal tax rate (see below). Second, it can be argued that much of tax avoidance and the complexity of the tax system are related to the progressivity of the schedule of tax rates. These ideas have been adopted as guidelines for tax reform in many countries.

It may be useful to take note of the logic which underlies these guidelines. The imposition of taxes clearly involves both administrative costs for the authorities and costs of compliance for the taxpayers. But economists also identify another cost – the loss of economic 'efficiency' which results from the effect of taxes on economic behaviour. These changes in behaviour both reduce the revenue yielded by the tax and leave individuals with consumption, work or savings decisions which were not their first choice. Economists define the efficiency or deadweight cost of a particular tax in terms of these 'distortions'. It turns out that the extent of the excess burden depends on how responsive individuals are to pure changes in relative prices or wages. Furthermore, where such responsiveness exists, it is the *marginal* tax rate alone which matters. It is this which has led to a general desire to design tax systems with low marginal rates.

This is closely related to a second general characteristic of recent tax reform in many countries: a reduction in the spread of income tax rates and, in some cases, a reduction in progressivity. Two ideas underlie this. First, the idea that the

'distortionary' costs or excess burden of taxation are related to the marginal rates of tax has led to the perception of a general trade-off between progressivity and efficiency. While this perception is ultimately correct, the principles which yield it must be applied with care. Second, the existence of a wide range of tax rates makes the tax system complex and gives rise to sophisticated efforts to avoid tax. This is not only wasteful and inequitable, but also frustrates the achievement of policy objectives.

Tax Reform and Social Inequality

One of the central principles which underlies the Council's strategy for economic and social development is that policy should reduce the inequities and inequalities in Irish society. This has two important applications in the area of taxation policy. First, the taxation system, viewed in the broad sense, contains many provisions which are inequitable in that they confer very unequal and unfair advantages on certain individuals over others. These inequities should be minimised wherever possible. Second, the taxation system is an important influence on the overall distribution of income and resources in the society. The elimination of poverty is among the major goals of the strategy proposed by the Council. Tax reform can and should play a role in reducing the gross inequality which poverty represents.

(v) Applying the Principles to Reform of Income and Social Security Taxes

The Next Steps of Irish Income and Social Security Tax Reform?

In view of the principles stated above and the pattern of reform in many OECD countries the question naturally arises as to what are the next steps of tax reform in Ireland. It is important that both income tax and PRSI be considered when seeking desirable and achievable reforms. We begin by briefly comparing the existing structure of income tax rates in Ireland with those in force in other OECD countries. We then consider the proposal for further rate reductions and ask how such a strategy relates to the Council's existing proposals on tax reform. The major argument against a further flattening of the schedule of income tax rates is that it would remove much of the progressivity from the tax system. This argument must be taken seriously and we consider what it implies for the pattern of income and social security tax reform.

Rate Schedules in Ireland and Other OECD Countries

A common feature of recent tax reform in OECD countries is the reduction in marginal income tax rates (OECD, 1990A). In considering the strategy of reducing income tax rates further, and reducing the number of rates, it may be useful to compare Ireland's income tax rate schedule with that in other OECD countries. Such a comparison reveals that governments have chosen very different ways of obtaining desired levels of nominal tax rates and progressivity. Some, such as Canada, the UK, the US and Ireland, have opted for relatively simple income tax rate structures, while others, such as Austria, Belgium, France, the Netherlands and Spain, have chosen multi-bracket structures with more "smooth" rate increases. Indeed, the only countries with simpler rate schedules than Ireland are the UK and the US, while Denmark and Canada have somewhat flatter schedules.

Taking the OECD as a whole and considering income tax alone, Ireland is an outlier in the height of its *standard rate*, and the rapidity with which citizens reach the top rate, rather than in the height of its top rate. It might be argued that, from a labour supply and migration point of view, the OECD as a whole is less relevant than the UK, the US and Australia – two of which have both a simpler schedule and a lower top rate. This argument might have validity if labour supply and migration decisions were influenced by the income tax *schedule rates* alone. While this is a possible, though highly irrational, pattern of behaviour, it must be judged unlikely. The income tax *schedule rates* do not give an accurate picture of the *effective* marginal rates (which are influenced by both social security taxes and the structure of exemptions and allowances). When these are taken into account they reinforce the point that Ireland has high rates on low incomes and an extremely rapid progression to the top rate. In addition, while the 'distortionary' effects of taxation are related to the size of marginal rates, the overall labour supply effects are influenced by both average and marginal rates. This is likely to be especially true of migration decisions, which – in as much as they are influenced by tax at all – are probably influenced by average rather than marginal tax rates.

Schedule Rate Reductions and the Council's Principles

We now ask how a strategy of income tax rate reduction and schedule simplification relates to the Council's existing proposals that tax reform must achieve a widening of the base and a reduction of the rates faced by taxpayers. First, a reduction in the income tax schedule rates, or a simplification of the schedule, is not *necessary* in order to achieve base widening and rate reduction. For example, a widening of the tax bands, with retention or even *increase* in rates, would achieve a reduction in the average marginal rate. Second, a reduction in income tax schedule rates, or a flattening of the schedule, is not *sufficient* to achieve the Council's fundamental objective of base widening and rate reduction. Indeed, the tax changes since 1986 involved rate reduction without significant base widening. It follows from these two points that reduction or flattening of the income tax rate schedule *is neither a necessary nor sufficient condition* for achieving base broadening and rate reduction.

Third, in devising ways of achieving rate reduction and base widening, policy makers should not be confined to changes in the schedule of *income* tax rates. Changes in the rates of PRSI, or the PRSI base, are also available and must be considered.

Which of the many possible routes to reduction in effective rates is taken depends on the precise objectives of tax reform, including both equity considerations and where on the income spectrum the major disincentive effects, if any, are thought to arise. While we have little reliable information on the disincentive effects the Council has strong views on equity.

Arguments for a Simplified Rate Schedule

Although income tax schedule rate reduction is neither a necessary nor sufficient condition for the achievement of the Council's objectives, there are, however, some general arguments in favour of a highly simplified rate schedule. One argument in favour of a very simple schedule of rates is that it would simplify the tax system, would greatly reduce the incentive to search for ways of reallocating income and would increase vertical equity by making discretionary reliefs of equal value to all taxpayers. However, these arguments for a highly simplified schedule of rates should not be taken too far on their own. The existence of multiple rates of tax is by no means the main cause of non-simplicity. Furthermore, as pointed out in *Strategy for Development, 1986-1990* the real importance of achieving a very simple rate schedule resides in the objective of securing eventual harmonisation of the tax treatment of earned income, company income, capital gains and capital acquisitions. Thus, reducing the number of rates from three to two, while not actually proceeding to harmonise personal, capital and corporate taxation, and while leaving a plethora of allowances and reliefs in the system, is not necessarily a great improvement in the overall tax system. Indeed, the case for a simple schedule of rates is a part of a much broader and much more significant argument – the argument for a *comprehensive definition of income*. The fundamental importance of a comprehensive definition of income emerges and re-emerges whenever the Council considers ways of improving either the efficiency or equity of the Irish income tax system.

Loss of Progressivity

A major anxiety about a further reduction of income tax rates which flattened the overall rate schedule, is that it would entail a reduction in the degree of progressivity of the tax system as a whole. This fear is very relevant to the next phase of Irish tax reform since the analysis earlier in this chapter suggests that the changes introduced since 1986, the most prominent of which was the reduction of income tax rates, have indeed tended to reduce the progressivity of the income tax system – especially over higher ranges of income. Our purpose is to assess how valid this fear of loss of progressivity is, to decide whether it constitutes a conclusive case against further flattening of the Irish income tax rate schedule and to identify what other tax reforms it suggests. Our conclusion is that it is generally correct that income tax rate reductions will tend to reduce progressivity, but this does not necessarily bias the Council against the proposal to flatten the income tax rate schedule since there are feasible and easily identifiable base-widening measures which, if taken in conjunction with income tax rate reductions, would preserve, or even enhance, the progressivity of the system. However, the Council sees little possibility of, or case for, income tax rate reductions, and especially for further flattening of the rate schedule, which are undertaken without significant widening of the base.

The general validity of the point that rate reductions, and especially income tax schedule flattening, tend to reduce progressivity, does not necessarily bias the

Council against the proposal to further flatten the Irish income tax rate structure. Nor does observation of the pattern of tax reform in other countries lead the Council, on equity grounds, to oppose further rate reductions in Ireland. It is important to note that reduction of progressivity was not an *unavoidable concomitant* of tax reform but was, in fact, a *central objective* of many tax reforming governments in the 1980s.⁷ In fact, there are a number of reasons why a tax reform which flattens the income tax rate structure and reduces top marginal rates may not, in fact, reduce the redistributive effect of the tax system. The past practice of enacting highly progressive bracket rates frequently achieved very little and very uncertain redistribution because high rates were made ineffective by a deficient income definition and a plethora of discretionary reliefs (Musgrave and Musgrave, 1982). The extent of redistribution in existing and earlier systems is seen to be even less when indirect and payroll taxes, and flat rates and ceilings for social security contributions, are taken into account (Hagemann, Jones and Montador, 1988). Tax avoidance and evasion also reduce the progressivity of the system (Stiglitz, 1988).

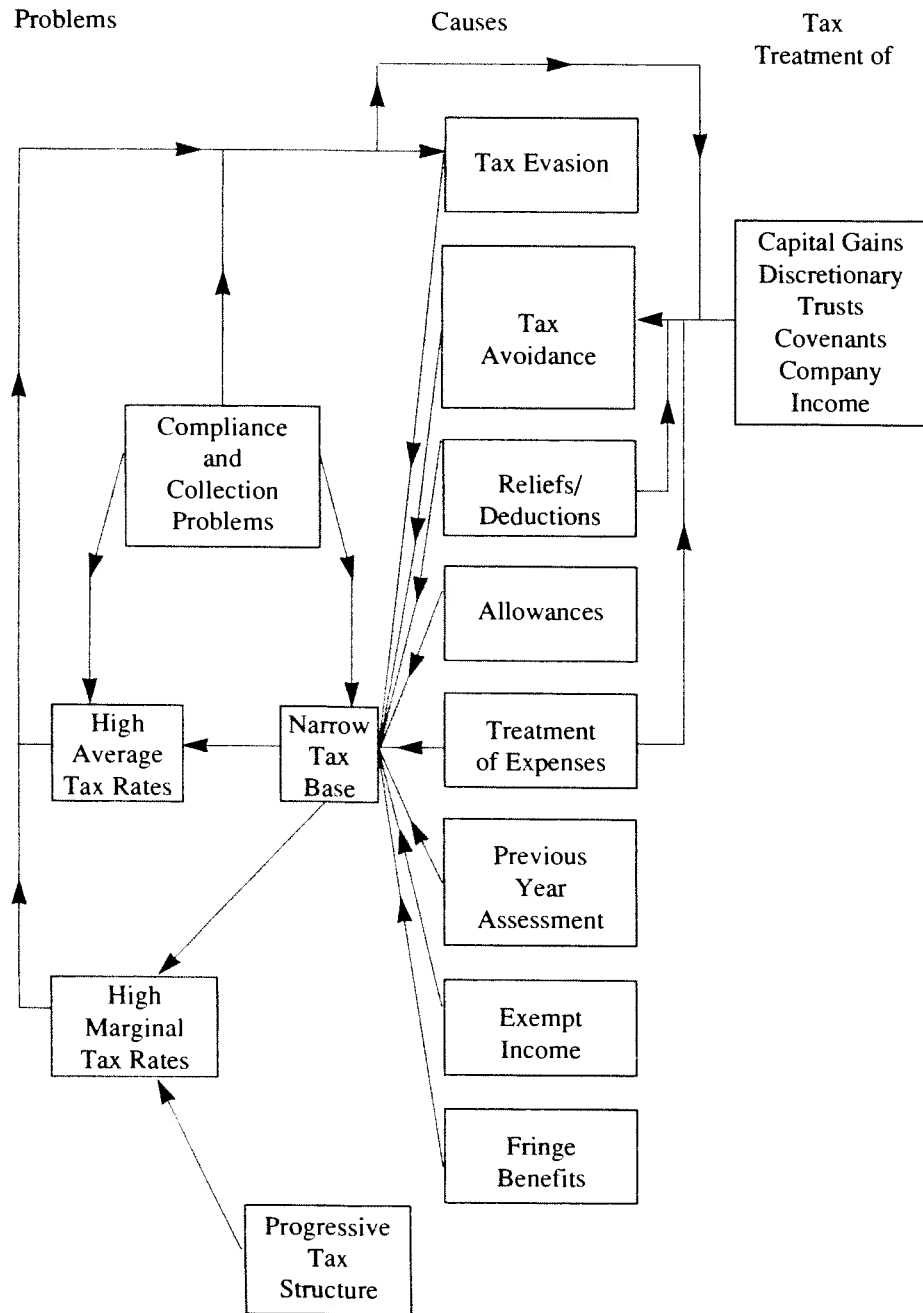
Indeed, it has been argued that tax reform may even make it possible to increase the progressivity of the tax system relative to the current situation, while acknowledging that “in the limit there is a clear trade-off between the competing goals of increased efficiency and greater vertical equity” (Hagemann *et al*, 1988). Thus, where reduction of the progressivity of the system as a whole is not an objective, it may be possible to undertake tax reform which does not increase inequality in the distribution of income. But all the considerations listed above show emphatically that the key to tax reform without reduced progressivity of the system as a whole is widening of the base – especially, adoption of an income definition which equalises the treatment of earned income, capital gains and investment income, abolition of the plethora of discretionary reliefs and introduction of a tax on property. Broadening the base in these ways tends to increase the progressivity of the system and, for this reason as well as others, is the natural and necessary concomitant of income tax rate reductions. Indeed, elimination of a number of reliefs has been a very important concomitant of income tax rate reduction in several countries (OECD, 1986B). Likewise, any increase in the basic relief or in welfare payments tends to increase progressivity. Of course, in the Irish case base-widening which will reduce the overall burden on earned income must include introduction of a comprehensive property tax (see footnote 7).

Reforms of PRSI

We have identified a number of benefits of rate reductions and, indeed, some possible advantages of a single rate. The main argument against a further flattening

7. A recent symposium on 'The Conservative Revolution' revealed that despite numerous claims about supply side miracles, new approaches to macroeconomic management and deregulation, the real change in economic policy in many countries in the 1980s was a redistribution of resources and income from the poor to the rich (*Economic Policy*, No 5, October 1987).

Figure 6.10
The Irish Income Tax System
-Problems and Diagnostics



of the income tax rate schedule is that it would tend to undo progressivity. While this argument is a valid one we have judged that it does not constitute a conclusive case against further flattening of the income tax rate schedule. However, when we consider PRSI we find that movement to a single rate does not face the objection that it would undo progressivity of the system as a whole. Such a change would reduce progressivity where progressivity is agreed to be too high (in the bottom half of the income distribution) and increase progressivity over higher ranges of income.

In the Council's view, there is a strong case for adopting a single rate of employees' PRSI without an exemption at the lower end or a ceiling at the upper end. Such a restructuring of social security contributions would allow a lower rate to be applied. The advantages of this reform are considered in more detail in Chapter 7, on Social Welfare Policy. However, we may summarise these advantages here:

- the schedule of effective marginal and average tax rates would be smoother across the income distribution;
- the administratively cumbersome exemption which exists at present would be abolished;
- by removing one of the main regressive elements in the overall tax system, the abolition of the PRSI ceilings would give policy makers more choice in setting income tax rates – without fear of reducing the overall progressivity;
- the imposition of a lower rate would imply a distinct reduction in marginal tax rates for those on lower incomes with a consequent amelioration of the poverty trap (see Chapter 7).

Conclusions

Six conclusions can be drawn from this discussion. First, there is a general case for low marginal rates of tax wherever possible. Second, there is a strong case for lower average rates of tax on earned income in Ireland. Third, technically there are many ways of achieving lower average and marginal rates but, having considered the efficiency, equity, income distribution and public finance considerations, the Council is certain that significant widening of the base is the central requirement in the next phase of reform. This will involve both extension of the *income* tax base – by abolition of exemptions, allowances and reliefs – and extension of the *total* tax base by the introduction of a tax on property. Fourth, there are arguments both for and against schedule rate reductions and movement to a very simple and relatively flat schedule of income tax rates. The major argument against further flattening of the schedule of rates is that it will further erode the progressivity of the tax system as a whole. Fifth, the benefits of schedule tax rate reductions can be maximised and the costs, in terms of lost progressivity, minimised, if the tax base is broadened sufficiently. Sixth, there is a strong case, in both efficiency and equity, for a single, lower rate of employee's PRSI without exemption at the lower end and without an income ceiling at the upper end.

The logic of these conclusions, and the way in which they relate to each other, can be highlighted by noting how they address the problems of the Irish tax system. In *Strategy for Development 1986-1990* Figure 6.10 was used to illustrate the structure and problems of the Irish income tax system. Note how high marginal rates are the result of *both* the progressive tax rate structure and the narrow tax base. It was this that led the Council to its emphatic conclusion on tax reform:

The Council believes that the narrowness of the existing tax base is the proximate cause of the most serious problems and costs associated with the present taxation system... Accordingly, the Council believes that the priority of taxation policy in the coming years must be the widening of the tax base and the simultaneous reduction of tax rates.

The discussion in this document confirms the importance of widening the tax base. Indeed, the severe pressures on revenue which will arise from harmonisation of VAT, excises and DIRT imply that a major aim of tax reform – reduction in marginal and average rates of tax on earned income – can only be achieved if the tax base is widened.

(vi) Applying the Principles to the Overall Tax System: A Comprehensive Property Tax

We have identified a wide range of benefits which would flow from reduction in marginal tax rates and considered how this might be achieved. However, another very important objective is reduction of *average* rates of tax. The achievement of substantial reductions in average and marginal rates of tax on earned income is conditional on a restructuring of the overall system. This requires the introduction of a comprehensive property tax.

The case for taxation of property has been developed in previous Council studies (NESC, 1989A). The two points we wish to highlight here are, first, that the principles which support a property tax are the same as those which suggest reform of income tax and, second, that further simplification and reduction of taxes on earned income is conditional on the introduction of a property tax. Both these points have been neatly made by Vickrey in a recent essay on progressive and regressive taxation. He points out that the “most fundamental and most often overlooked question is that of the base to which the tax system is to be related” (Vickrey, 1987). In his view there is a case for including in the tax base not only income *per se* but some element of wealth or net worth:

Most of the disadvantages of the income tax can be avoided by keeping the rates low. There are also advantages to a uniform rate in terms of the administration of withholding and collection at source. One appropriate way to take advantage of these qualities would be to limit the income tax to a single uniform flat rate, relying on the exemption and allowances to provide the graduation at the bottom of the scale, and relegating to other forms of progressive taxation the task of carrying on progression at middle and high income levels.

In the Irish context the obvious gap in the tax system is the absence of a comprehensive property tax. This argument suggests that tax rates should *only* be further reduced with the introduction of such a tax and that its introduction would allow several desirable objectives to be achieved^{8,9}

(vii) Conclusions and Recommendations

We conclude this chapter by briefly stating the Council’s recommendations for the next phase of Irish tax reform.

1. *The Council considers that tax policy must accommodate, as far as possible, the approximation of VAT, excise and DIRT tax rates which will emerge in the Community. This reflects our strong support for the process of European integration and our acceptance that significant tax approximation is necessary to create a genuine common market.*
2. *Tax Policy in the period 1991 to 1993 should aim to achieve a VAT rate of 18 per cent and a 3 per cent VAT rate on items currently zero-rated. This proposal reflects both need for reform of indirect tax and the need for indirect tax harmonisation.*
3. *Measures to compensate the least well off must accompany the imposition of VAT on items currently zero rated. A generalised small increase in social welfare is inappropriate. A thorough investigation of the low income losers and a targeted set of measures is necessary.*
4. *The Council recommends reductions in effective marginal and average rates of tax on earned income. This is necessary to enhance the efficiency of the Irish economy and to promote faster growth in output and employment.*

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8. The IFA, ICMSA and ICOS oppose the imposition of a property tax on agricultural land, farm buildings and structures for the following reasons.

Agriculture is unique in that a very large amount of fixed capital is required to generate a family income. Figures based on the National Farm Survey show that using extremely conservative assumptions, i.e. labour valued at the minimum agricultural wage rate, zero remuneration of farmers management input and a 5% return on working capital, the average return on investment in land and buildings through most of the 1980s was negative.

Farming profits are subject to taxation under the income tax code, therefore, the imposition of a property tax on agricultural land, farm buildings and structures would amount to double taxation. Furthermore, it would be:

- (i) inequitable between taxpayers, since most taxpayers other than farmers, do not require a large amount of fixed assets to produce an average family income;
- (ii) regressive since it would have to be paid out of normal family living expenses since the average rate of return on land and farm buildings is zero or negative;
- (iii) it would be detrimental to the future development of Irish agriculture given the long pay back period on investment and the high incremental nature of fixed capital formation. On the typical Irish farm, total income is inadequate to reward labour and working capital, with no residue to reward fixed capital, i.e. land buildings and structures.

9. See footnote 1, Chapter 8 for a CIF reservation on the property tax proposal.

5. *The Council warns that reductions of income tax rates, especially those which flatten the schedule, may tend to reduce progressivity over the relevant ranges of income. This reflects the Council's interest in income distribution and its insistence that the effect of tax changes on progressivity be taken into account.*
6. *The progressivity of the income tax system can be retained, to the extent desirable, even with a flattening of rates, if the base is broadened sufficiently. The Council sees little prospect of, or benefit in, further schedule rate reductions without significant widening of the base. This reflects, first and foremost, the Council's belief that budgetary pressures in the coming years – deriving in part from approximation of VAT, excise and DIRT taxes within the EC – will make it impossible to reduce marginal and average tax rates on earned income unless the tax base is widened. It also reflects the Council's awareness, derived from analysis, that schedule rate reductions, on their own, do little to improve the efficiency effects of the tax system.*
7. *The Council recommends the imposition of employee's PRSI at a single rate with no exemption and no ceiling. Such a restructuring would allow a lower rate of tax to be applied. This recommendation derives from the Council's recognition of the fact that compulsory social security contributions bear many of the characteristics of taxes and, therefore, must be analysed in the same way as taxes. Such an analysis suggests that several significant benefits would flow from the reform suggested here – the greatest of which will be some amelioration of the poverty traps which currently arise from the interaction of tax, social security and low pay.*
8. *Given the pressures on revenue the Council considers that further reductions in taxes on earned income are only possible with measures to broaden the tax base including the introduction of a comprehensive property tax.¹⁰ Broadening of the tax base was, and remains, the heart of tax reform. In the Irish case the most striking feature of the tax base is its concentration on earned income, and the most blatant gap is the exclusion of property. Given this, both policy-makers and the public must be aware that lower average and marginal taxes on earned income are possible, as soon as they choose to have them.*

¹⁰ See footnotes 8 and 9 for reservations on this recommendation.

1. INTRODUCTION

In *Strategy for Development 1986-1990* the Council agreed that four inter-related sets of policies were required in the circumstances then prevailing: appropriate macroeconomic policies, tax reform, development policies, and social policies in pursuit of a more equitable society (NESC, 1986B). The latter set of policies was seen by the Council as an essential and intrinsic element in the mix of policies it then proposed.

Social policies relate to the pursuit of minimum standards, the redistribution of income, resources and life chances, and the development of human capital. Accordingly, social policies are effected largely through cash transfers, direct and indirect taxation and the provision of a wide range of goods and services such as health, housing and education. Chapter 6 deals with taxation, while Chapters 8, 9 and 10 respectively deal with non cash social services – housing, health and education. The system of cash transfers, the most significant area of social expenditure in Ireland, is the subject of this chapter.

The chapter focuses on the analysis in the *Strategy for Development* report. Firstly, the circumstances prevalent in 1986, and the Council's prescriptions at that time are concisely restated. This section also contains a brief note about recent research results on incomes and poverty in the year 1987 in Ireland. Secondly, a tentative assessment is made of the evolution of personal incomes since 1986 with particular reference to the social security system. Some data on the trends in total social security expenditure are also included here. Thirdly, the wider picture affecting gross earnings and the impact of income taxation on disposable earnings is briefly considered. This analysis is also informed by the Council's 1986 assessment. Finally, some policy issues which arise for the future in relation to social security are discussed.

2. STRATEGY FOR DEVELOPMENT (1986)

The Council concluded its discussion of social security policy in 1986 as follows:

The Council's recommendations in the area of social welfare represent a proper balance of the criteria which should govern social policy discussions in the period to 1990. Council recognises the magnitude of the social welfare budget and thus cannot recommend overall indexation of payment levels.

Equally, however, the importance of minimum standards and redistribution suggest that the very lowest social welfare payments should accrue relative increases. The potential significance of disincentives in a segment of the labour market requires that payments not evolve independently of employees' disposable earnings. The importance of both efficiency and redistribution criteria dictate that a comprehensive approach towards the earmarked social security contribution and a greater contribution from revenues to social welfare expenditures should be initiated (NESC, 1986B).

This summary of the Council's position refers to three specific issues. Firstly, the Council noted the critique by the Commission on Social Welfare of the varied and anomalous *structure* of social security payments which was then in place, and suggested that a more targeted approach be adopted in relation to increases in social welfare payments. This targeting should focus on narrowing the then wide gap between the higher and lower payments. Secondly, the Council pointed to the need for co-ordination between policies affecting social welfare payments and policies which affect the disposable income of employees. In particular, the Council suggested that an undue narrowing of the social welfare/ disposable earnings gap should be avoided. Thirdly, the Council advocated a more comprehensive coverage for social insurance by incorporating the complete labour force into the mainstream social insurance contribution system. In keeping with its expressed views on tax reform, the Council also proposed the inclusion of social welfare payments in the definition of annual income for tax purposes.

A central thrust of the Council's strategy in 1986 was the economic benefit to be gained from tax reform.

The general principles underpinning the reports of the Commission on Taxation were considered and then adopted by the Council. Some aspects of taxation and tax reform are relevant to the issues of poverty and income distribution and overlap with social welfare policy. For example, the Council documented the evolution of marginal tax rates and pointed to the modest levels of income at which high marginal rates then applied. "The priority of taxation policy in the coming years", the Council argued, "must be the widening of the tax base and the simultaneous reduction of tax rates" (NESC, 1986B).

A complete assessment of developments in the tax system in the light of the above analysis is given in Chapter 6. However, specific aspects of the relationship between taxation and social welfare give rise to policy problems. These problems are addressed in Section 4 below.

3. INCOME POVERTY IN IRELAND IN 1987

The *Strategy for Development* report was published in 1986. In 1987 a large scale national survey was undertaken by the Economic and Social Research Institute of

household and personal incomes and the utilisation of State services in Ireland. Data compiled in this survey has been used to assess the extent of poverty and of low incomes in Ireland in 1987. The results of this research have been published and widely reported, and features of the results have shaped policy debate and policy priorities. A brief account of the methodology of the research and some of its key results are therefore given in sub section (iii).

(i) Definition of Poverty

The ESRI research is conceptualised in terms of relative poverty. Poverty is essentially seen as exclusion, through lack of resources, from the generally approved standards and styles of living in society as a whole. This approach rests on the fact that *perceptions* of acceptable and minimum standards change over time and differ between countries and between economies with varying levels of income.

The implications of the relative definition can be grasped if the choice of a *constant* standard over time is considered. If a constant (ignoring inflation for simplicity of argument) standard is applied, say £x per capita, as the line below which persons are deemed poor, then over a very extended period, as incomes grow, poverty effectively disappears. This approach, while arithmetically valid, is of little relevance, as the real *meaning* of poverty is thereby lost. There may be little social meaning to a statement, for example, that by a constant real standard fixed in 1950 poverty does not exist in 1990.

However, the use of fixed standards does have an analytical value, especially in relatively short time periods. Adopting a fixed real standard allows judgements to be made, for example, about progress in bringing some households or segments of the population up to a specific standard.

(ii) Measurement of Poverty

The underlying rationale for a relative definition of poverty is that people whose resources are very much below the average will be unable to afford conventional standards and will effectively be excluded from participation in society. It follows, therefore, that measures of relative poverty are formulated in relation to average incomes. For example, relative poverty 'lines' are customarily set at a particular percentage of mean or median income. Many studies measure poverty as the proportion of households/families whose incomes fall below half of mean income in the population as a whole. The extent of poverty can now rise or fall or disappear entirely.

Two specific points are important here. First, the use of half average income as a threshold in many studies is simple *convention* – it has no analytical basis. Second, and related to this point, the use of a poverty threshold such as 50% or 60% of mean income does *not* yield a unique, authoritative "poverty line" – a line below which people are "poor". Results of headcounts of the poor below particular

thresholds are sensitive to the precise demarcation used and it is essential, therefore, to have figures for a number of thresholds.

The relative income measure is simple, it provides a starting point for the identification of groups in poverty and the causes of poverty, and it permits comparisons across countries and over time. The approach also provides a measure of poverty which is *independent* of official measures such as basic social assistance rates and which is free of arbitrary judgements about the expenditure patterns or "basic needs" of the poor.

In the assessment of trends in poverty over time the relative income approach is more plausible in periods of growing real income, and less so in the admittedly unlikely circumstances of a sustained period of real income decline. In other words, a drastic decline in general living standards is not recorded as an increase in poverty unless the relative position of the lowest income groups deteriorates. Conversely, in periods of overall income *increases*, the improvement in living standards must be shared by the 'poor' for this to be reflected in a reduction in poverty. However, the relative income approach does not equate poverty and inequality. A measure of poverty which defined as poor the lowest (for example) tenth or fifth of the income distribution would make poverty indistinguishable from income inequality. Under such a definition the extent of poverty could not rise or fall. On the whole, measures of poverty have to be judged in the light of the context in which they are applied and in the knowledge that the search for a universally agreed definition and measure is likely to fail.

Finally, a particularly complex issue in the interpretation of data on poverty is the role of current income as a measure of resources. Current income includes not only earnings, transfer payments and so on, but also income streams from assets such as dividends and rents. However, ownership of assets *per se* may affect consumption and therefore living standards. Furthermore, other types of resources, such as occupational fringe benefits and non cash public services, also affect living standards. This is the first qualification which attaches to the use of current income as a measure of resources in poverty studies.

A second qualification concerns the relationship between current income and the various dimensions of poverty. Current income, it can be expected is highly correlated with certain aspects of poverty: for example, a low current income will constrain expenditure on food, clothing, heating and lighting etc. However, housing conditions may not be strongly correlated with *current income*. Many elderly persons, for instance, whose sole income is a social welfare pension payment, may own and occupy adequate dwellings. More broadly, poverty and deprivation are *multifaceted*, and measures of income and resources vary in the strength of their relationship to facets of deprivation. One policy implication of this discussion is that certain aspects of deprivation must be addressed by policies to increase the *incomes* of the 'poor' (for example, low income families affected by

unemployment whose income precludes the purchase of adequate food, clothing etc), while other aspects may require *non-income*, social service intervention (such as the physical isolation and poor housing of some of the rural elderly population).

(iii) Unit of Measurement

Data was collected and analysed at the level of households, persons and tax/benefit units, as the extent of measured poverty varies according to the *unit* of analysis. *Per capita equivalence scales* are then applied to incomes to standardise data for households with variable sizes and compositions. A variety of such scales are used and the sensitivity of the results to the extent and characteristics of poverty is examined.

(iv) Key Findings for 1987

The first key result concerns the overall extent of poverty in Ireland in 1987. Mean income per adult equivalent in 1987 was £79.50, £86.40 or £85.50 using scales A, B and C respectively.¹ The 50% poverty line (in 1987 prices) was therefore in the range £40 – £43 weekly depending on the line chosen. As Table A7.1 reveals, about *one fifth* of all persons fell below the 50% poverty line, and just under a *third* below the 60% line.

Secondly, Table A7.2 reports the *trends* for the time periods 1973-1980 and 1980-1987, for the 50% poverty line. From 1973 to 1980 the percentage of *households* below the poverty line fell marginally, while the percentage *increased* from 1980 to 1987. For *persons* however, the trend is upwards, and more sharply, during both periods. Most of the increase, the Table shows, took place in the period 1980-1987.

Thirdly, poverty lines and the associated percentages of those 'above' and 'below' the lines offer a 'headcount' of poverty. They do not reveal anything about the *extent* of poverty. For example the 'poor' could, theoretically, be located marginally below the poverty line, or at the other extreme, they could be at a significant remove from it. The 'per capita income gap' measure, and a distribution sensitive measure, have been developed to incorporate in the measure of poverty the income gaps of the poor and the income distribution below the poverty line. According to these measures, shown in Table A7.3, the extent and severity of poverty has increased.

Fourth, the data in Table A7.4 shows that the risk of poverty for families with four or more children has more than doubled over the period 1973-1987; at the 50% relative poverty line the risk was 36.5% in 1987. If the 60% line is adopted (data not shown) for 1987 the risk for these families is 50.3% – about half. Conversely, the risk of poverty among the elderly has sharply declined (data not given) and is associated with significant real improvements in state pension provisions. This dramatic increase in *family* poverty is, in very significant measure, attributable to the rise in unemployment. Unemployment affects the pattern and risk of poverty

1. See Appendix Tables for A,B,C Scales.

either by an increase in the *risk* of poverty for any level of unemployment, or by an increase in the incidence of unemployment. The detailed decomposition of the increase in poverty among families as between these two factors points to the latter, increased unemployment, as 'the predominant cause' (Callan and Nolan, 1989).

Fifth, the role of labour force status and participation is important in understanding the relative risk of poverty. Households with an unemployed head, as Table A7.5 indicates, have a 'poverty risk' of 58.9%, and in the case of household heads who are ill the figure is 51.2%. As regards the incidence (or composition) of the poor by labour force status, the largest single category comprises the unemployed (34.2%), followed by farmers (23.7%) (subject to the caveat given in the footnote below)² and employees (9.6%).

Sixth, at the 50% poverty line 12% of poor households are paying tax/PRSI, and at the 60% line the proportion is 18%³. Table A7.6 shows the relationship between the incidence of poverty and the joint incidence of poverty and payment of direct taxation. Of the households below the 50% line, 9.4% are headed by employees. However, of that 9.4% of households below the line who are also paying tax/PRSI, 56.7% are employees. Correspondingly, of the households below the 60% line and paying tax almost two thirds (62.2%) are employees. There is an overlap between low gross incomes, tax/PRSI and poverty, and this overlap is largely inhabited by *employees*. Households with *children* predominate among those households below the poverty line who are in the tax/PRSI net. Notably, 71% of such households comprise households with at least one child at the 50% poverty line; the figure rises to 75% at the higher poverty line.

The results summarised above must be viewed in the light of developments since 1987. In the absence of a follow up representative survey of incomes it is not possible to make ad hoc calculations about how the overall extent of poverty has changed.⁴ It is worth noting, however, that since 1987, in the light of the report of the Commission on Social Welfare and the findings of the poverty research, that disproportionate improvements have been made in the tax/benefit system for some categories. Notably, long-term unemployment assistance for families has been increased markedly, Family Income Supplement for low paid employees has been improved, and child additions to the income tax exemption limits have been introduced and extended. These changes may have resulted in a change in the *pattern* of poverty as between family households and other households.

2. Among farmers the risk of poverty is 35.8%. The farm income data refers to 1986, and as farm incomes increased significantly in 1987 the relative position of farmers in the comparison must be judged with some caution.

3. The discussion here is couched in terms of households, not persons or tax/benefit units.

4. To estimate poverty in the current year and to compare it with the 1987 figures it would be necessary to firstly ascertain *average* incomes in 1990 – this in turn requires representative data on *all* incomes.

4. TRENDS SINCE 1986

In this section a brief assessment is offered of trends in social welfare in recent years against the backdrop of the Strategy for Development Report of 1986. A summary of the relevant material in that report was given above in Section 2.

(i) Structure of Social Welfare Payments

The Council's argument in 1986 was that the structure of social security payments was anomalous and that the payment system should be more uniform in its treatment of different contingencies. Table 7.1 provides the information with which to assess developments in this regard since 1986. Some progress has been made in narrowing the very wide and unjustified variation in the payment structure. Notably, the long term unemployed received disproportionate increases in payments so that by 1990 they benefited from cumulative (nominal) increases of 16.8% in the case of the insurance payment (benefit) and 41.2% in the case of long term unemployment assistance.

A particular point stressed by the Commission on Social Welfare, and quantified in some detail in the ESRI poverty research (see Section 2 above), was the high risk of poverty among *families* whose main earner was unemployed. The figures in the lower panel of Table 7.1 indicate that this problem has received some attention⁵. In *per capita equivalent* terms, a family's entitlement on long term unemployment assistance has increased by 28.5% and the gap between such families and traditionally better off recipients such as pensioners has therefore narrowed. Other payment categories such as those for single women and the disabled have also been brought into the mainstream of the payments system.

However, the relative amounts of unemployment benefit and unemployment assistance payments have altered. Currently the weekly rates are £48, £45 and £52 for benefit, short-term and long-term assistance respectively. Unemployment assistance (long term) rates are now *higher* than those for unemployment benefit. This may be anomalous in an insurance based system where PRSI contributions supposedly lead to non-means-tested entitlement to a payment *higher* than the corresponding means tested allowance. Furthermore, in 1987 the contribution conditions for unemployment benefit were made more rigorous and restrictions were imposed on the pay related benefit scheme.

The rationalisation of the pattern of Child Dependent additions proposed by the Commission on Social Welfare has been largely implemented. In 1986 the Commission noted a proliferation (thirty six in all) of rates of Child Dependant Additions – without any apparent basis for the wide variation in these additions. By 1990, the number of such rates was down to six with consistent differentiation in the payments as between insurance and assistance recipients and between long term and short term categories of recipient.

5. The child additions to UA payments, as well as the personal rates, were used as the mechanism to address this issue.

Table 7.1
The Structure of Social Security Payments 1986 and 1990

Insurance	1986	1990	% Change
		<i>£ weekly</i>	
Contributory Old Age –80	53.45	61.50	15.1
Contributory Old Age 80+	57.10	65.50	14.7
Contributory Widow –66	48.10	56.00	16.4
Contributory Widow 66–80	49.10	56.00	14.1
Invalidity Pension –66	47.10	54.10	14.9
Invalidity Pension 66+	48.05	55.10	14.7
Unemployment/Disability	41.10	48.00	16.8
Unemployment as % of Old Age Pension –80	76.9	78.00	
<i>Assistance</i>			
Old Age –80	45.75	53.00	15.9
Old Age 80+	49.10	57.00	16.1
Widows/Deserted Wives –60	44.90	53.00	18.0
Widows/Deserted Wives 66–79	45.75	53.00	15.9
Unemployment long term	36.70	52.00	41.7
Disabled Persons Maintenance Allowance	43.20	52.00	20.4
Single Womens' Allowance	39.15	52.00	32.8
Unemployment as % of Old Age Pensions	80.2	98.1	
<i>Families on Unemployment Payments:</i>			
<i>Man, Wife, Two Children</i>			
Per Capita equivalent Unemployment Benefit	37.76	43.88	16.2
Per Capita equivalent Unemployment Assistance	35.23	45.26	28.5

Source: Department of Social Welfare; NES Secretariat.

Notes: Per Capita equivalence scales are 1.0, 0.66 and 0.33; Pay Related Benefit is not included in Unemployment or Disability. 1990 figures are post July 1990 rates.

This rationalisation was effected by means of significant increases in the CDA payments. For example, in July 1987 a couple on long-term unemployment assistance would have received £27.10 CDA support for three children: in July 1990 the figure is £33 – 22% higher. This extension in the role of CDAs in the overall package of Child Income supports must be viewed in the light of the analysis of the Commission on Social Welfare, on which the Council bases its views. The Commission considered that CDAs should gradually diminish in scope over time as Child Benefit improved. This strategy may now be more difficult to implement as a result of the enhancement of CDAs in recent years. CDAs contribute to whatever poverty and unemployment traps exist in the tax/social welfare system, as the policy discussion in Section 5 argues.

Figure 7.1
Social Welfare Payment Rates £ Weekly
Constant 1985 Prices

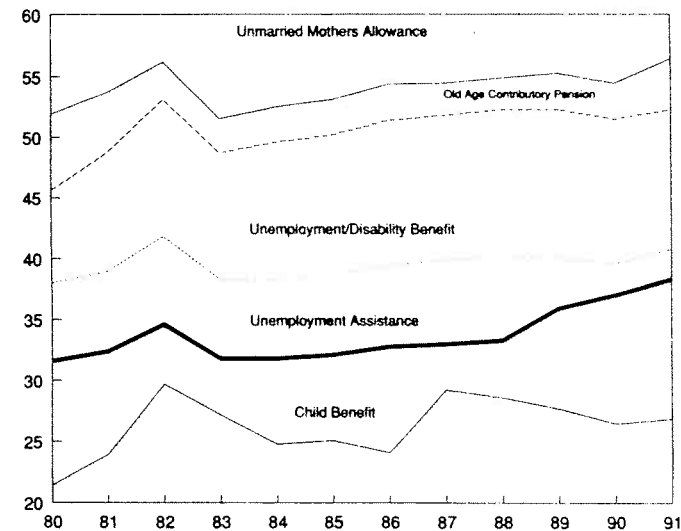


Figure 7.2(a)
Pension (Single Person)

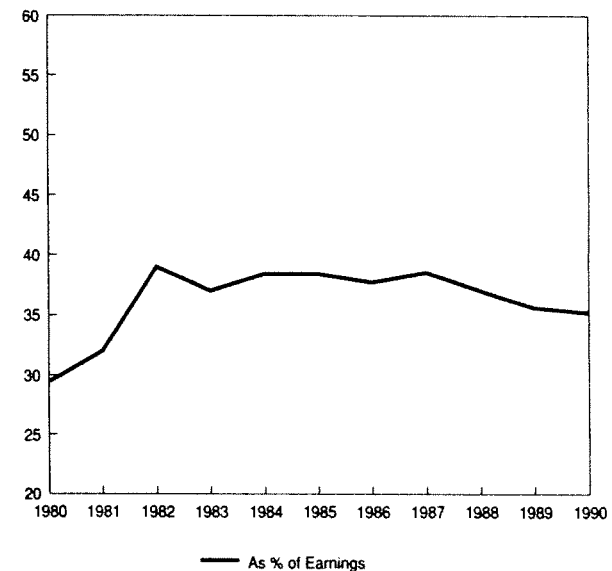


Figure 7.2(b)
Unemployment Benefit (Single Person)

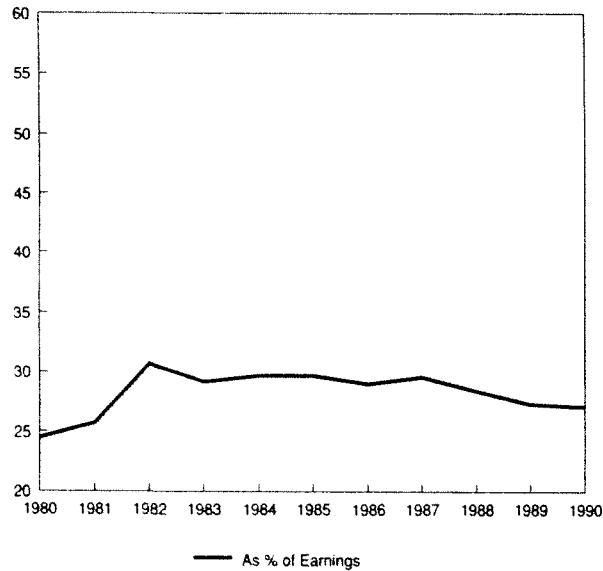
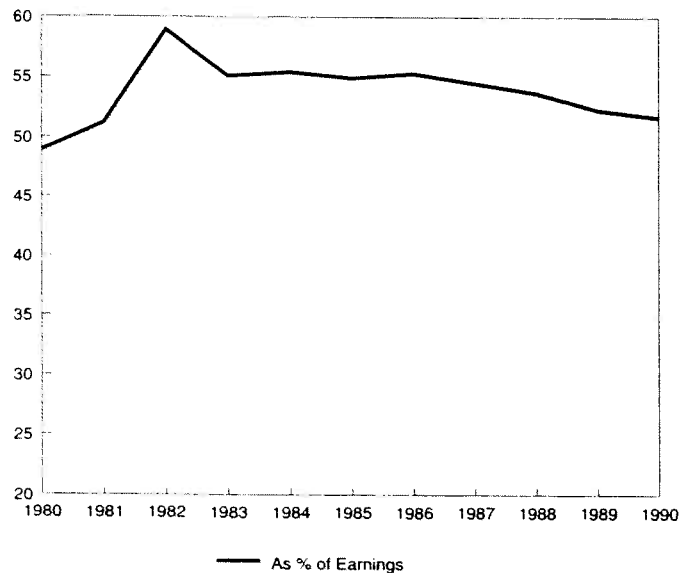


Figure 7.2(c)
Unemployment Benefit (Man + Wife + 2)



(ii) Social Welfare Payment Rates

A summary of the evolution of social welfare payments in real terms is given in Table 7.2 and Figure 7.1. Overall the picture is one of cumulative real increases over the decade 1986-1990. Most of the increase took place in the period prior to 1987; within that sub period 1982 represented a peak. Since 1987 payments have remained approximately constant in real terms. Two features of the figures should be noted. First, unemployment assistance will have grown by 16% in real terms from 1987 to 1991 – an exception to the static picture for other schemes and an indication of stated government priorities in regard to social welfare. Additionally, *long-term* unemployment assistance increased significantly in real terms from 1987 to 1990 – a real increase of about 25%. The majority of UA recipients receive the long-term rate. Second, the child benefit increases, 2.2% per annum and almost 24% cumulatively for the decade, are the largest. However, the trend for child benefit is erratic: significant real increases followed by 2-3 years of decline. The 1990 figure for Child Benefit is still less (in real terms) than that for 1982.

Table 7.2
Social Welfare Payment Rates 1980 – 1990 (Constant 1985 Prices)

Year	Unemploy/ Disability Benefit	Old Age Cont.Pension Allowance	Unmarried Mothers	Unemploy. Assistance	Child Benefit
	£	£	£	£	£
1980	38.0	45.6	51.9	31.6	21.4
1981	39.0	48.7	53.7	32.4	23.9
1982	41.8	53.1	56.2	34.6	29.7
1983	38.3	48.7	51.5	31.8	27.2
1984	38.3	49.6	52.5	31.8	24.8
1985	38.7	50.2	53.1	32.1	25.1
1986	39.5	51.4	54.4	32.8	24.1
1987	39.9	51.8	54.5	33.0	29.2
1988	40.2	52.3	54.9	33.3	28.6
1989	40.1	52.3	55.3	35.9	27.7
1990	39.6	51.5	54.5	37.0	26.5
1991	40.8	52.3	56.5	38.3	26.9
	% Change				
P.A. 80-90	0.4	1.2	0.5	1.6	2.2
Total Change 80-90	4.2	12.9	5.0	17.1	23.8

Source: Department of Social Welfare.

Notes: Rates are those weekly rates which applied on April 1st each year, and apply to individual recipients; Child Benefit rates are for two children per month; the UMA figure is for a mother and one child; UA rate is urban short term rate; Old Age Pension is for a person aged 66-80; CPI is for May annually; CPI increases for 1989/90 of 4% and 1990/91 of 4%; 1991 figures are estimated.

An assessment of how the *relative* incomes of social welfare recipients have evolved can be gleaned from Table 7.3 and from Figures 7.2 and 7.3. In Table 7.3 it can be seen that for single persons social welfare incomes are a relatively small share of average net employee incomes. For single pensioners the percentage rose during the decade from 29.4% to 35.6%; in the very recent years, 1987-90, the percentage stabilised and then declined. In the case of the single rate for Unemployment Benefit, the percentage was about 3% points higher in 1990 than in 1980. Here too the pattern is one of a growing replacement of earnings in the early part of the decade and a stabilisation thereafter.

Table 7.3

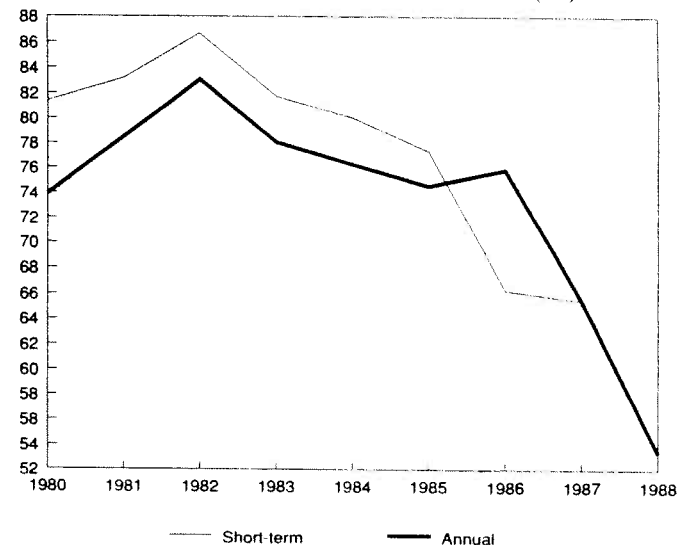
Net Disposable Incomes Per Annum of Selected Social Welfare Recipients and Disposable Income of Average Male Worker, 1980 – 1990 (Current Prices)

Year	Single Person				Married Person, 2 Children			
	Cont. Pen.	As % of Earn-ings	Unemp. Ben.	As % of Earn-ings	Net Earn-ings	Unemp. Ben.	Net Earn-ings	Unemp. Ben. as % of Earn-ings
	£		£		£	£	£	
1980	1274	29.4	1063	24.5	4332	2479	5067	48.9
1981	1594	32.1	1277	25.7	4969	2959	5776	51.2
1982	2093	39.0	1646	30.7	5360	3809	6470	58.9
1983	2093	37.0	1646	29.2	5646	3809	6914	55.1
1984	2345	38.4	1810	29.7	6101	4162	7519	55.4
1985	2509	38.4	1937	29.7	6529	4438	8090	54.9
1986	2673	37.7	2054	29.0	7087	4709	8691	55.3
1987	2780	38.5	2137	29.6	7217	4913	9000	54.5
1988	2865	37.0	2200	28.4	7744	5051	9405	53.7
1989	2954	35.6	2267	27.3	8289	5197	9932	52.3
1990	3042	35.2	2340	27.1	8637	5343	10337	51.7

Source: Secretariat Calculations; Department of Finance

Notes: UB and Pension rates are the April rates annualised. Net earnings figures refer to average male earnings in transportable goods industries; the 1980 earnings figure is for 1980/81, the 1981 figure is 1981/82, et seq. For the married/2 children example annual child benefit amounts are included (April Rate x 12).

Figure 7.3
Replacement Ratio 1980-1988
For Married Man with Two Children (%)



Source: OECD Economic Surveys, Ireland 1988/89

The arithmetical relationship between social welfare incomes and net employee incomes is extremely sensitive to the specific illustrations chosen. Thus the 'replacement ratios' for the 'married with two children' case are significantly higher. The pattern of a peak in the early part of the decade, followed by a decline thereafter is evident in these figures also. Figure 7.3, for comparison, displays the replacement ratios reported by the OECD, which are based on different conventions. In particular, the OECD distinguish short term (initial period of unemployment) from long term replacement ratios and include pay related as well as flat rate unemployment benefit. The trend reported for the other illustrations of a peak early in the eighties and a subsequent stabilisation and decline is confirmed in the OECD data.

In 1986 the Council expressed the view that the social welfare – net earnings gap should not become unduly narrow. Trends since then show that the combined impact of policy decisions about social welfare and direct taxation, and of endogenous factors such as earnings growth, has resulted in a lowering of replacement ratios without retrenchment in real rates of social welfare.

A more detailed discussion of income replacement ratios and of the role of cash and non cash benefits in contributing to poverty traps is given in Section 5 (iii). There it can be seen that income replacement ratios are sensitive to the family circumstances chosen, and to the earnings benchmark. The discussion of Table 7.3 refers only to average earnings.

(iii) Employee Incomes

The discussion above concerns social welfare incomes and their relationship to average employee incomes. It is useful, however, to attempt a broader illustration and to inquire about the relative incomes of 'high' and 'low' earners. To facilitate such an illustration, Appendix Tables A7.7, and A7.8 compare the trends in gross earnings and disposable earnings for males on average industrial earnings, for statutorily defined low paid employees and for chief executives (as defined by the IMI Annual Survey of Executive Salaries). These data, it is emphasised, are illustrative rather than representative, as no up-to-date representative series on incomes is available. With these qualifications in mind, a trend of widening disparities in incomes can be observed in the data. As a proportion of the high earning, the low paid employee's earnings had fallen to 10.6% by 1989, and as a proportion of average earnings it had declined to 22.8% from 26.2% in 1981. The gap between the 'low' and the 'average' may also have widened.

Limited information on the impact of the tax/PRSI and benefit systems on these illustrative earnings levels is given in Table A7.8. The tax/PRSI system significantly reduces the inequalities in gross earnings in all years. However, the redistributive role of the tax system was being played out in a context of widening gross earnings inequalities. Turning to disposable income, the picture is one of a narrowing of disposable income disparities from 1981/2 to 1985/6 and a re-emergence of these disparities from 1985/6 to 1989/90.

In brief, these data may be indicative of a growth in (gross) income inequality which may not have been counteracted by the tax system. However, the data are illustrative and refer only to *earnings*. A more complete assessment of trends in income distribution would require representative data on households' incomes. Such data are currently not available.

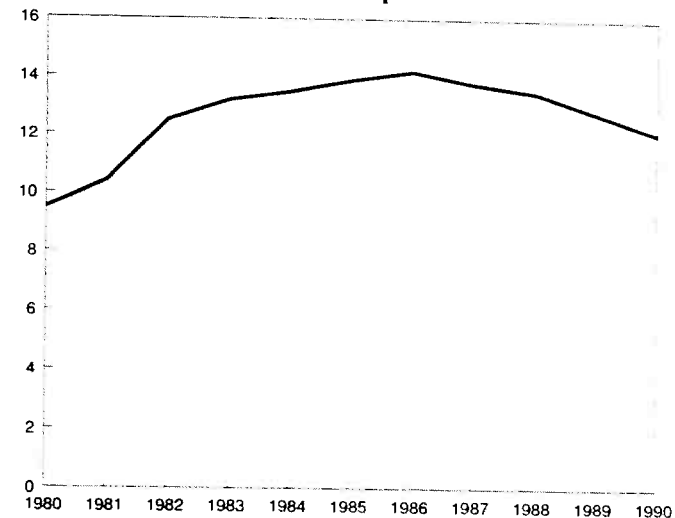
Three aspects of the tax/transfer data should be noted. First, tax rates were rising during the early to mid eighties. Second, although tax rates fell in the later part of the 80's (both total and income tax) the illustrations suggest that they fell *more* for the higher earner – a suggestion which is confirmed in the more detailed analysis of taxation in Chapter 6. Third, the introduction and significant expansion of FIS has improved the relative position of the low paid.

(iv) Social Welfare Expenditure

A brief overview is given in this section of trends in social welfare expenditure. Figure 7.4 summarises the evolution of total expenditure in relation to GNP. It can be seen that expenditure was rising rapidly up to 1986, when it peaked at just over 14% of GNP. Since then this proportion has fallen continuously and is estimated at about 12% of GNP in 1990. In an arithmetic sense, this decline in the macroeconomic share of social security expenditure is attributable in part to economic growth. As the commentary in Chapter 1 emphasised, GNP growth was significant in the period since 1986, and stagnant prior to then. Zero growth, rising

unemployment and demographic factors in the first half of the decade conspired to push the expenditure – GNP ratio rapidly upwards. Contrasting forces are now at work lowering the ratio.

Figure 7.4
Social Welfare Expenditure



Note: 1990 data are estimated.

— As % of GNP

More detailed data are given in Table 7.4. Real expenditure rose by just under 1% from 1985 to 1989. Expenditure on old age and widows pensions and on lone parents schemes rose significantly. Total expenditure on unemployment and sickness payments, however, *declined* in real terms, while child benefit increased by 5.8%. The most rapidly growing social welfare programmes are for lone parents – a real increase of 55% is recorded in the table.

Central to an understanding of these trends, and of likely *future* trends, is the role of beneficiary numbers on the one hand and the rate of benefit payments on the other. The significance of this distinction is that it separates the influences on total expenditure into underlying *demand* factors, over which there may be little immediate policy control, and *policy* factors which are the subject of specific deliberation and decision.

For the expenditure outcome as a whole these two factors have 'pulled' in opposite directions. Trends in beneficiaries exerted a downward influence on expenditure and payment rates an upward influence. The direction of those two influences varied however between expenditure programmes. The growth in lone parents' expenditure is entirely due to increased numbers of beneficiaries. By way of contrast, payment rates and beneficiary numbers both contributed equally to the growth in widows' pensions.

Table 7.4
Analysis of Expenditure Growth on Main Social Welfare Expenditure
Schemes 1985-1989 (Constant 1985 Prices)

	1985	1989	Real	£m	£m	£m	
	£m	£m	Change	Due to	Due to	Residual	
			%	Numbers	Payment		
					Rates		
Old Age Pensions	680	700	2.9	20	15.0	4.8	0.2
Widows Pensions	234	254	8.5	20	9.7	9.9	0.4
Unemployment	629	602	-4.3	-27	-60.0	37.1	-3.5
Sickness	304	264	-15.2	-40	-58.2	22.6	-4.3
Lone Parents	64	99	54.7	35	35.9	0.6	0.3
Child Benefit	172	182	5.8	10	-6.4	16.6	-0.6
Total	2083	2101	0.9	18	-64.0	91.6	-7.5

Notes: Pensions figures include 'free schemes'. Lone Parents figure does not include Prisoners Wives or Single Womens Allowance. Sickness refers to Disability Benefit and Invalidity Pension. Sickness expenditure is marginally overstated in 1985 due to inclusion of Pay Related Benefit element of Occupational Injuries in the total. Child Benefit recipients are counted as individual adult beneficiaries. The decomposition of expenditure growth is calculated using per capita equivalent (1.0, 0.66, 0.33) rates of payment and per capita equivalent numbers of recipients. The totals in the right hand panel may not add exactly to the total real change because of rounding. Pay related benefit included in sickness and unemployment payments. Some minor schemes are excluded - Rent allowances, FIS, etc.

A decline in real expenditure on unemployment payments took place: this is the net outcome of upward pressure on expenditure due to increased average payments and downward pressure from falling numbers of beneficiaries. The unemployment figures refer *only* to income maintenance payments. There are other public expenditure costs associated with unemployment, both direct and indirect. The cost of the Social Employment Scheme, in particular, should be noted. Since it was first introduced in 1985 expenditure on the scheme has grown to £43.8 million in 1989, in respect of 9,200 participants, an average cost per participant of £4,760.

Finally, the figures for Child Benefit reveal the impact of the declining birth rate: the population of child beneficiaries exerted a negative impact on expenditure although significant increases in real payment rates substantially offset the demographic decline.

(v) Social Insurance

The Council's recommendation in 1986 that the social insurance system be more comprehensive has been reflected in policy developments since then. Self employed members of the labour force are now contributors to the social insurance fund and are prospective beneficiaries of certain long-term social insurance benefits. Furthermore, the social insurance status of part time employees is now under reconsideration. If this segment of the labour force, which has grown relatively rapidly in recent years, can be included in the social insurance system it will further extend the contribution base for social insurance and offer income maintenance protection to a vulnerable section of the labour force.

5. POLICY ISSUES

In this section key policy issues in social security (and related aspects of taxation) are addressed, and tentative arguments are offered as to the appropriate strategies. These issues are concerned with the *type* of arrangements in the tax and benefit system, as distinct from issues affecting the level or adequacy of benefits. Firstly, however, a brief overview is adopted of the possible evolution of total social security expenditure in the context of the likely 'demands' on the system and of the inflation and growth rates which may prevail. It is in this context that views about the future *levels* of social security payments must be formulated.

(i) Social Security Expenditure and Levels of Payments

Table 7.5 below summarises a probable scenario for social security expenditure for the period 1989-1993. The calculations merit some explanation. Assumptions were adopted about the growth in 'demand' for social welfare; the assumptions are in most cases a continuation of the 1985-1989 trend in the rate of change in beneficiary numbers.⁶ In the case of unemployment a fall in the number of unemployment payment recipients of 2,500 per annum was assumed, with a proportionate fall in beneficiaries (adult and child dependants): this assumption is informed by the prognosis in Chapter 3 of a decline in unemployment of 2,000 - 3,000 per annum to 1994.

Secondly, two alternative assumptions are adopted about real rates of payment for social security - either a *constant* real rate of payment, i.e. indexation of payments to prices *or* an annual average *real increase* of 1%. Thirdly, growth rates of 3.25% and 3% per annum respectively in consumer prices and GNP growth are adopted.

The calculations suggest that social security expenditure will continue to decline relative to GNP, if real (CPI adjusted) payment rates remain constant. By 1993 the social security/GNP ratio could be 10.2% on this assumption. If a scenario of a 1% real increase per annum is assumed the ratio would be slightly higher at 10.6%, but still lower than the figure for 1989 of 11.6%.⁷ It will be recalled that in 1986 the

6. Beneficiaries here include not only *recipients*, but also their adult and child dependents.

7. Recall here that some of the insignificant schemes, FIS etc. are not included in the figures.

8. No implication is intended here that there is an analytically 'correct' ratio of social security to GNP.

ratio was only marginally below 15%.⁸ These calculations are illustrative and many variants of the assumptions could be tested. In the Council's view, the scale of social security expenditure is so significant, and the system of social security is so central to Governments' social objectives, that detailed projections of future expenditure are continually necessary.

Table 7.5

Projected Growth of Social Welfare Expenditure 1989-1993 on Assumption of 3.25% Inflation and 3.0% Real GNP Growth Per Annum, Constant 1989 Prices.

Expenditure Category	1989 £m Per Annum	% Increase in Volume £m 1993	Constant 1989 Prices £m 1993	1% Real Increase Per Annum
Old Age Pensions	797	0.55	926	964
Widows Pensions	289	1.02	342	356
Unemployment	685	-1.18	742	772
Sickness	299	-5.5	271	282
Lone Parents	113	11.8	201	209
Child Benefit	208	-0.95	228	237
(1) Total £	2391		2710	2830
(2) GNP £m	20698		26475	
(3) 1 as % of 2	11.6		10.2	10.6

Source: NESC Secretariat

The scenario outlined in the medium term outlook (see Chapter 3) indicated that sustained GNP growth of 3% per annum is likely to prevail in the period up to 1994. This is associated with a decline in unemployment of 2,000 to 3,000 per annum. The assumptions which underpin Table 7.5 are therefore broadly consistent with this wider scenario. Table 7.5 suggests that social welfare beneficiaries can share to some extent in the real growth which will take place, without the macroeconomic burden of social security expenditure escalating to its earlier level. Finally, however, the Council suggests that future policy decisions about increases in social welfare payments must take cognisance of the wider fiscal context, of the social objectives of improving in particular the levels of the *lowest* social welfare payments, and of the need to maintain an appropriate relationship between disposable earnings and social welfare payments.

The longer term questions of social security however, are about the *structure* of the system as well as about the *level* of benefits it entails. It has been shown that real increases in social security payments can take place even in a scenario of a declining social security/GNP ratio. Within this fiscal context however, it is important that structural policy problems in social security are addressed. Some such problems are described and considered below.

(ii) The Tax/Benefit System

The systems of cash transfers ('social welfare' is its administrative designation in Ireland), taxation and non cash benefits interact at the level of individual tax payers and benefit recipients. Consequently, it is necessary to analyse the effects, and the problems which may arise from the *joint* impact of these administratively separate systems. There is now an established tradition of policy analysis which adopts this integrated perspective. A strong variant of this perspective would advocate complete integration of the systems of personal taxes and social security cash payments. For example, a 'social dividend' has been advocated as a means of giving the entire population a uniform basic income, with *all* income above the dividend taxed at a simplify rate without exemptions or allowances.⁹ Such a scheme would eliminate means tests, abolish the need for a separate social insurance contribution, greatly simplify both the tax and social security systems and remove the need for administering contingency based schemes such as retirement pensions, sickness payments and so on. (See Parker, 1990; Kay et al, 1984; National Consumer Council, 1984; Atkinson, 1970).

Analyses of integrated approaches to taxes and transfers have been undertaken in Ireland. The NESC rejected wholesale integration in its consideration of a consultant's study (NESC, 1978). More recently, the Commission on Taxation and the Commission on Social Welfare also argued against such an approach (Commission on Taxation, 1982; Commission on Social Welfare, 1986). However, there is now widespread acceptance that within the framework of administratively separate tax and social security systems there is a need to analyse the systems jointly and to identify *specific* aspects of the systems requiring integration. For example, social security contributions are earmarked for social insurance funds out of which benefits are paid; further, individual's contribution histories determine their entitlement. Nevertheless, these contributions bear the characteristics of taxes and, consequently, it is essential to evaluate their structure and impact in the context of the tax system. Similarly, social security payments are administered (through means tests or contribution entitlements) largely independently of the tax system. However, these payments are *income* and must logically be incorporated in the definition of income for tax purposes and subject to income tax.

9. The social dividend concept is chosen as an example of integrated models because of its simplicity. However, tax credit schemes and negative income tax schemes are other, equally widely canvassed, options.

In the discussion below the analysis is informed by this approach to the tax and benefit systems, i.e. a search for solutions to policy issues which focuses on the combined impact of the two systems.

(iii) The Poverty Trap

The term 'poverty trap' is now widely used, and applied loosely to the range of deprivations and problems encountered by persons with very low incomes. In this context, however, it has a specific, analytical meaning as depicted in Figure 7.5. The line in Figure 7.5 shows a purely hypothetical relationship between gross income (horizontal axis) and net income (vertical axis). As the amount of gross income increases, net income increases. A 'kink' exists in the graph at the point where gross income increases from G1 to G2. This increment results in a fall in net income from N1 to N2. The term 'poverty trap' refers therefore to a theoretical situation in which an increment of gross income is associated with a decline in net income.

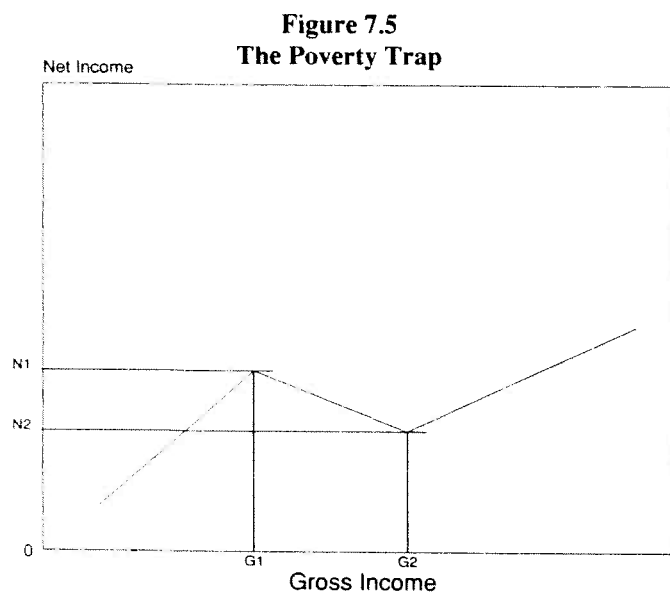


Figure 7.5 is illustrative of the most extreme form of 'poverty trap'. More generally, the situation may be one where the slope of the line depicting the gross-net relationship in Figure 7.5 is very gradual; i.e. for any unit increase in gross income there is a significantly lower increase in net income.

The poverty trap arises from the interaction of changes in economic status/activity with changes in tax, social insurance contributions, and entitlements to cash and non cash benefits. For example, a person with a family who is unemployed receives an unemployment payment. Under current arrangements there could also be an entitlement to a medical card subject to a means test, i.e. full entitlement,

free-of-charge, to all medical services for the family – and if the recipient is a local authority tenant his rent will be related to his income. The disposable income available from low paid employment (after tax and social insurance contributions are deducted) can be contrasted with the total cash and non cash benefits available to the unemployed person to appreciate the *prima facie* scope for poverty traps.

It has been argued that in Ireland currently the unemployed, in particular, face such poverty traps. The argument is as follows. In evaluating job offers the unemployed compare the effective purchasing power afforded by the benefits they receive when unemployed on the one hand, and the *net* income and benefits they receive from employment on the other. If many of the unemployed were to accept a job offer, the argument continues, they lose not only their unemployment payment but their gross income is subject to PRSI deductions, they may have an income tax liability, and their medical card entitlement, based on gross income, could be lost. Further, their local authority rent, where applicable, may increase.

To summarise the outcome, for the tax/benefit year 1989/90, certain illustrative figures are given in Table 7.6. These show the net disposable income of persons receiving long-term unemployment assistance, as a percentage of the disposable income of employees, at varying levels of gross earnings. The calculations incorporate the effect of tax, social insurance, travel to work costs and cash and non cash benefits such as Family Income Supplement, medical card entitlement and local authority rent subsidies. For some of the illustrations the replacement ratios are high. At earnings levels significantly below average earnings, combined with dependency responsibilities, the ratios are particularly high. For single persons, the ratios are significantly lower and below 40% when earnings are in the range around average earnings. Clearly, an unintended outcome of the insufficient co-ordination between the tax and benefit systems is the existence of high replacement ratios and possible work disincentives, for specific segments of the population.

The intricacies of the tax/benefit nexus and the poverty traps to which they can give rise, can be simply understood by reference to Figure 7.6. These graphs plot the relationship between gross earnings (horizontal axis) and net income, for a hypothetical case, for the tax/benefit year 1989/90. The theoretical deficit in Figure 7.5 is reflected in the graph (see Figure 7.6) based on the *actual* arithmetic of the tax/benefit arrangements. Earners with dependent spouses and families are evidently prone to poverty traps at gross earnings levels in a range above £6,000 per annum.

The detailed arithmetic in Appendix Table A7.9 for the man/wife/4 children illustration can be used as an explanatory guide to the poverty trap in Figure 7.6.¹⁰

10. Table A7.4 contains the details on which the graph for the man/wife/4 children illustration is based. The corresponding tables for the other illustrations are not given in the appendix, but they are available on request from the NESCS.

PRSI, for example, is levied at the very lowest income ranges and income tax is also deducted at modest income levels. For instance, PRSI at an earnings level of £7,000 is £385, more than *three times* the amount of the income tax liability: this highlights the need to evaluate PRSI in the context of the overall tax system. Family Income Supplement, which adds significantly to net earnings at low levels of earnings is withdrawn sharply: over the gross earnings range £8,000 – £10,000 FIS declines from £988 to nil. Furthermore, at certain earnings levels there are discontinuities and ‘jumps’ in means tests: as earnings rise over the range £5,000 to £10,000 local authority rents rise more than five-fold.

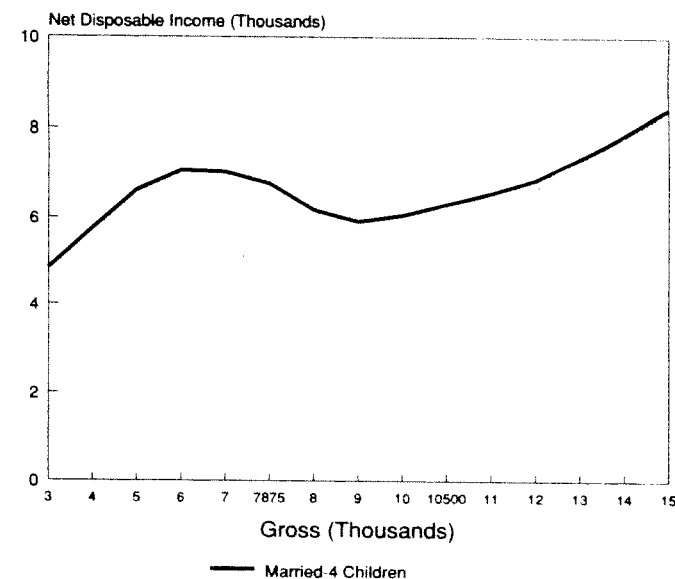
Table 7.6
Schedule of Replacement Ratios: Disposable Income and Long-Term Unemployment Assistance

Gross Pay (£) Person	Single + 2 %	Married + 4 %	Married + 6 %	Married %	Married %
5,000	69	93	92	88	91
6,000	59	81	91	80	84
7,000	51	80	104	81	80
7,875	49	76	100	84	81
8,000	48	75	98	93	83
9,000	45	70	92	99	87
10,000	42	64	85	97	99
11,000	40	59	78	89	100
12,000	38	55	72	83	96
13,000	36	51	67	77	90
Proportions (%) in Dependency Category	55.3	5.2	7.5	5.0	2.6

Source: Department of Finance.

Note: The data refers to the tax/benefit year 1989/1990 – all figures are post-Budget 1989. The percentages in the last row do not add to 100 as not all dependency categories are given.

Figure 7.6
The Poverty Trap 1989-1990



Source: Department of Finance.

In summary, as gross income rises through the range £6,000 to £9,000 per annum net disposable income falls from £7,093 to £5,930. A parallel poverty trap occurs in the larger family illustration, but somewhat further up the gross income scale, and occurs also in the smaller (2 child) case but lower down the income scale and over a narrower range of incomes. These data refer to the tax/benefit year 1989/90. While the arithmetical details will have changed somewhat in the current tax/benefit year the basic structure of relationships in the data will remain the same.

The analysis above is based on an illustration, and the question therefore arises as to the representativeness and policy significance of the analysis. A number of points should therefore be noted.

Firstly, although popular discussion of this issue focuses on the ‘unemployment trap’ and the low pay/poverty trap, these are but instances of the more general question of the equity and efficiency implications of tax and benefit arrangements (in the widest sense). Thus, persons approaching pension age might, depending on the treatment of savings in the pensions means test, alter their savings behaviour – for example reduce their savings to ensure a full State pension. Similarly, a low paid employee may not take up enhanced income opportunities (through overtime

for example) if the marginal rate of income tax on the additional income is high or if it is compounded by loss of other benefits or entitlements. The phenomenon of the poverty trap therefore alerts us to the potential for efficiency and equity losses arising from the lack of integration and co-ordination of taxes and benefits. A reduction in savings, for example, associated with State pension arrangements would be an efficiency loss. Likewise a longer duration of unemployment as a result of the relative incomes/benefits of employees and the unemployed.

Secondly, the *extent* to which poverty traps actually exist is an *empirical* issue. It will be clear that the arithmetic of potential poverty traps is contingent on the particular cases chosen and the important question, therefore, is to determine how many tax/benefit units are in reality in the circumstances depicted in any given illustration. For instance, in Table 7.6 a potential 'unemployment trap' was readily identified in the case of a recipient with a large family on long term unemployment assistance, who had medical card and who was also a local authority tenant. However, it is misleading to posit a *general* argument on this specific case. In the first place, men with large families are only a small minority of the unemployed (as the final row of Table 7.6 shows); the gap between their social welfare income and net earnings is much narrower than in the case of single persons, as recipients with children receive additional child dependant payments. Furthermore, the income comparisons in the case also depend on the income-rent means test for local authority tenants. However, only 29% of unemployment assistance recipients resided in the local authority sector in 1984, and the respective figures for unemployment benefit and for *all* social welfare recipients are 19.8% and 17.0% (Commission on Social Welfare, 1986).

It is clear that a proper assessment of the extent of the 'poverty trap' and related issues requires *representative, aggregate* data about the actual distribution of incomes, taxes and benefits and other circumstances in the economy as a whole. If prototype poverty traps exist under certain hypothetical situations it is important also to establish how widely these traps actually extend in practice.

Thirdly, implicit in much discussion of the 'poverty trap' is the assumption that individuals are not only rational income maximisers, but also that they know and *understand* the intricacies involved and that they modify their behaviour in the light of this understanding. In the Irish context there is no research evidence on the issue of recipients'/taxpayers' detailed knowledge of taxes/benefits/entitlements. The question of behavioural responses is highly contentious and has been extensively examined. In the case of unemployment and sickness payments, the evidence seems to support the view that the benefit system may contribute a small increase in the duration of unemployment and contributes to certified sickness absence from work (Blackwell, 1986; Hughes, 1982). However, even if behavioural responses do not take place the question of equity still remains: should net disposable, for example, fall as a result of an employee increasing his labour supply?

Fourth, there is considerable scope for disagreement about important aspects of the calculations involved in analysis of the poverty trap. For example, if comparisons are being made between the net income of employees and those out of work sick, or unemployed, should travel to work costs be subtracted from net earnings? How should the purchasing power equivalent of medical card entitlement be defined and calculated? Which measure of housing subsidy should be incorporated in local authority tenants' income? What 'benchmark' earnings should be used in measuring the poverty trap? The existence of poverty traps and their severity are sensitive to the specific procedures and calculations which are adopted¹¹.

On the whole, it is wise to conclude that an examination of the interaction of taxes, benefits and means tested entitlements is warranted. Such an examination should determine the nature and extent of 'poverty traps' and the scope to ameliorate them through better co-ordination and integration of the tax and benefit systems. In particular, the impact of the tax/benefit systems on families must be examined. The discussion below of Child Income Support reinforces the argument for some restructuring of taxes and benefits.

(iv) Child Income Support

There are a number of different elements of Child Income Support. Child Benefit was introduced as Children's Allowances in 1944 for third and subsequent children and was extended to all children in the nineteen sixties. Occasional debate takes place as to whether the payment (renamed Child Benefit in 1986) should be means tested or taxed. Expenditure on the scheme in 1989 was £208 million, in respect of 470,000 families and 1.14 million children (approx).

Family Income Supplement was introduced in 1984 to coincide with the final phasing out of food subsidies (and therefore to compensate low income families) and to overcome what were perceived as unemployment disincentives among workers with children. The payment is for *low paid employees with children*; a target gross income for each family size is prescribed: a family's actual gross income is subtracted from the target and 60% of the difference is paid as FIS subject to a maximum payment (which is also variable according to family size). Since the scheme was first introduced it has been improved and extended in a number of ways. It should be noted, however, that FIS's introduction was to be temporary, pending the establishment of a more unified, integrated Child Benefit for all families! Expenditure on FIS in 1989 was £6.3 million.

A third income support mechanism is the system of Child Dependant Additions (CDAs). These are the additional payments per child which are payable with the personal rates of social welfare. For example, a recipient of long-term

11. Work by Blackwell (1989) suggests that low paid employees face poverty traps at low gross wages and that FIS exacerbates these traps. This particular research incorporates non cash benefits such as local authority tenancy and medical cards but the treatment of some items in the analysis can be validly criticised and alternative procedures adopted.

unemployment assistance now receives a CDA payment of £11.00 per child per week. These CDAs have long been part of the payment structure in social welfare, although their relative importance in the total income of social welfare beneficiaries has increased in recent years. In 1989, there were 338,644 child dependant additional payments in force – over half of these applied to unemployment payment recipients.¹² Expenditure on CDAs in 1989 was in the region of £200m.

Finally, in relation to current tax/benefit provisions in respect of children, it will be recalled that a child tax allowance was in force until 1986. The nominal and real value of this allowance had declined sharply in the decade 1976-1986 and at the point of its abolition the amount of the allowance was £100 per child per annum. Income tax exemption limits were differentiated according to the number of children for the first time in 1989/90. The limits were differentiated by £200 per child and in 1990/1991 this figure was increased to £300. An illustrative summary of how these child income supports impinge on families is given in Table 7.7

Table 7.7
Annual Incomes of Families with Children in 1989/90: Married man with (Dependent) Spouse and Two Children

	Unemployment Assistance		Low Pay		Average Pay	
	£	%	£	%	£	%
Net Earnings	–		5650	87.4	9588	96.4
Social Welfare	3856	72.4	–			
Child Benefit	361	6.8	361	5.6	361	5.6
Family Income Supplement	–		454	7.0	–	
Child Dependant Additions	1112	20.9	–		–	
Disposable Income	5329	100	6465	100	9949	100

Notes: The U.A. case is the long term rate. The social welfare figure under U.A. is the personal and adult dependant rate combined.

12. This is the figure for full rate CDAs: there were an additional 93,152 half rate CDAs in payment in 1989.

An integrated long-term policy in relation to child income support is now necessary for a number of reasons. First, the evidence of poverty referred to in Section 2 reveals a high risk of poverty among families with children. Secondly, it was also shown that families with children where the main earner is on low pay may be caught in poverty traps as a result of the combined impact of tax, PRSI, FIS and non-cash benefits. Equally importantly, employees with children face higher replacement ratios when unemployed, and a significant component of this ratio comprises the CDA portion of their social welfare payment. Thirdly, although there have been continual, incremental adjustments to specific elements in the child income support system, there is no evidence of official commitment to an overall, integrated policy (McCashin, 1988; Blackwell; 1988).

A reconsideration of Child Income Support policy will need to address two key issues. In the first place, the desired mix of vertical (from high to low income) as against horizontal (from one type of household to another type at any given level of income) redistribution must be elaborated. At present Child Benefit is completely horizontal in its distributive impact. There are occasional statements of official interest in modifying the structure of Child Benefit by taxation or means testing of the benefit. However, no recent Government has articulated a long term coherent framework for Child Income Support into which discussion of Child Benefit could fit. Thus, if the *primary* objective is to direct resources to achieve vertical redistribution towards lower income families, then some further 'selectivity' might be desirable.

The issue of vertical/horizontal redistribution impinges on the other elements in Child Income Support. Both FIS and Child Dependant Additions are targeted – FIS is means tested and CDAs are paid on a social welfare contingency basis. Arguably, therefore, the *total package* of child income support contains a mix of vertical (FIS, CDAs) and horizontal (Child Benefit and Child Related Tax Exemptions) redistribution. The difficulty with this mix, however, is that it may contribute to the potential poverty traps discussed earlier. CDAs form a significant proportion of the total income of the unemployed person with children (Table 7.7) and because of the size of the CDAs (£11 p.w in 1990) relative to Child Benefit the unemployed with families receive significantly more child income support than the employees. This lack of 'neutrality' as between work and unemployment in the system of child support contributes to whatever disincentives may affect those with families.¹³

FIS was intended to redress these potential disincentives by directing an element of child support exclusively to *low paid employees*. The difficulty however with FIS, as the analysis earlier has shown, is that the means test interacts with other means tests with the possible consequence that FIS implies *higher* 'marginal tax rates' than existed prior to its introduction.

13. More accurately as between child support to those with earnings and to those in receipt of social welfare payments.

In summary, some rearrangement of child income support provisions is warranted at this stage. Such a re-arrangement should address the need to reduce unemployment and poverty traps among those with families and should target the improvements at lower income families. Proposals to this end are contained in Section 6. Finally, it should also be noted that there are significant social changes taking place which are reshaping the relationship between the family and the economy; increased female labour force participation, a rise in the incidence of non marital births and a growth in lone parent families, and a significant decline in the birth rate. These changes highlight the necessity of a long-term, fundamental review of child and family income support policies.

(v) Low Pay and Poverty

The evidence noted in Section 2. of the factors associated with poverty suggested that a subset of 'the poor' are in fact in the labour market. This is indicative of a role for low paid employment in understanding the causes of poverty and consequently of a role for policies to tackle low pay and related labour market disadvantages. Analysis of low pay arises from a concern with three sets of issues. First, the *distribution* of earnings is one important aspect of the distribution of resources generally. Second, individuals' labour market experiences as a whole are, in a lifetime sense, crucial to their general economic and social status. Low pay may therefore be a dimension of a complex array of labour market disadvantages. Third, it is useful to quantify the link between low pay and poverty and to establish to what extent the general poverty population overlaps with that of the low paid. It is only the third of these issues which is addressed here, and only briefly.

As with poverty, there is no agreed definition of low pay. Two general approaches can be adopted – either a relative definition based on the earnings distribution, or a normative approach using some relevant official or legislative benchmark. Relative definitions commonly take the form of low pay defined as a percentage of mean or median pay, or alternatively a cut off point in the earnings distribution, such as the lowest decile (tenth) or quintile (fifth). The normative approach implies a gross pay figure which is associated with an official benchmark for a minimum income. In the Irish case this might be the gross pay figure which results in a net income equal to (say) the Supplementary Welfare Allowance payment for a couple with two children. Measures of the extent of low pay are sensitive to the definition adopted and it is important therefore to examine low pay data in the light of different measures.

A preliminary analysis of low pay in Ireland is now available (Nolan, 1990A). This analysis is based on data for 1987 collected in the ESRI's Survey of Poverty, Income Distribution and Usage of State Services. In the analysis of these data two definitions are reported for comparative purposes: a *lower* threshold of £100 (usual gross weekly pay) which is somewhat above the 1987 equivalent SWA rate for a family with two children but close to the lowest decile cut off point for *all* male

employees; the higher threshold of £130 compares with the FIS eligibility cut off point of £123 and is in fact the lowest decile point for all *adult male full time* employees (Nolan, 1990A). The basic results of the analysis, reproduced from this recent study, are given in Table 7.8. It can be seen that 27.6% of employees are below the higher, and 17.3% below the lower threshold.

Table 7.8
Employees in ESRI Sample With Usual Gross Weekly Pay Below Various Thresholds

Threshold (£ Per Week)	Percentage in sample with usual gross pay below threshold
£80	12.7
£90	15.5
£100	17.3
£110	20.9
£120	23.5
£130	27.6
£140	31.9

Source: Nolan, 1990A. Table 4.

The basic data in Table 7.8 combines both full time and part time workers. If a minimum of 30 hours weekly is taken as the definition of full time, and if part time employees' earnings are expressed on an *hourly* equivalent basis for the higher threshold then one third of part time employees have *hourly* earnings below the low pay threshold, (£3.25 per hour in 1987). When part time and full time employees are aggregated on an hourly and weekly basis respectively, about 24% of *all* employees are low paid (Nolan, 1990A). This compares with the figure of 27.6% derived on the weekly threshold basis for all employees¹⁵.

The link between low pay among employees and poverty among families/households is by no means clearcut. If a particular proportion of poor households is headed by an employee this does not quantify adequately the low pay-poverty relationship. For example, an employee *above* the low pay threshold

15. Data have been published on the sectoral, occupational, and educational characteristics of the low paid. These results are reported in Nolan (1990A) and are not summarised here.

may be a member of a poor family. The employee's disposable income, as the poverty analysis revealed, will be affected by income tax/PRSI and the family's per capita equivalent income may be low due to a large family size. The converse may also apply: a low paid employee may be in a household *above* the poverty line because of the existence of other income/earnings in the household.

A statistical summary of the low paid employee – household poverty link can be gleaned from Table 7.9 – reproduced from the relevant study. The figures show that only 3.6% of employees below the lower threshold are in households below the most stringent poverty line and only 20.6% of them are in poor households on the more generous poverty line measure. To quote from the relevant study on the link between low pay and poverty;

“The degree of overlap is in fact limited. This comes about because most employees are not in poor households, most poor households do not contain an employee” (Nolan, 1990A).

Table 7.9
The Overlap Between Low Pay and Poverty

In households below relative poverty line	% of Employees Below Low Pay Threshold	
	“Lower” threshold %	“Higher” threshold %
40% line	3.6	2.3
50% line	9.8	8.4
60% line	20.6	18.6
(% of all employees)	17.3	27.6

Source: Nolan, 1990A, Table 11.

The more interesting issue, however, is to identify the factors which link low paid employees to poverty *for that small sub set of employees who are, in fact, in poor households*. Analysis of this sub set of the population shows that, *among the low paid*, married men and heads of household are more likely to be in poor households, when poverty is measured in terms of *disposable* income per capita. Further, low paid employees in poor households, when compared with low paid employees *not* in poor households, are more likely to have families with children,

more likely to have two or more children, and much *less* likely to be in a household with additional earners.

From a policy perspective the important implications of the above are, firstly, that *in general* the low pay-poverty relationship is tenuous and, secondly, that a *specific* set of factors, notably family and dependency circumstances, connect low earnings with household/family poverty. Policies which focus on the generality of the low pay problem will therefore require a rationale wider than that of dealing with poverty¹⁶. Equally, the particular conduits through which low pay impinges on poverty, – family and dependency circumstances – raise important issues about family income support and child income support in particular. These issues are considered again in Section 6.

6. POLICY STRATEGIES AND PROPOSALS

In this section the themes raised in the previous section are discussed again – in this instance to argue the case for specific proposals. The analysis here, as in the previous section, considers both the tax and social security systems. The discussion is informed by the general principle that specific elements in these systems must be integrated without a fundamental integration of the total tax and benefit regimes.

(i) Social Welfare and Taxation

The most elementary integration of taxation and social welfare would be the inclusion of all social welfare income in annual income for tax purposes. This integration has yet to be implemented in respect of certain short-term social welfare payments. In the tax year 1989/90 the revenue foregone is in the region of £60-70 million.¹⁷ The non taxation of this form of income is an inequitable distinction between incomes from different sources. Revenue gleaned from the extension of the tax base can be applied to the reduction of tax rates. The Council therefore reiterates its view – a view also expressed by the Commission on Taxation and the Commission on Social Welfare – that the legislation which facilitates the taxation of short-term social welfare payments be administered and implemented.

A second element in the social welfare/tax nexus concerns the relationship between the basic allowances and exemptions in the income tax system on the one hand and social welfare payments on the other. In relation to the tax exemption limits these were increased significantly from 1986/7 to 1990/1 – a nominal increase of 23% for married tax payers, and higher increases for those with children. This co-ordination of rising exemption limits and increases in social welfare payments prevented a narrowing of the social welfare disposable income gap at lower earnings levels.

16. Such a rationale would derive from a concern with the distributional issues *per se* and with wider concerns with labour market disadvantages.

17. Communication from Department of Finance to NESI Secretariat.

In relation to basic personal, PAYE and PRSI allowances it will be recalled from Chapter 6 that over the period 1986/7 to 1990/1 the real value of the personal allowances and the PAYE and PRSI allowances *declined* in real terms. This decline coincided with a significant real increase in some social welfare payments, and represents a degree of lack of co-ordination between the tax and social welfare systems. The Council's view on this issue is informed by its adherence to the Commission on Taxation's principles: the Council in 1986 recommended *indexation* of these basic allowances. Failure to index the allowances results in low income employees entering the tax net more rapidly than would otherwise occur. Accordingly, the Council reiterates its general view that such indexation should take place. The view expressed in 1986 has added force in the light of increasing concern about poverty traps.

(ii) Social Insurance and The Tax System

The need for a restructuring of social insurance derives from three sources. First, the Council in 1986, while endorsing the principle of an earmarked social security contribution and an accompanying system of social insurance eligibility, argued that social security contributions and levies be *evaluated* as taxes. Further, the Council proposed that the social security system be a fully comprehensive one.

Second, the analysis of developments in the PAYE system given in Chapter 6 indicates that the structure of PRSI (a proportional rate with an income ceiling) contributes to a regressive decline in average tax rates in a range of income above average earnings. The analysis revealed that marginal tax rates (when PRSI and levies are included) declined most significantly for higher income persons: this arose in part from the absence of any reductions or restructuring of PRSI during this period.¹⁸ Reductions in *tax rates* from 1986 to 1990, were confined to income tax rates although PRSI also impinges disproportionately on very low paid employees. The overall problem of high marginal tax rates is one which includes rates of PRSI.

Third, the poverty trap details outlined earlier show that PRSI deductions are one of the elements in the poverty trap arithmetic.

Currently the PRSI contribution (confining the discussion to ordinary class A contributions) is 5.5% of employees' gross annual income up to a ceiling of £17,300. The employers' matching contribution is 11.3% to a ceiling of £18,600. In the light of the analyses what changes should be made to this structure? The option of an outright exemption below an income threshold can be rejected. Exemptions, a priori, create discontinuities and 'jumps' in marginal tax schedules. A PRSI exemption, if added to the current plethora of taxes and benefits, could only compound the undesirable effects detailed earlier. This reasoning, it should be noted, also applies to the current exemption for earnings below £60 in any one week. Moreover the weekly basis of the present exemption does not sit easily with the *cumulative* basis of the PAYE tax system.

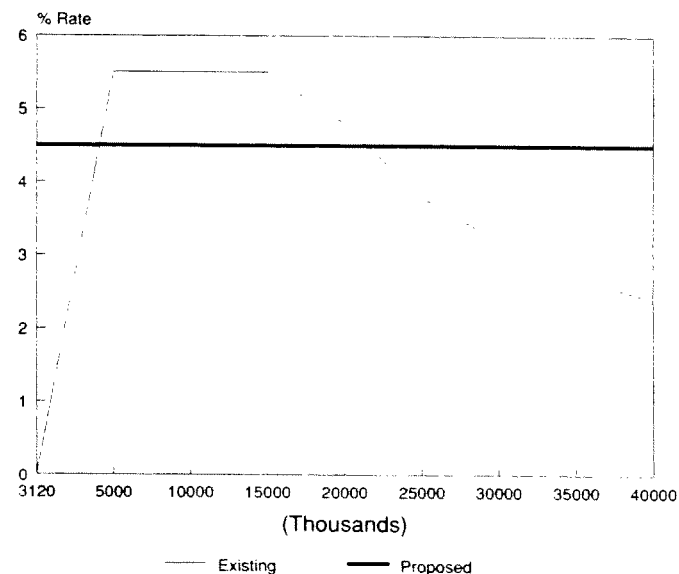
Similar arguments would apply to the option of tiered rates of PRSI, with higher rates applied to higher levels of income. These increases in rates would co-exist with the rate structure for income tax and the means tested entitlements to FIS, rent subsidies, health care and so on.

On balance, the Council considers that reducing the *rate* of PRSI, applying PRSI at one rate without an exemption and without an income ceiling, is the appropriate strategy. This approach would effect a number of improvements:

- deductions from the income of earners below the current ceiling would fall and this would disproportionately benefit those on the lowest incomes, with a consequent amelioration of the poverty trap;
- the schedule of total marginal tax rates (PRSI included) would be smoother across the income distribution;
- the administratively cumbersome exemption which exists at present would be abolished;
- the earnings base for social insurance contributions would be comprehensive.

The schedule of PRSI rates across the income distribution under the current regime and a (hypothetical) proposed alternative are shown as line graphs in Figure 7.7. It can be seen that rates would be reduced in the middle to lower ends of the earnings spectrum and increased at the higher end, relative to existing rates.

Figure 7.7
PRSI Rates 1990/91



18. It also arose, of course, from the pattern of changes in tax rates, tax bands and allowances (See Chapter 6).

The PRSI tax allowance must be considered in any prospective reform. Considered in the light of underlying taxation principles it is difficult to assert a rationale for the allowance. In 1989/90, as the details in Chapter 6 show, this allowance entailed a diminution in the tax base of £194 million, and revenue foregone of £77.4 million. If the allowance were abolished – an initiative which would be fully convergent with the Council's overall concern of broadening the tax base – the revenue thus accrued could be applied to a reduction in PRSI rates. By definition, the reduction in rates can be greater if the proposed restructuring of PRSI includes the abolition of the PRSI allowance.

The Council suggests that the proposed restructuring of PRSI be implemented in the context of overall policy regarding the total tax burden. If it is considered that this burden should be reduced, then, logically, some of that reduction could be applied to PRSI. This scenario would then imply a restructuring with revenue losses and correspondingly greater scope for PRSI rate reductions. Conversely, if the overall burden of taxes on income is not to be permitted to fall this suggests that the PRSI restructuring should be neutral. (An intermediate position exists which entails a reduction in the PRSI burden and an offsetting increase in the PAYE tax burden).¹⁹

(iii) Child Income Support

A number of issues and problems raised in the chapter point to the need for a review of Child Income Support. It is clear that low pay and family poverty are intertwined; that the system of CDA payments in social welfare, and FIS for the low paid with families, are elements of the poverty trap. For instance the details in section 5 (iii) above show that FIS is withdrawn relatively sharply over a narrow band of income. These problems, furthermore, co-exist with a significant incidence of poverty among households with children.

In previous studies the Council has adverted to the relative income status of families and has called for concerted reallocation of resources to them. The Council in 1980, in response to a consultant's study on Family Income Support, stated that:

The Council considers action in the area of family income support to be of such importance as to warrant a contribution to expenditure being met from either increased taxation, a change in the incidence of taxation, a redeployment of expenditure, or a rearrangement in favour of families of such increases in expenditure as may be decided from time to time (NESC, 1980).

¹⁹ The Council does not offer precise proposals on the details of the proposed restructuring. At the time of writing an Inter Departmental Committee is undertaking a review of PRSI. It is understood that the Committee is considering proposals broadly along the lines suggested by the Council, and compiling detailed figures on the revenue and other implications of the proposals.

A later study by the Council on the redistributive impact of social expenditure endorsed its concern that the overall system of taxes and benefits did not proportionately reflect the needs and costs of the family life cycle. In 1988, in the context of its analysis of the redistributive impact of taxes and benefits the Council argued that:

Family income support, and the wider question of family policy, merit particular priority in the context of available resources (NESC, 1988).

The issues raised in this chapter, therefore, echo the underlying theme in the Council's policy studies – the need for a restructuring of Child Income Support. Two issues in particular merit some discussion. The first issue is the status of Child Benefit and the scope to improve the payment by making Child Benefit more 'selective'. In redistributive terms there are two dimensions to be considered – *horizontal* redistribution between households at a given level of income and *vertical* redistribution between households at different income levels. It is difficult, in principle, to disagree with the Commission on Taxation's analysis, namely, that Child Income Support, and other needs – related payments, should be effected through cash payments. Furthermore, the role of Child Benefit in the Commission's analysis is to equalise the (per capita) post tax incomes of households with identical incomes, but different needs (number of children, for example). According to this analysis, Child Benefit should not be selective (through means testing or taxing).

This analysis, however, must be placed in context. Ireland has a significant demographic burden of dependent children; there is extensive reliance on social welfare incomes among families with children; there is a higher than average risk of poverty among families with children. In this context, the Council considers that there are strong grounds for according some priority to the vertical redistribution objective and reforming Child Benefit to achieve greater targeting on lower income families. The question arises as to how such targeting be implemented.

The Council's overall taxation strategy is founded on a broadening of the tax base. Consistent with this general approach the Council suggests that making Child Benefit subject to income tax and using the revenue gained to *increase* the Child Benefit payment would be a desirable reform. In general, the net effect of such a strategy would be to improve the situation of lower income/lower marginal tax families and conversely with higher income families. The proposal, it is emphasised, is not simply to tax Child Benefit at *existing* payment levels, but to restructure Child Benefit by simultaneously increasing it and making it taxable. Such a restructuring would be greatly facilitated if the increase in Child Benefit were above the level permitted by a revenue neutral reform. Recall here that the effective extension of the tax base to include short-term social welfare payments would have revenue generating effects. This revenue might be applied, in part, to further improve Child Benefit payments.

The Council's proposal is aimed at the attainment of a number of inter-related objectives. First, to achieve a greater degree of targeting in overall child income support arrangements, an objective which arises from the *context* in which these measures are to be applied and not from a principled view about the tax/benefit status of Child Benefit. Second, to enhance the importance of Child Benefit in the 'income package' of lower income families and thereby make the system of Child Income Support more neutral as between work and unemployment. Third, to attenuate the link between low pay, family size and poverty which, the evidence suggests, is one component of the overall family poverty problem.

An analysis of the actual impact of the Council's proposed strategy, based on a representative model of the tax and benefit in 1987/88 systems has been undertaken (Callan and Nolan, 1989).²⁰ The analysis reveals, firstly, that under a revenue neutral restructuring the pattern of 'gains' and 'losses' would be broadly progressive, with the distribution of gains skewed towards the lower income deciles, and conversely with the distribution of losses. Secondly, the analysis considers whether the revenue neutral restructuring would worsen the poverty trap by bringing more families into the tax net. The "vast bulk of tax payers", according to the analysis, would face unchanged marginal tax rates with only 1% of tax units moving in or out of the marginal relief area. Third, if a restructuring were combined with a net increase in expenditure of £20m, then a 50% increase in Child Benefit for those not paying tax would be possible with standard rate tax units unaffected, and net losses of between 14 and 35 per cent for higher rate tax payers. Alternatively, a more modest increase of 9% for *all* recipients could be financed.

A further, and considerably broader range of issues about child income support, arises. These broader issues can only be resolved, however, in a gradualist fashion over an extended period. The issues can be crystalised in this simple observation: there are now *four* separate mechanisms of child income support in the tax and benefit systems. (Child Benefit, Family Income Supplement, Child Dependent Additions, and Tax Exemptions differentiated by child responsibilities). The origins and the overlapping rationale and development of those separate mechanisms have been well documented (McCashin, 1988; Nolan and Farrell, 1990).

In 1984 the then Government proposed the unification of all existing forms of child support into one Child Benefit payment, taxable, and at a considerably higher level than the prevailing Children's Allowances scheme. The then government stated in *Building on Reality* that:

A new Child Benefit Scheme will be introduced which will unify in a single payment State support towards the cost of rearing children. Selectivity in favour of the less well-off will be achieved mainly by treating the new monthly child benefits as assessable income for tax purposes. The restructured scheme will be carefully designed to channel available resources to those most in need and to provide a more significant independent income

for mothers whose work is in the home. It will also help to improve the incentive to work by being more neutral than the existing system as between situations in which a head of family is in employment or out of work (Ireland, 1984).

The merits of such an integrated approach may still pertain. Child Dependent Additions would no longer exist, nor would the high replacement ratios which affect families, and large families in particular. Family Income Supplement would also be subsumed and thus the high marginal tax rates on low paid employees with families would be significantly reduced. Finally, the tax allowance for children which then existed would also be abolished. In the event the tax allowance was abolished in 1986, Children's Allowances were renamed Child Benefit and the latter was increased in the 1986 Budget. However, the integrated, unified Child Benefit has not been implemented.

It would be difficult to attempt an outright integration of this type in the short-term – unless a significant increase in public expenditure were contemplated. This difficulty is attributable to the current role and impact of FIS and CDAs. Consider the example of a family man with three children with a gross wage of £150 per week: his FIS entitlement would be £6 per week. To integrate FIS into a taxable Child Benefit would require a Child Benefit increase to compensate for the loss of FIS – if the integrated benefit is to improve the incomes of those on low earnings. Similarly with CDAs. At present these are in the range £11-£15 weekly and any reduction would result in a loss for social welfare families, to be compensated for by a Child Benefit improvement. The dilemma with the CDAs arises from the increases in their levels in recent years. These increases were against the advice of the Commission on Social Welfare that CDAs should gradually diminish in importance relative to Child Benefit, thereby making the overall structure of child income support more neutral as between employees and social welfare recipients.

Notwithstanding these difficulties, however, the Council considers that the fully integrated Child Benefit scheme offers a benchmark against which incremental changes in the tax and benefit system should be evaluated. Specifically, the Council recommends that CDAs should gradually diminish in scope in the child income arrangements while Child Benefit's role should be enhanced. Finally, it should be noted that the first aspect of child income support discussed above – the restructuring and targeting of Child Benefit – can be seen as an initial step towards the longer term integrated benefit.

7. RESTRUCTURING AND REFORM

The Council has argued for four beneficial restructurings in the tax-benefit system. These are:

- (i) reform of the employee PRSI contribution structure by abolition of the ceiling, removal of the exemption, and the lowering of the contribution rate;

20. The tax benefit model is based on data for the 1987/88 tax year.

- (ii) abolition of the PRSI tax allowance in the context of the overall strategy of reform for the tax/PRSI system;
- (iii) taxation of short-term social welfare benefits;
- (iv) reform of Child Benefit by a simultaneous increase in the level of benefit and taxation of Child Benefit.

The Council recommends that the Child Benefit strategy and the PRSI reform strategy (i.e. (iv) and (i)) should be revenue neutral. The taxation of short-term benefits and the abolition of the PRSI tax allowance (i.e. (iii) and (ii)) yield additional revenue and hence offer further policy choices. Revenue from these changes *could* be deployed to lower average tax rates on earned income, to lower employee PRSI rates beyond what a revenue neutral restructuring would allow, to increase Child Benefit levels above the levels inferred by a revenue neutral restructuring, or to some combination of these options.

The Council's broad strategy would suggest that revenue from these base broadening policies be devoted to reductions in average tax rates on earned income (including employee PRSI as taxes for purposes of this discussion). However, the beneficial effects of the Child Benefit restructuring would be enhanced, in the Council's view, if the increase in Child Benefit were greater than the increase allowable within a revenue neutral reform. These beneficial effects include a greater targeting of Child Benefit on lower income families, a more effective redistribution of resources towards families, and a system of Child Benefit which is more efficient from an incentives point of view. The Council therefore suggests that there is *limited* scope to apportion part of the revenue increase to an additional improvement in Child Benefit rates.

APPENDIX TO CHAPTER 7

ADDITIONAL TABLES

Table A7.1
Per cent of Households/Persons below Alternative Relative Poverty Lines in 1987, using Alternative Equivalence Scales*

Per Cent of Households/Persons Below the line	Equivalence Scale		
	A	B	C
<i>40% Line</i>			
Per Cent of Households	10.0	8.9	7.5
Per Cent of Persons	12.8	10.5	8.2
<i>50% Line</i>			
Per Cent of Households	18.9	18.5	17.5
Per Cent of Persons	22.9	21.2	19.8
<i>60% Line</i>			
Per Cent of Households	29.0	30.5	30.0
Per Cent of Persons	33.5	32.2	31.4

Source: Callan, Nolan et al, 1989, Tables 5.1, 5.2.

1. The Scales are as follows:

A: Head of Household = 1, Other Adults = 0.7, Children = 0.5.

B: Head of Household = 1, Additional Adult = 0.6, Children = 0.4.

C: Head of Household = 1, Additional Adult = 0.66, Child = 0.33.

Children are those under 14.

Table A7.2
50 Per Cent Relative Poverty Line Applied to ESRI Sample and HBS 1973 and 1980.

Percentage of households/persons below 50 per cent line	Equivalence Scale		
	A	B	C
<i>Percentage of households</i>			
1987 ESRI	18.9	18.5	17.5
1980 HBS	17.2	17.6	16.8
1973 HBS	18.2	17.9	17.7
<i>Percentage of persons</i>			
1987 ESRI	22.9	21.2	19.8
1980 HBS	19.2	17.4	16.2
1980 HBS	17.8	15.9	14.8

Source: Callan, Nolan et al 1989, Table 5.4.

Note: HBS 1980 and HBS 1973 refers to the respective Household Budget Surveys and ESRI 1987 refers to the ESRI survey data.

Table A7.3 (a)
Per Person Income Gaps using Relative Poverty Lines and Different
Equivalence Scales, 1973, 1980 and 1987

Equivalence Scale	Relative Poverty Line								
	40%			50%			60%		
	1973	1980	1987	1973	1980	1987	1973	1980	1987
A	0.022	0.031	0.036	0.043	0.054	0.065	0.075	0.085	0.100
B	0.020	0.029	0.033	0.039	0.049	0.058	0.068	0.078	0.093
C	0.018	0.027	0.030	0.036	0.046	0.054	0.062	0.074	0.087

Table A7.3 (b)
Distribution-Sensitive Poverty Measure using Relative Poverty Lines and
Different Equivalence Scales, 1973, 1980 and 1987.

Equivalence Scale	Relative Poverty Line								
	40%			50%			60%		
	1973	1980	1987	1973	1980	1987	1973	1980	1987
A	0.011	0.018	0.022	0.018	0.019	0.026	0.031	0.040	0.048
B	0.010	0.016	0.021	0.017	0.024	0.030	0.028	0.036	0.044
C	0.009	0.016	0.021	0.015	0.023	0.029	0.026	0.034	0.041

Source: Callan, Nolan, 1989, Tables 5.7, 5.8.

Table A7.4
Trends in risk of Poverty by Broad Household Type at 50 per cent Relative
Poverty Line, 1973, 1980 and 1987
Equivalence Scale: 1, 0.66, 0.33

	1973	1980	1987
	HBS	HBS	ESRI
1 adult	42.3	30.2	13.5
2 adults	21.9	14.3	14.4
Other adults only	10.0	11.4	12.3
2 adults, 1 child	9.6	6.9	16.7
2 adults, 2 children	5.0	10.2	19.4
2 adults, 3 children	9.0	10.7	21.7
2 adults, 4 + children	14.7	23.2	36.5
Others with children	14.8	19.1	24.0
All households	17.7	16.8	17.5

Source: Callan & Nolan et al. 1989, page 96

Table A7.5
Risks of Poverty by Labour Force Status of Head of Household, 1987

Labour Force Status of HOH	Per cent of hh in sample	40% line Risk (%)	50% line Risk (%)	60% line Risk (%)
Employee	37.9	1.9	4.4	11.1
Farmer	12.4	24.1	35.8	45.0
Self-employed	7.5	7.2	11.6	19.1
Unemployed	10.3	12.8	58.9	74.4
Ill but intending to seek work	1.2	30.6	51.2	65.3
Ill and not intending to seek work	4.8	7.3	25.0	63.0
Retired	14.4	5.1	11.4	21.5
Home duties	11.3	7.9	12.3	42.1
All Households	100.0	7.5	17.5	30.0

Source: Callan and Nolan et al. 1989, page 106

Table A7.6
Composition of All Households Below Relative Poverty Lines, and Those Below Paying Income Tax/PRSI, by Labour Force Status of Head and Composition of Household

	Relative Poverty Line					
	40%	50%		60%		
Labour Force Status of Head	% of all below line	% of those below and paying tax	% of all below line	% of those below and paying tax	% of all below line	% of those below and paying tax
Employee	9.6	59.3	9.4	56.7	13.5	62.2
Farmer	37.3	18.1	23.9	17.3	17.6	11.1
Self-employed	6.9	7.6	5.0	6.2	4.8	6.0
Unemployed	17.2	6.4	34.9	8.8	25.6	10.5
Sick/Disabled	8.8	8.6	10.4	9.3	12.6	5.2
Retired	9.5	—	9.2	1.1	10.2	0.8
Home Duties	10.3	—	7.0	0.6	15.4	2.1
Total	100	100	100	100	100	100
Composition of Household						
% with at least one child	48	57	58	71	52	75
% with three or more children	22	24	28	32	24	40
Total	100	100	100	100	100	100

Source: Nolan and Callan, 1989B, Tables 1 and 2.

Table A7.7
Annual Gross Earnings of Selected Statutorily Defined Low Paid Employees, Male Employees on Average Earnings and Chief Executives, 1980-89

Year	Per Annum					
	(1) Low Paid	(2) Average	(3) High Paid	(4) (1) ÷ (3)	(5) (2) ÷ (3)	(6) (1) ÷ (2)
1981	3690	7086	27,040	13.6	26.2	52.1
1982	4058	7993	29,980	13.5	26.7	50.8
1983	4547	8936	34,960	13.0	25.6	50.9
1984	4900	9927	35,108	14.0	28.3	49.4
1985	5212	10,781	44,131	11.8	24.4	48.3
1986	5472	11,577	44,800	12.2	25.8	47.3
1987	5732	12,042	42,784	13.4	28.1	47.6
1988	5908	12,627	54,880	10.8	23.0	46.8
1989	6116	13,132	57,624	10.6	22.8	46.6

Source: Dept of Labour; CSO; IMI Surveys of Executive Salaries

Notes: The low paid are those in Zone A of the Agricultural Workers scheme' for Statutory minimum wage rates; The Senior Executive figure was the average gross salary of Chief Executives at the median salary point for executives in companies with 250-500 employees.

(e) estimated on the basis of a 5% nominal increase from 1988 to 1989.

Table A7.8
Details of Earnings, Taxation and Transfer Payments for Low Paid, Average Paid, and High Paid Employees, Selected Years, Married Man, Wife, 2 children.

	1981/2			1985/6			1989/90		
	Low	Average	High	Low	Average	High	Low	Average	High
Gross Earnings	3600	7086	27,040	5212	10,781	44,131	6116	13,132	57,624
Tax Allowances	3220	3220	3220	4886	4886	4886	5186	5186	5186
Tax £	0	1153	10,542	0	2063	20,825	0	2543	25,941
PRSI £	175	337	404	391	916	1804	336	1001	2286
Net Earnings £	3511	5596	16,094	4821	7802	21,502	5780	9588	29,397
Average Income Tax Rate %	0	16.3	39.0	0	19.1	47.2	0	19.4	45.0
Average Total Tax Rate %	4.7	21.0	40.5	7.5	27.6	51.3	5.5	27.0	49.0
FIS	-	-	-	231	-	-	478	-	-
Child Benefit	180	180	180	289	289	289	361	361	361
Disposable Income	3695	5776	16270	5341	8091	21791	6619	9949	29,758
Index of Disposable Income (Low = 100)	100	156	440	100	151	408	100	150	450
Index of Earnings (Low = 100)	100	192	732	100	207	847	100	215	942

Source: Department of Labour: C.S.O: IMI Survey of Executive Salaries

Notes: The low paid employee's income was below the tax exemption threshold in each of the three years: only personal tax allowances, PAYE, and PRSI allowances are included. Child Benefit rates are the April rate annualised for 1981/2 and the July rates annualised for 1985/6 and 1989/90. The low earnings figures are estimates of annual earnings for the tax/benefit year based on prescribed minimum rates under employment regulation orders. FIS payments at 1 July are applied.

Table A7.9
The Poverty Trap: Man, Wife, Four Children, 1989/1990, £ Per Annum

Gross Pay	Tax	PRSI	Levies	Net Pay	Plus: FIS	Medi-card Value	Net Income	Less: LA Rent	Travel to Work Costs	Net Disposable Income
3,000		165		2,835	2,184	440	5,459	94	520	4,845
4,000		220		3,780	2,184	440	6,404	140	520	5,744
5,000		275		4,725	2,184	440	7,349	187	520	6,642
6,000		330		5,670	2,184	440	8,294	681	520	7,093
7,000	120	385		6,495	1,560	440	8,495	910	520	7,065
7,875	645	433		6,797	1,040	440	8,277	952	520	6,805
8,000	720	440	180	6,660	988		7,648	936	520	6,197
9,000	1,220	495	203	7,082	364		7,446	993	520	5,930
10,000	1,540	550	225	7,685			7,685	1,082	520	6,083
10,500	1,700	578	236	7,986			7,986	1,123	520	6,340
11,000	1,860	605	248	8,287			8,287	1,165	520	6,602
12,000	2,180	660	270	8,890			8,890	1,456	520	6,914
13,000	2,500	715	293	9,492			9,492	1,555	520	7,417
14,000	2,820	770	315	10,095			10,095	1,659	520	7,916
15,000	3,140	825	338	10,697			10,697	1,758	520	8,419

Source: Department of Finance

1. INTRODUCTION¹

In discussing policy and strategy for the 1990s (Chapter 2) it was argued that in social policy a number of principles must guide the formulation of future policies. Some of these principles are relevant to the housing system. In particular:

- (a) public expenditure must be controlled while protecting the disadvantaged and pursuing greater social equity;
- (b) targeting, and the careful identification of priorities, must inform the allocation of resources; and
- (c) area based strategies should be developed to deal with the regional and local concentration of social deprivation.

The Council's previously published research and recommendations on housing policy are consistent with the above principles.

The NESC recently published a report on housing, *A Review of Housing Policy*, (NESC, 1989A). In the report the Council advanced its views and proposals on a range of housing policy issues. The general structure of the housing system and the pattern of housing policies have remained unchanged since the Council completed its work. Consequently, the Council's overall analysis remains pertinent. Limited changes have taken place in aspects of housing policy and in the housing market. The discussion below suggests that these changes offer an added impetus to the Council's original analysis. This chapter is primarily, therefore, a summary and re-statement of the Council's policy position. However, where appropriate, recent developments are noted and their implications for the housing system and for housing policy are assessed.

Housing policies and conditions vary significantly according to tenure (whether rented or owner occupied housing, for example). This tenure distinction is applied throughout the policy discussion in this chapter. Two sub-sections precede the policy analyses in respect of the tenures. Firstly, the Council's recommended overall strategy for the housing system as a whole is restated. Secondly, recent trends in total house building are reported, and then assessed in the light of projections of future housing requirements.

1. The Construction Industry Federation representative on the Council does not subscribe to the analysis of housing policy in this chapter – this analysis is based on the Council's published report, *A Review of Housing Policy* (NESC, 1989A). In particular, the CIF opposes the introduction of a property tax and of capital gains tax on the sale of principal private residences without a prior, thorough assessment of their impact on the housing market.

2. HOUSING POLICY

The central thrust of housing policy has always been the encouragement of owner occupation. In the Council's view, owner occupation per se should not be an end in itself, but one of a series of instruments to achieve the goal of adequate housing, in an acceptable environment, at an affordable price or rent. The Council recognises that owner occupation is a widely preferred and superior tenure and recommends that it should continue as the main tenure, but within a more balanced framework which supports a positive role for the other tenures in the housing system. Achieving a better balance between tenures and ensuring that the other tenures – local authority, private rented, and voluntary/social housing, play an appropriate role should be the fundamental aim of housing policy.

The following points summarise the key elements in the proposed housing strategy:

- an equitable and efficient tax/subsidy regime for owner occupied housing entailing a property tax, full mortgage interest tax relief at the standard rate and capital gains tax on real gains from sales of dwellings;
- a greater emphasis throughout the housing system as a whole on maintenance, refurbishment and renewal;
- an explicit policy for the private rented sector which sustains demand for this tenure, encourages supply and provides a modicum of regulation (but not rent regulation);
- a more sophisticated policy for local authority housing, incorporating a more equitable and efficient rent system, better maintenance and management and a much more restrictive use of discount sales of dwellings;
- a greater commitment to the voluntary, social and co-operative sectors;
- a locally co-ordinated, resettlement strategy for the homeless and those with acute housing needs.

The Council emphasises the essential complementarity between these recommendations and the need to pursue all of the elements proposed. For example, a reduced emphasis on new dwellings in the local authority sector must be complemented by greater support for other elements in the housing system which can cater to low income households.

3. HOUSING REQUIREMENTS AND NEEDS

In its report the Council provided projections of future housing requirements. The projections were based on data about the future size and structure of the population and incorporated appropriate assumptions regarding the long-term evolution of economic, demographic and social variables. It was estimated that over the period 1986-1996 total housing requirements would be in the range of 11,000 to 15,000 new completions per annum on average, with a figure at the upper end of that range more appropriate. More recent projections prepared for the Construction

Industry Development Board suggest that required housing completions will be 18,600 per annum for the period 1986-1993 (DKM, 1990).

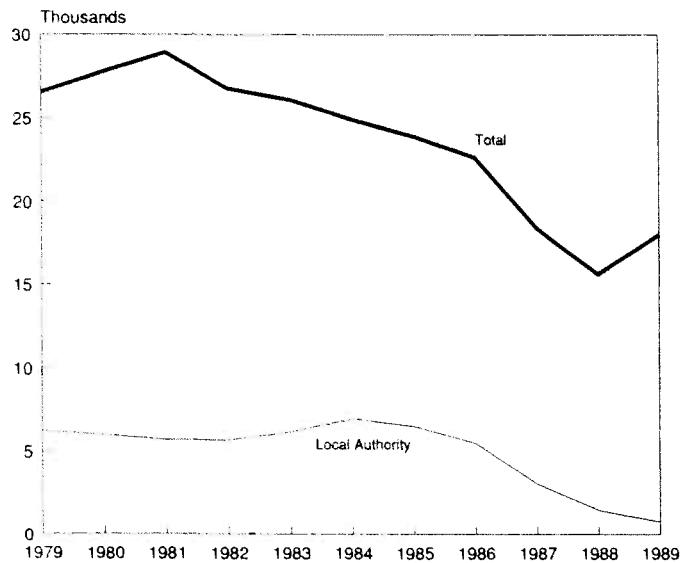
Figure 8.1 and Table 8.1 below provide the basic data on housing completions for the decade 1979-1989, for both local authority and private sector completions. Completions were at a peak in 1981 and were generally higher in the early part of the decade. It can be seen that total completions since 1986 were 74,552, an annual average of 18,713. The recent and current level of completions is therefore in the range of projected requirements.

Table 8.1
Housing Completions 1979 –1989

Local Year	Authority	Private	Total
1979	6,214	20,330	26,544
1980	5,984	21,801	27,785
1981	5,681	23,236	28,917
1982	5,686	21,112	26,798
1983	6,190	19,948	26,138
1984	7,002	17,942	24,944
1985	6,523	17,425	23,948
1986	5,516	17,164	22,680
1987	3,074	15,376	18,450
1988	1,450	14,204	15,654
1989	768	17,300	18,068

Source: Annual Bulletin of Housing Statistics, Department of the Environment.

Figure 8.1
Housing Completions 1979-1989



Source: Annual Bulletin of Housing Statistics, Department of the Environment.

A significant aspect of the completions data is the relative scale of local authority completions. This figure has fallen continuously since 1984 and in 1989 stood at 768. The mix of house completions has therefore shifted markedly towards private owner occupation. In the Council's view, this diminution in the role of local authority house completions merits three observations.

Firstly, during the period 1984-1988, declining local authority completions were not associated with overall shortages as indicated by waiting lists for local authority dwellings. Secondly, however, since 1988 there is evidence of a lengthening of housing waiting lists in the Dublin area: for example, Dublin Corporation's list increased from 1,800 to 3,000 from May 1988 to May 1989 (Fitzgerald, 1990). Thirdly, and most importantly from the Council's standpoint, if a coherent housing strategy is adopted, the emerging need for local authority dwellings does not necessarily imply the resumption on a large scale of a local authority house building programme.

The Council emphasises that the response to indicators of housing need lies in the implementation of its *overall strategy*. Accordingly, an assessment of the need for additional local authority dwellings must be made in the wider context of the role of other tenures and of other methods of improving the housing system. For example, an active, positive policy in relation to the private rented and voluntary/social sectors would diminish the need for directly state-provided housing. Similarly, a more adequate system of income support for housing would

facilitate households to obtain housing in the private market. Equally important, the supply of local authority dwellings could be conserved and improved through better maintenance and management and, notably, through more restrictive local authority discount sales of dwellings. In the Council's perspective, it is the *absence* of these wider policies which result in manifestations of housing need such as housing waiting lists.

4. OWNER OCCUPIED HOUSING

The Council's view on this tenure are conditioned in part by the generally adequate quality of owner occupied housing in Ireland and by the already high level of owner occupation achieved. Historically, owner occupation has been stimulated by a wide range of incentives and subsidies. The Council's analysis, and many independent commentaries, were critical of the level of subsidisation to the tenure, which has been shown to be regressive and inefficient (Blackwell, 1981; Tansey, 1987; NESC, 1989A).

(i) Tax Treatment of Owner Occupied Housing

The first, and central, element in the Council's proposals concern the tax treatment of owner occupation. Detailed consideration of the underlying taxation and housing policy arguments led the Council to argue for the imposition of a *property tax* on all residential property and the retention of *full tax relief on mortgage interest at the standard rate of tax*. These proposals are analytically intertwined.² Further, and in keeping with its fundamental principle of broadening the tax base, the Council also proposed the inclusion of capital gains on the sale of principal private residences in the income tax base.

The extended arguments put forward by the Council in support of these proposals can be summarised in two key points. First, from the perspective of the *housing system* the proposals represent more neutral tax treatment: equity between owners and renters, and between investors in housing and in other assets, would be achieved. Furthermore, the existence of significant tax relief combined with the absence of a property tax acts as an unnecessary stimulus to the demand for owner occupation, bids up house prices, and results in the effective capitalisation of the subsidies in house values.

Secondly, from the standpoint of *tax reform*, the absence of property taxation and capital gains tax, combined with the continuation of significant levels of mortgage interest relief, represents an inequitable and inefficient limitation of the overall tax base. Inequity arises because of the regressive impact of mortgage interest tax relief at varying income tax rates and because of the disproportionate benefit to

2. Simply, the property tax represents an extension of the income tax base to include the imputed income arising from owner occupation, while the interest relief, in effect, offsets the cost of acquiring the income generating asset. A combination of a property tax and full tax relief on mortgage interest is therefore a measure of the 'net' imputed income derived from owner occupation housing.

higher income households and owners of larger dwellings from the absence of capital gains tax and property tax. Inefficiency arises because the tax treatment of owner occupation displaces investment into a non traded sector of the economy, and contributes to an overall imbalance in the tax system in favour of property and against income.

The Council considers that its proposals in relation to the tax treatment of housing must be seen as part of its more general concern with tax reform. In particular, the Council insists that implementation of its proposals *must* be accompanied by reductions in *income* taxation. Reforming the tax treatment of housing, the Council argues, should not result in a *net* increase in the overall tax burden, but rather a *restructuring* of the tax burden away from income and towards property. The Council also pointed out the need for careful design and implementation of its proposals with a view to avoiding undue disruption of the housing market.

The Council's analysis of the tax regime for housing focussed on the interrelationship between the taxation of housing property and mortgage interest tax relief. Specifically, the Council adopted the view that, in the absence of a property tax, mortgage interest relief should be restricted:

If a property tax is introduced, as the Council has recommended, it would be logical and equitable to have full mortgage interest relief at the standard rate of tax; if the present non-taxation of property continues then a very restrictive approach to interest relief should be initiated (NESC, 1989A).

Prior to 1974 all mortgage interest was allowable against income tax, but in successive Finance Acts the relief has been restricted. In the tax year 1988-1989 the Council recommended the initiation of a very restrictive approach to interest relief in the absence of a property tax. The relief then stood at 90% of interest up to a maximum of £4,000 for a couple, and in the subsequent tax year, 1989/90, the relief was further restricted to 80% of interest to a maximum of 80% of the qualifying amount of £4,000.³

Since the Council expressed its recommendations, therefore, interest relief has been curtailed again, to 80% of interest subject to a maximum of £4,000 for a couple, and income tax rates have been reduced. The tax rate reductions have been facilitated in part by this broadening of the tax base (and in part also by the relative revenue buoyancy in recent years). The Council acknowledges that this further restriction in interest relief, to 80%, combined with reductions in tax rates, is a reflection of the Council's broad taxation strategy of rate reduction and base widening.

3. In addition, the further restrictions introduced on the tax relief on life assurance premia have reduced the attractiveness of endowment type mortgages.

Moreover, as interest relief at varying marginal tax rates renders the relief regressive the restriction on the relief has, de facto, increased the progressivity of the income tax system.

However, an appreciation of the impact of recent policy in regard to mortgage interest relief must be set in the context of changes in the housing market. Firstly, as Figure 8.2 illustrates, the price of housing has risen significantly in the period 1987-1990. Secondly, mortgage interest rates rose significantly over the period mid-1988 to mid-1990, as Figure 8.3 shows, and in recent months declined marginally. The interaction of these changes with the changes in the provision of mortgage interest relief, and with trends in gross and disposable earnings is illustrated in Table 8.2. The data shows that, in absolute terms and relative to disposable and gross earnings, interest repayments have significantly increased. The interest relief allowed grew in nominal terms in the period under review, but declined significantly relative to total interest repayments (in the first year). After allowing for mortgage interest relief, interest repayments comprised 27% of disposable income in 1990, compared to 20.6% in 1987. When the restricted interest relief is set in the context of evolving house prices, it appears that persons on average earnings are being required to commit significantly higher proportions of their income to interest repayments.

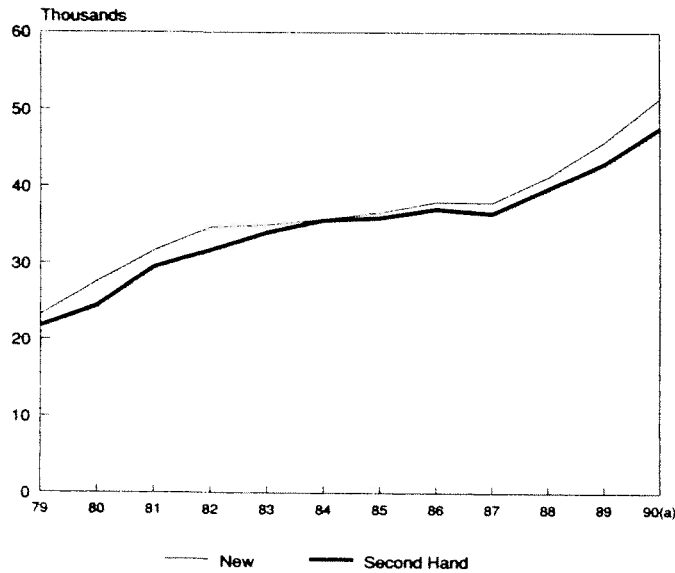
Table 8.2
Earnings, Interest Rates, House Prices, Mortgages and
Interest Relief, 1987/88 and 1990/91

	1987/88	1990/91	% Change
1. Gross Earnings of Couple £	18,956	21,270	12.2
2. Average Gross Price of New House £	37,922	51,480	35.8
3. Average Mortgage for New House £	25,000	34,865	39.5
4. Average Interest Rate %	11.31	12.15	—
5. Disposable Income	13,698	16,083	17.4
6. Interest Repayments (First Year)	2,828	4,237	52.9
7. Interest Relief Allowed	2,545	3,200	26.7
8. Interest Relief as % of Interest Repayments	90.0	74.0	—
9. Interest Repayments as % of Disposable Income	20.6	26.9	—

Sources: *Quarterly Bulletin of Housing Statistics; Central Bank Bulletins. Central Statistics Office.*

Notes: 1990/91 earnings are estimates. Disposable income assumes PAYE, PRSI, personal and mortgage interest allowance. Average mortgages are calculated as total new mortgage debt for new houses divided by the number of such new mortgages. Interest rates are averages of March, June, September and December for 1987/88, and averages of March, June and September for 1990.

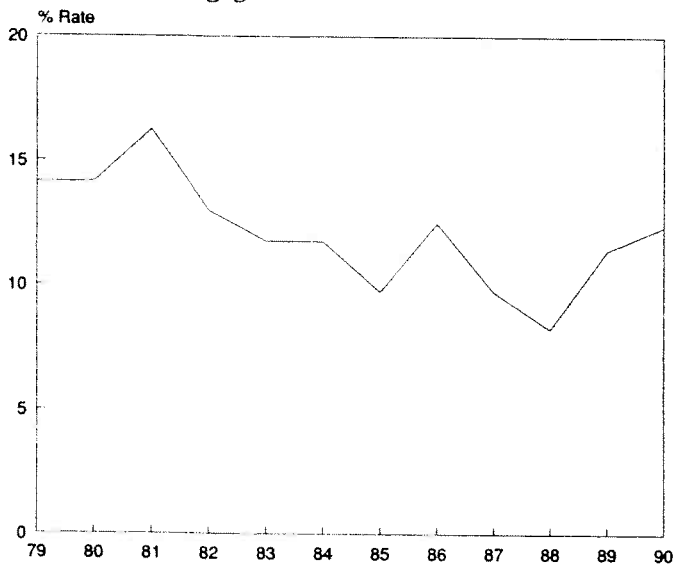
Figure 8.2
House Prices 1979-1990



Source: Annual Bulletin of Housing Statistics, Department of the Environment.

(a) First Quarter Only.

Figure 8.3
Mortgage Interest Rates 1979-1990



Source: Annual Bulletin of Central Bank.

Notes: Rates are those applicable in December: the 1990 figure is for the first Quarter only.

It is important to note that the Council is *not* proposing that interest relief be modified in response to recent changes in house prices and interest rates. On the contrary, the Council recognises that the policy of interest relief reductions is compatible with the existing policy on the non imposition of property taxation, i.e. that in the absence of a property tax a very restrictive stance on interest relief is justified. The Council emphasises that in its view the appropriate policy is one which combines property taxation with retention of interest relief.

First, from a housing policy point of view it may be more difficult to facilitate first time buyers in a situation where interest relief is restricted relative to prevailing mortgages and interest repayments. This could make the attainment of official policy (endorsed by the Council) in relation to the encouragement of owner occupation more difficult. In short, the alternative position of full mortgage interest relief at the standard rate, combined with a property tax, is more consistent with the objective of encouraging owner occupation. Second, the broadening of the tax base entailed in the property tax is a considerably more comprehensive extension of the base than restriction of interest relief. Property taxation, for example, would apply not just to properties with mortgages but also to those owned outright. Restricting interest relief extends the *income* tax base, while property taxation would be a *structural* improvement in the overall tax base away from income and towards property. Third, the absence of a property tax and of capital gains tax and the availability of a substantial level of mortgage interest relief underpins the rise in prices: the former two benefit most those who own large dwellings and those who own outright.

The Council reiterates that the combination of capital gains tax on sales, the retention of mortgage interest relief, and a property tax would be the most equitable and efficient policy for the tax treatment of housing. These proposals in relation to the imposition of a property tax and capital gains tax have implications for the existing income Related Residential Property Tax and stamp duties. The income Related Residential Property Tax would be replaced by the overall property tax proposed by the Council.

In the case of stamp duties, the logic of the Council's tax reform proposals, based on the analysis of the Commission on Taxation (Commission on Taxation, 1984), suggests that stamp duties on the conveyance of lands, houses, property and so on impart both equity and efficiency losses. The Commission stated that:

in general, we believe that stamp duties on conveyance are an inefficient form of taxation which does not have any place in a modern fiscal system. They have undesirable effects particularly in inhibiting labour mobility. We recommend the abolition of stamp duties on conveyances of lands, houses and other property, leases, mortgages and settlements.

We do not consider the complete abolition of stamp duties on conveyances to be a priority in the reform of the tax system (Commission on Taxation, 1984).

The Council therefore suggests that in the context of its overall proposals for the taxation of housing, stamp duties be eventually abolished.

A number of points should be noted about this proposal. Firstly, in the context of a tax system which levied capital gains tax on house sales, stamp duties would comprise double taxation. Second, in so far as stamp duties are levied to meet the administrative cost of retaining registers, records and so on, then they can be replaced by economic charges for these administrative services. Thirdly, the Council emphasises that the process of phasing out stamp duties on property etc, can *only* begin when the wider reforms it has proposed are in place – property tax and capital gains tax. Fourth, the Council recognises the revenue significance of stamp duties (almost £60m in the current tax year for stamp duty on houses) and suggests that they can be phased out over a period of time as resources permit, and *only* when the preconditions of property taxes and capital gains tax are met. The Council attaches much greater priority in tax reform to the reduction in taxes on earned income and the reform of indirect taxes. The Council therefore endorses the analysis of the Commission on Taxation in relation to stamp duties but, following the Commission, the Council does not see reform in this area as a priority.

Finally, the possible implications for housing of EC VAT harmonisation should be noted. Currently, housing and building is subject to VAT at the lower rate of 10%. Under the Commission's current VAT approximation proposals, a standard rate in the range of 14-20% will apply, with a reduced rate in the range 4-9% and a limited range of goods at zero rate. No decision has yet been made as to which items will be classified as reduced or zero rated or as to the minimum which might be required.⁴ The Council does not offer a specific view on the appropriate VAT rate for building/housing: this matter must be considered in the light of the efficiency, distributional and revenue effects of the overall VAT structure which is proposed.

(ii) Other Aspects of Owner Occupied Housing

Firstly, cash grants have been used as instruments to subsidise access to owner occupied housing. The Council is of the view that *general* cash subsidies for owner occupiers are an inefficient and inequitable instrument and considers that such grants can only be appropriate if selective, and targeted to meet specific housing needs.

Secondly, 'discount' sales schemes to tenants of local authority houses have been extensively used to stimulate owner occupation. While endorsing the *principle* of facilitating access to owner occupation for low income families, including local authority tenants, the Council regards the terms of the schemes as inappropriate. The objectives of the schemes relate to the development of socially mixed, stable

4. This is the ECs position on VAT approximation as determined at the December 1989 meeting of EC Finance Ministers. It was agreed in 1989 that goods which are important to Member States' "social and cultural" policies should be in the reduced VAT category, but the interpretation of this criterion has not been agreed.

communities and the reduction in local authorities' maintenance costs, but the Council's research reveals that these objectives have been frustrated by the schemes. Further, there are no strong *financial* grounds for the sale. A number of modifications to the policy of discounted sales schemes were proposed:

- The relationship between the terms of the sales and the level of sales should be examined with a view to obtaining a higher level of sales on less discounted terms;
- Restrictions on the extent of sales in specific areas should be considered to prevent local shortages of dwellings to let;
- Variations in the terms of sales should be attempted so that low demand and high demand dwellings and areas command higher and lower discount terms respectively – this will encourage social mix and community stability in a variety of locations;
- Dwellings with very high maintenance costs should be identified and their sale should be a particular objective of the schemes;
- Measures should be devised to ensure that purchasers remain in the dwellings for reasonable periods as owners to ensure a stable social mix and to prevent quick capital gains from early re-sale; a clawback of some of these capital gains should be considered.⁵

The Council argued that the above modifications would enhance the potential of the sales schemes to meet their stated objectives. If the modifications are impracticable, then the Council recommends that:

the sales schemes be abandoned because of their efficiency, equity and financial consequences (NESC, 1989A).

The Council notes that its recommendations in respect of discount sales have not been implemented. On the contrary a new scheme of sales was initiated by the Minister for the Environment in 1988 and the take up of this scheme has been high. In the Dublin local authorities (City, County and Dun Laoghaire) approximately 15,000 tenants applied to purchase. An analysis in the public media of the terms of the schemes carried the title "*Dublin's housing sale of the century*" – a reference to the huge disparity between the sale prices and the market values of the dwellings (Kerr, 1990).⁶ An official of Dublin Corporation is quoted in this analysis as stating that;

We found that even though we were selling off thousands of houses, the maintenance bill didn't come down that much. It was quite obvious that the people most eager to buy were those looking after their own houses anyway (Kerr, 1990).

5. A clawback arrangement was contained in the 1966 Housing Act which legislated for local authorities' discount sales schemes. The 'clawback' was terminated in 1977 and its statutory basis was removed in the 1979 Housing (Miscellaneous Provisions) Act.

6. The Dublin Tribune newspaper invited a property consultant, John Barry of Hoban's Auctioneers, to value three of the dwellings sold under the Dublin Corporation 1988 sales scheme. The consultant is reported (Dublin Tribune, 31 May 1990) as stating that all the houses "were built to a very high standard and would be superior in terms of construction to new private houses".

This material confirms the analysis in the Council's report that one of the objectives of the sales schemes – the control of maintenance costs – was not being achieved. The Council is concerned that the schemes – which it supports in principle – are not contributing to better maintenance of the housing stock and that the extent of the sales may result in shortages of dwellings to let.⁷ The financial, social and economic arguments against the terms of the schemes, which the Council outlined in its report, should be considered and acted on by the Government. These arguments, it should be noted, reflect the Council's general concern that interventions in housing and in other areas should be carefully designed and targeted to meet specific needs and objectives.

Finally in relation to owner-occupation, the Council supports the policies in place to channel mortgage finance to those on low incomes, namely the direct provision by local authorities of mortgages, and the arrangement (initiated in 1987) whereby financial institutions facilitate mortgages under a guarantee system. It will be important to ensure that the level of mortgages available under such schemes adequately reflect prevailing house prices. Since these schemes came into effect house prices have risen significantly.

5. PRIVATE RENTED HOUSING

In general the Council believes that there has been no overall policy in relation to this tenure, which has reinforced its long-term decline. Three general issues must be addressed – demand for rented housing, supply of rented housing, and regulation of the tenure.

(i) Demand

The effective demand in this tenure must be underpinned by an adequate system of income support for housing costs, as many prospective and actual tenants have low incomes. The Council recommends that the existing ad hoc arrangements (Supplementary Welfare Rent Allowances, Social Welfare Rent Allowances for Decontrolled Tenancies, and the Rent Tax Allowance for those aged over 55) be revised and an overall 'housing benefit' system be established to replace those provisions. This should be a means tested, nationally uniform, statutory scheme.

The proposed allowance, as with all of the individual proposals, must be viewed in the context of the overall strategy. An adequate allowance would allow households with low incomes remain in private rented accommodation (or owner occupation) and would generally facilitate households to choose and afford their own accommodation. This, in turn, diminishes the need for direct State construction and management of local authority dwellings – which is the alternative method of meeting housing need.

(ii) Supply

The Council believes that specific measures to enhance the supply of rented accommodation are necessary. "Section 23" relief (first introduced in 1981) has affected only the limited, expensive end of the rental market – and at the significant cost of a regressive diminution of the tax base.⁸ The measures proposed by the Council to affect supply are:

- support for *demand* in the tenure which may generate an automatic response in supply;
- encouragement to Voluntary Housing Associations which provide rental accommodation for those with special housing needs (the homeless, students, the handicapped, disabled).

A further proposal made by the Council has since been implemented, namely the enactment of legislation to permit Building Societies and financial institutions to provide private rented accommodation.

(iii) Regulation

In the Council's view *rent regulation* is an inappropriate policy and in fact it could exacerbate the underlying supply problem in the tenure. However, the Council recognises that many tenants have low incomes, that there is evidence of serious deficiencies in some of the accommodation, and that there is no cheap accessible tribunal for landlords and tenants. Therefore in the Council's view there are grounds for regulation:

- to ensure basic standards and to develop good practice regarding rent books, leases and similar matters (NESC, 1989A).

The Council has pointed out that under existing legislation, the 1982 Housing (Private Rented Dwellings) Act, the Minister for the Environment has power to make regulations on these matters.⁹

It must be recognised that the private rental sector is a potential alternative tenure for those not in owner occupation or in local authority housing. For those on low incomes in particular, the need for an adequate private rental sector has been accentuated in recent years: the supply of new local authority dwellings has contracted due to the sales schemes and the decline in new build, and access to owner occupation has become more expensive with increases in house prices and interest rates.

6. LOCAL AUTHORITY HOUSING

The Council notes that the role of local authority housing in the overall housing system has been increasingly shaped by the growth of long-term unemployment

8. Under the "Section 23" provisions investors in newly built private rental accommodation offset their rental income against tax – subject to a maximum relief of the purchase price less the site cost.

9. This legislation has been used to regulate the former controlled tenancies but has not been applied to the private rented tenure as a whole.

7. See Section 6(ii) below for the Council's views on maintenance costs.

and the concentrated incidence of unemployment and deprivation in local authority housing areas. Factors compounding these problems include the allocation system for housing, insufficient flexibility and innovation in housing maintenance, and the absence of wider community and social planning accompanying the physical construction of dwellings.

(i) Social and Spatial Division of Housing

A general concern of the Council is the degree of social segregation entailed in the pattern of housing provision. The provision and location of local authority and private sector housing is generally based on separate and often extensive areas of exclusively local authority or private housing. This reinforces economic differences and contributes to social class and social status distinctions. In the future, therefore, the Council proposes that:

planning and housing arrangements should attempt to achieve greater social integration and social diversity. The scale of housing estates, for instance, should be reduced so that entire areas of towns or cities do not exclusively contain 'public' or 'private' housing; planning arrangements should allow dwellings of different types (public rental and owner occupied), and of different values, to be provided in areas and estates; local authorities should purchase, and rent to local authority tenants, owner occupied dwellings in estates of private houses (NES, 1989A).

(ii) Maintenance

The Council's report reveals that little data is available on the precise amounts spent on maintenance, by type of dwellings, by age of dwelling and other relevant factors. The difficulties and expense of maintaining the housing stock are given as part of the rationale for discount sales of dwellings to tenants (who thereby become responsible for maintenance). Accordingly, the Council has recommended that a full analysis of maintenance costs should be undertaken by the Department of the Environment, to quantify maintenance costs in detail, to determine whether costs are excessive and to consider options for controlling costs. Furthermore, the Council suggests that the management and maintenance practices of local authorities should be more decentralised and estate-based, and also more consultative and participatory.¹⁰

(iii) Rent Structure

The Council considered the Differential Rent system in detail and evaluated alternative systems. The Council did not propose an alternative rent framework, but identified three problems with the current system which can be resolved within its existing parameters:

- (a) the need to make the scheme more progressive in relation to income;

10. Dublin Corporation has undertaken a study of the maintenance and management problems of its housing stock. The report of the Environment Research Unit to the Corporation's Housing Committee (1989) broadly reflects the thrust of the Council's proposals in relation to maintenance.

- (b) the "poverty trap" implicit in the income/rent criteria (which could be compounded by means tests for other benefits and services); and
- (c) the necessity for a nationally uniform scheme in place of the locally devolved schemes in place at present.

(iv) Other Issues Affecting Local Authority Housing

Two other general proposals advanced by the Council which complement the other measures should be briefly noted:

- (a) Local authorities should *purchase* dwellings, new and second-hand, to rent to tenants, as this may often be a quicker, more flexible, and less costly means of meeting housing needs;
- (b) In allocating tenancies, less emphasis should be placed on length of residence, as this discourages mobility and weighs more heavily on the homeless and marginal groups. A broad interpretation should be taken of the medico-social effects of involuntary sharing, homelessness etc.,. Single persons aged under 60 should be deemed part of housing need. There should be greater scope for families to transfer to different dwellings as the family cycle evolves and their housing needs change. Finally, entitlements to tenancies should be reviewed in the light of households' incomes as they change over time.

7. VOLUNTARY, CO-OPERATIVE AND SOCIAL HOUSING

In the Council's view there are significant arguments in favour of an active and substantial voluntary sector. These arguments are:

- the suitability of the sector to meet special housing needs and the needs of those on low incomes;
- the role of voluntary housing in reducing the need for direct state production and allocation of housing;
- the potential of the tenure to contribute to inner city and urban renewal programmes.

The Council proposed a number of measures to expand and support the role of this tenure:

- more realistic support to maintain a central organisation to advise and co-ordinate individual associations – this issue will become more important as the stock of voluntary and co-operative housing gradually increases from a small base;
- recognition of co-operatives as legal entities for the purpose of receiving State grants, loans and guarantees (at present State agencies are largely geared to providing loans and grants to individuals);
- inclusion of the voluntary and co-operative sectors in the current arrangement between the Department of the Environment and the financial institutions whereby specific amounts of loan finance are made available for housing low income persons;

- provision of finance for the running and current costs, as well as capital costs of voluntary and co-operative projects.

8. HOUSE IMPROVEMENT AND URBAN RENEWAL

In relation to house improvement, the Council recognises that there are equity and efficiency grounds for state intervention. The Council is of the view that house improvement, relative to new-build, should be accorded greater priority in the future. In future, in considering specific house improvement interventions, the following principles should be adhered to:

- The central objective of any scheme of grants should be the attainment of minimal standards in all of the housing stock, rather than high quality improvement to a limited part of the stock;
- Grants are more likely to yield high levels of return in terms of improvement if they are narrowly focussed on particular and acute problems;
- In urban areas in particular, economies of scale and high social returns can be achieved if area-based improvement policies are pursued for specific periods of time;
- There is a strong case for a degree of selectivity in relation to income when eligibility for grants is determined; this case is strengthened if it is accepted that capital gains arising from the improvement accrue (untaxed, at present) to the house owner;
- The case in principle for loans rather than grants should be considered, and the role of private financial institutions in funding house improvement could arguably be extended.

Housing policy is directly relevant to the question of urban renewal: four key arguments were made by the Council. Firstly, any tax or other incentives for inner-city housing or urban renewal housing schemes should emphasise *improvement and refurbishment* rather than new construction. Secondly, policy should be *area-focussed and intensive*. Thirdly, improvement schemes should include the *physical environment as a whole*, including dwellings. Finally, specific measures should be devised to *increase private sector housing investment* in areas requiring urban renewal.

9. HOMELESSNESS AND SPECIAL HOUSING NEEDS

The generality of the Council's proposals affecting local authority housing, income support in respect of housing costs, and the role of the voluntary/social/co-operative sector will all improve the access to housing for the homeless and disadvantaged.

The Council emphasised, however, that a definite overall strategy to deal with homelessness is necessary. This strategy must entail *co-ordinated* elements of housing, income maintenance, health and social services, and must be based on a recognition of the complex social and economic causation of housing need. The Council is of the view that a specific *local structure* may be necessary to implement the required resettlement strategy. At present, responsibility for the relevant services is divided among various authorities.

Subsequent to the publication of the Council's report, further research confirmed the general conclusions and recommendations made by the Council (Kelleher, 1988; Kelleher, 1990). The Council notes that the guidelines applicable to the relevant sections of the *Housing Act 1988* offer positive direction to local authorities which will improve services for the homeless.¹¹ In addition, some practical progress has been made in the Dublin area in developing and improving housing services for those with acute housing needs: administrative liaison between the housing authorities and voluntary groups now takes place; housing administrators now undertake more in depth assessment of applicants' needs; some homes in high demand areas have been allocated to those with acute housing needs and Dublin Corporation have agreed to establish a Housing Forum comprising the statutory and voluntary interests to co-ordinate policy and services (Kelleher, 1990).

10. CONCLUSION

The approach to housing policy proposed by the Council is indicative of its concern to make some policy interventions more targeted. For example, the Council's critique of local authority discount sales and its expressed view that housing grants and improvements schemes should address very specific problems, areas, or target groups are illustrations of this general targeting strategy. This strategy is especially relevant to housing. Housing conditions on the whole have improved considerably in the last two decades: for the generality of the population housing conditions are adequate. The task now is to direct public policy at the most acute housing needs and to develop a strategy for the management of the housing system as a whole.

11. The guidelines suggest better liaison between local authorities, Health Boards and voluntary organisations, support services for the homeless, and the provision of accommodation appropriate to needs.

1. INTRODUCTION¹

The Commission on Health Funding was appointed by the Minister for Health in 1987. The Commission's terms of reference were as follows:

To examine the financing of the health services and to make recommendations on the extent and sources of the future funding required to provide an equitable, comprehensive and cost-effective public health service and on any changes in administration which seem desirable for that purpose.

In September 1989 the Commission's Report was published (Commission on Health Funding, 1989). The Commission's report contains recommendations about the financing, provision, management and organisation, and evaluation of health care. Detailed recommendations are also made by the Commission about the mix of services and their organisation and delivery.

The publication of the Commission's report and the attendant debate on its proposals present an opportunity to the Council to formulate its views on health policy. The importance of health policy is indicated by the sheer scale of direct public expenditure on health, £1.3 billion in 1989, and by the difficult trade-offs between meeting demands for health care on the one hand and providing an equitable structure of services while controlling costs, on the other. In his address to the Commission in 1987 the Minister for Health aptly summarised the problem:

We have embarked on a difficult but unavoidable programme of correcting the public finances; nonetheless, it is also our responsibility to ensure that a health service is available to our people which meets their needs in a comprehensive and equitable way. There is thus a conflict to be resolved, not only by the Government but by society as a whole. On the one hand there is almost universal acceptance of the need to reduce public expenditure, taxation and borrowing. On the other hand, the cost of health care inevitably rises rapidly over time, with the increasing emphasis on high-technology, and the steadily growing demand for more and better services. To resolve this conflict we need to arrive at a consensus view on how best to provide a service which, while comprehensive and equitable, will also be cost-effective and affordable. (Minister for Health, 1987).

The Council does not attempt to evaluate all of the detailed proposals put forward by the Commission. *Key* issues affecting the future of the health care system are

considered in the light of the Commission's analysis and proposals, and the Council's views on these issues are presented. As a necessary background to the main discussion, Section 2 contains some observations on the historical development of the health services and on the complex interplay of 'public' and 'private' care.

2. HISTORICAL DEVELOPMENT AND THE PUBLIC/PRIVATE INTERPLAY

The context in which current health policy and health services in Ireland must be assessed is one shaped by past events and developments (Barrington, 1987). In a number of crucial respects historical patterns have been indelibly imprinted on today's health care system. First, in the development of the hospitals system the voluntary hospitals played a key role. The continued significance of the private and voluntary hospitals sector has created a somewhat diffuse and complex structure of hospital provision. Second, from the time of the Poor Law Workhouses, local health care institutions (general hospitals, psychiatric hospitals, workhouses etc.) acquired considerable economic and political significance, which has made it difficult to rationalise and co-ordinate hospital provisions. Third, in the evolution of the health care system there has been recurrent conflict over the appropriate roles of the State, the Church and the voluntary sector. One outcome of this is a complex structure of entitlement and provision – a three-tier, means-tested system of entitlement to publicly provided services, supplemented by overlapping State monopoly provision of insurance for private care.

Fourth, as a result of the complex structure of health care provision and entitlement, different patterns of access to health care among different socio-economic groups have developed. Consequently, the issue of 'equity' – the relative benefits and costs incurred by different income groups and the relative ease of access to services – has long been a subject of controversy. This controversy is focussed on contrasts between 'public' and 'private' care. However, the actual mix of 'public' and 'private' in the health care system is extremely complex. In Barrington's terminology, it represents "an extraordinary symbiosis of public and private medicine" (Barrington, 1987).

Because of the complexity of the public/private interplay and because of the centrality of that interplay to the analysis and reform of health policy, it is important to carefully set out the actual linkages between 'public' and 'private'.

Figure 9.1 represents, in stylized form, the relative balance of public and private in health care for illustrative health care usages. The important distinction in the chart is between *finance* and *production*. Some services are privately produced – for example, GP services are provided by self-employed contractors. GP services to low-income medical card holders, however, are publicly financed through the GMS scheme. The examples in the chart, chosen to represent typical and important health care transactions, develop the argument more fully.

Figure 9.1
Public and Private Production and Finance of Health Care

Type of Health Care	PROVISION					
	Public Finance			Private Finance		
	Public	Mixed	Private	Public	Mixed	Private
1. Consumers' Purchase of medicine						*
2. Medical Card Holders' purchase of medicine				*		
3. Consumers' Purchase of prescribed medicine with Health Board Refund					*	
4. GP consultation by Medical Card Holder				*		
5. GP consultations by VHI Contributor with GP cover					*	
6. School health examinations and child vaccinations	*					
7. Hospital outpatient visit in public hospital		*				
8. Hospital outpatient visit for medical card holder	*					
9. Inpatient hospital treatment – Medical card holder	*					
10. Inpatient public hospital treatment – others		*				
11. "Semi-private/private" facilities in public hospital — VHI contributor		*				

Figure 9.1 (Continued)

Type of Health Care	PROVISION					
	Public Finance			Private Finance		
	Public	Mixed	Private	Public	Mixed	Private
12. "Semi-private/private" facilities in private hospitals – VHI contributor					*	
13. As above for non-VHI						*
14. Inpatient psychiatric care in general psychiatric hospital	*					
15. Elderly resident in commercial nursing home without H Board subsidy						*
16. Elderly handicapped resident in H Board institutions	*					
17. Elderly recipient of social services from voluntary organisation					*	
18. Domiciliary care of handicapped children and dependent relatives					*	
19. Health Board Dental services for medical card holders	*					
20. Dental services for PRSI insured workers					*	
21. Dental services for uninsured workers						

Some health transactions are utterly private – unregulated decisions between private ‘consumers’ and private providers without subsidies or interventions. Row 1 gives one such example – the routine purchase of non-prescribed or prescribed medicines by consumers from pharmacies. In row 2, however, prescribed medicines purchased by medical card holders are free at the point of purchase but the cost of the drugs is paid for by the GMS to the pharmacist. This transaction is therefore an instance of public finance with private provision. The picture is mixed in the instance noted in row 5: middle and upper income groups receive some subsidisation of their drug purchases through a refund of part of the excess above a (monthly) limit.

GP services are all privately produced but their financing varies from one context to another. GP utilisation by medical card holders is publicly financed. Utilisation by other users is either privately financed or *mixed* as in the case of users who claim refunds under the VHI coverage for GPs. This latter instance is mixed, *not* private finance, as VHI contributions are tax deductible at marginal tax rates. Some services are, of course, unambiguously public in both production and finance: children availing of the various vaccination programmes and school medical examinations receive services financed from general taxation and provided by the public authorities (Health Boards).

Turning to hospital out-patient services, the picture is more complex. As row 6 indicates, medical card holders using outpatients’ clinics in Health Board hospitals are publicly financed users of publicly produced services. However, an element of private finance is entailed in non-medical card holders’ use of these services, as a £10 charge (introduced in 1987) is levied for this service. Depending on the assumptions made about the relationship between the *charge* and the *actual cost* one can argue that such utilisation is publicly provided/privately financed or publicly provided/mixed financed.

In-patient hospital treatment is also public on both finance and production criteria where medical card holders are concerned. This service has *mixed* finance in the case of other patients, as a charge of £10 per in-patient per day (to a limit) is applied – although the mixture is more public than private. ‘Mixed’ finance in the context of public production also describes the situation in row 11 – that of the patient who avails of “semi-private” amenities in (say) a Health Board hospital and pays for the “semi-private” amenity through VHI cover. This financing mode is not fully private as the VHI subscription is tax deductible. Whether this particular financial mixture is more public than private is contingent on the relationship between the *charges* imposed on the patient (and paid by VHI) and the real costs of the services. Even in the case of private facilities in private hospitals (see row 12), i.e. private *production*, the VHI contributor receives a VHI tax allowance and is in a *mixed* financing context. In row 13, unambiguously private production *and* finance does arise, however, as this row refers to patients without VHI (or other insurance) using private facilities in private hospitals, and paying directly without third party intervention.

Straightforward public finance and provision is the norm in the case of most institutional services. For example, a long stay psychiatric patient in one of the Health Board (psychiatric) hospitals, or an elderly resident of a Health Board Home are both classified (rows 14 and 16 respectively) in public provision and public financing settings. A contrasting situation (row 15) is that of an elderly person residing in a private commercial nursing home without any subsidy – this represents both private finance and private provision.

Dental services reveal a number of public/private combinations. Some patients (medical card holders) are eligible for the Health Board service directly provided by them and delivered by salaried dentists who are Health Board employees. This is public in both the financing and provision dimensions. Insured workers who obtain dental treatment under the Social Insurance Treatment Benefit scheme do so through private, self-employed dentists and mixed financing – employer and employee PRSI contributions to the Social Insurance Fund and direct charges for some of these services. Uninsured persons availing of private dentists are in a totally private context (row 21).

Finally, the examples of the elderly recipient of voluntary social services in a local community and that of the handicapped child being cared for at home (rows 17 and 18) should be noted. In the former case, the voluntary organisation is typically a private non-profit organisation which raises funds privately but which also receives a Health Board grant. On balance this scenario can be deemed mixed finance – although if the Health Board grants comprised the entire cost of the service the finance would, of course, be public. Parents of severely handicapped children who care for them at home receive a monthly cash allowance. This public finance is therefore combined with private ‘production’ of care within the family.

This account of the actual balance of public and private in the Irish health care system reveals such a complex set of interactions that the common place usage of the terms ‘public’ and ‘private’ may be seriously misleading. More important, however, are the implications of this public/private interplay for the analysis and reform of health policy. First, it is clear that the source of finance, on the one hand, and provision of services, on the other, are separable. Consequently, the range of options for the organisation of health care are more diverse than the conventional public/private descriptions would suggest. Secondly, the publicly provided health services in Ireland co-exist with a substantial private sector. Consideration of any proposed reforms must therefore include an analysis of the health care system as a *whole*.

3. HEALTH CARE – MARKET OR NON-MARKET ALLOCATION?

The first, and fundamental question addressed by the Council is whether health care can be provided, like most commodities, in the market place. Health care, it might be argued, can be provided in the market. It has a supply side of producers

and distributors (chemists, doctors, hospitals etc.) and a demand side (consumers/patients), and in a free market prices would be determined by the interaction of supply and demand. However, for markets to work *efficiently*, a number of conditions must first prevail, and if any of these are absent, then grounds for departing from a market system arise (Barr, 1987; Le Grand and Robinson, 1984).

The Council has considered the relevant theoretical material to determine whether first principles provide an initial basis for market or non-market allocation of health care¹ From its assessment of the theoretical issues the Council has considered that significant departures from the conditions for market allocation can be expected in the case of health care. The Council therefore accepts that there is a strong case on *efficiency* grounds for substantial non-market allocation in health. This preliminary conclusion does not automatically imply *total* public production or finance of health care. Furthermore, because of the analytic distinction, illustrated in Figure 9.1 above, between the finance and production of health care, it is important not to extend the theoretical efficiency case for non-market allocation to an argument for a particular health care *system* (such as a National Health Service).

What the *specific* arrangement should be for the production, finance, management and delivery of health care are questions which are now considered.

(i) Health Care Provision – The Commission’s View

The Commission’s report considers the fundamental aspects of health care provision in a framework of *policy criteria*. These criteria – comprehensiveness, cost effectiveness and equity – reflect exactly the terms of reference given to the Commission (see above). Alternative ‘models’ of funding health care were then considered by the Commission in the light of these criteria and the majority of the Commission recommended that: “The Irish health services should continue to be primarily tax funded and publicly regulated”. In addition, the Commission made recommendations about the role and extent of ancillary methods of finance (such as charges, private insurance and Lottery Funds).

The Commission’s conclusions inescapably derive from its policy principles and criteria. It is important to note that, while the Council’s conclusions are broadly compatible with the Commission’s, the efficiency and equity rationale adopted by the Council is based on *theoretical* considerations rather than the policy principles adopted by the Commission. In particular, a telling argument in support of largely non-market health care is the absence of the most basic pre-conditions for the efficient functioning of a market for health care. Without recourse to the a priori equity considerations of the type advanced by the Commission, a substantial case exists on *efficiency* grounds for non-market allocation of health care.

1. This material is contained in an annex to this chapter which is not published in this report, but which is available on request from the NESCC.

In the next section the specific options for the finance of health care are considered more fully. One important point is entered here as a prelude to this discussion. Health care systems are generally classified into ideal types such as National Health Systems (the UK), Social Insurance Systems (Canada, Holland) or Private Systems (the USA). Such ideal types are identified by reference to a combination of financing, organisational and delivery characteristics. For example, and simplifying somewhat, National Health Systems are publicly funded from general taxation with central State control on total expenditure, universally free access to most services and direct State provision and delivery of services. Analytically, however, it is not necessary, or even helpful, to combine all of these dimensions – financing, organisation and delivery. On the contrary, as the Commission argues, and as the theoretical exposition shows, it is important to separate these different dimensions. To quote from the Commission:

Throughout this report, the Commission makes a clear distinction between *funding* and *delivery* of health services. It is possible, for example, for health services to be funded wholly or partially from public sources while at the same time for some of them to be delivered through the private sector (Commission on Health Funding, 1989: emphasis added).

In line with this correct analytical distinction the Commission separately considered the issue of the finance of health care.

(ii) Private Insurance

De facto the arguments in favour of market allocation of health care amount to an argument for private *insurance* finance. Advocates of market provision recognise the unpredictability and cost of possible future illnesses and point to insurance as a market mechanism to cope with this uncertainty. In favour of this strategy, it is argued, individual consumers can determine their total level of health expenditure and the type of care they receive; they can also choose among health care providers.

The pre-conditions for an *efficient* private insurance market in health do not exist. Firstly, the problem of *adverse selection* arises as individuals with poorer health are *more* likely to seek insurance and, furthermore, consumers will have an incentive to conceal their true health and thus their probability of claiming. Secondly, *moral hazard* will exist as consumers can themselves affect the probability of certain illnesses and, more importantly, health care providers and consumers can affect the amount of the claims – indeed providers may have an incentive to do so.

Thirdly, the outstanding difficulty of a private insurance strategy is the problem of the poor who cannot afford insurance, the known chronically ill who would be refused insurance, and those who simply chose not to be insured. One outright solution to this “gaps in coverage” problem is for the State to directly provide

health care – or to pay for it – for those not covered. Under these conditions, private insurance must either offer something ‘extra’ to the State’s provisions or else no-one will become voluntarily insured, in which case private insurance becomes relegated to a minimal role. A more limited approach to the coverage problem is to make private insurance *compulsory* and to pay the premia for those below a “poverty threshold”. This solution, however, ignores the serious difficulties of enforcing compulsory insurance (how would the uninsured be identified?) and still leaves the more complex question of which groups among the “uninsurable” to subsidise (The elderly? The chronically ill? The handicapped? Would handicapped spouses of privately insured persons be subsidised?)

The control of costs is a central issue in the assessment of health funding systems. *A priori*, under private insurance, consumption is not constrained by price at the point of utilisation, nor is it limited, as in a public system, by administrative or political means. On the *supply* side the doctor/supplier has no incentive to ration the amount of care – this tendency is exacerbated in practice where doctors are paid a fee per item of service (Nolan, 1988). In effect, therefore, private insurance tends to *over-consumption* among the insured and *under-consumption* among the uninsured if the “gaps in coverage” have not been properly resolved.

These *a priori* considerations are borne out in the comparative research on systems of health care finance. The system of finance in the USA is the nearest practical example of the private finance model. Comparative analysis reveals that the growth of health spending there has been most rapid – health care expenditure rose from 4 per cent to 11.1 per cent of GNP from 1965 to 1987. Attempts to deal with the cost explosion through “cost sharing” and regulation have not dealt with the underlying problem; the process of cost control and regulation in a competitive provider context *generates costs*. Providers respond to this cost environment through non-price competition, competitive advertising and marketing and tighter administrative scrutiny and regulation of professionals’ behaviour (OECD, 1987A; Barr, 1987, pp.325-326; Quam, 1989; Roemer and Roemer, 1982).

A recent review of the American attempts at cost control – identified five specific difficulties as follows: (Quam, 1989).

- (a) Rising Administrative Costs: this is intrinsic in a system with over 1,000 insurance companies, a proliferation of State and federal programmes for veterans, the disabled, the poor and the elderly, each programme with its own billing system, premia collection, financial management, advertising and marketing, and so on.
- (b) High Cost of Redressing Information Asymmetries: to redress the imbalance between consumers’ and practitioners’ information, insurers, professional groups, employer funders of health insurance and federal and State agencies have all developed costly review procedures, management information systems and auditing systems; – consequently, any one hospital can have a large number of utilisation review programmes.

- (c) Volume Increases to Recoup Unit Price Reductions: Despite a 45% increase in physician numbers in the US from 1975 to 1987, total costs increased due to supplier-induced demand. Medical services increased in intensity and volume as indicated by surgery rates, incidence of diagnostic tests, X-ray utilisation etc. These increases were exacerbated, according to some studies, by compensatory responses on the part of suppliers to unit price reductions.
- (d) Non-Price Competition: Hospitals in particular have engaged in non-price competition by adding value to services through improved non-medical amenities.
- (e) Consolidation of Providers into Bargaining Units: HMOs (see below) initially had significant 'buyer' power over physicians and other providers such as hospitals. To counteract the competitive power of the HMOs, hospitals and physicians have now begun to form bargaining units. This development has called forth a further layer of inspection and regulation: the Department of Justice's Anti-Trust division now has a role in monitoring these bargaining units.

An extended quotation from this recent analysis of US Health care costs gives a succinct summary:

There are three main reasons for this continued rise in expenditure. First, administrative costs increased in the 1980s as competition resulted in a rise in the number and complexity of transfers. Second, the federal government, insurers, and employers attempted to redress the information asymmetry in medical care by monitoring the appropriateness of medical care. These attempts to detect inappropriate medical care proved very costly. Third, despite competition, health care providers maintained their incomes by increasing service volume, by competing on the non-price grounds of patient amenities and prestigious medical services, and by organising effective bargaining units.

Cost containment has not reduced total expenditure or the incomes of health care investors, providers or institutions. None the less, significant reductions have occurred in the provision of health care services to particular patients, for example, the uninsured. As well as increasing cost, the 1980s has been a decade of declining quality of care as measured by several indicators, including the percentage of the population with health insurance, the infant mortality rate, and the childhood vaccination rate.

Increased quality of care was an intended outcome of the competitive strategy. However, increased competition exacerbated the financial access problem in the US. Health plans profit more readily from enrolling healthy patients than effectively managing medical care resource allocation. Furthermore, hospitals and physicians gripped in competitive manoeuvres are less willing to provide uncompensated care to uninsured patients. These

events operate within an American health care environment in which over- and under- treatment based on a patient's insurance status has long been endemic. (Quam, 1989)

Considerations such as the above impelled the Commission to reject private insurance as its *main* funding mechanism. In addition, the Commission argued that it would be more difficult to have a planned, integrated health service, and to retain a 'Community rating' premium structure in a private funding context. The Commission's assessment of the private funding approach is supported by theoretical considerations and by empirical evidence. Accordingly, the Council is of the view that a private insurance regime cannot be the *general* source of finance for health care.

In relation to the private funding model a minority report argued for a *greater* role for private insurance. Specifically, this minority view recommended:

- (i) restriction of entitlements for middle and upper income groups;
- (ii) compulsory private insurance for these groups for "core" services only (i.e. services deemed to be free for all groups in the majority recommendation about eligibility);
- (iii) Community rating to be retained for health insurance;
- (iv) retention of tax relief on health insurance for "core" services.

This view is put forward on two grounds. First, the growth in public health expenditure on health is underpinned by "a system of financing which relies so heavily on central government taxation". This argument ignores the central point that the macroeconomic efficiency of health care is properly measured by *total* (public and private) expenditure (as a % of GNP for instance) not public expenditure. In this regard private systems are less efficient at expenditure control than public systems. The recent experience of Ireland, the UK and other countries reveals that public expenditure on health – its level and composition – can be, and has been, directly and centrally controlled through political and administrative decisions.

The second argument advanced for this minority recommendation is redistribution: "the extent to which the health services need to be tax financed depends on how much redistribution you want to do". It is clear from our discussion (see Annex) of market and non-market allocation that *efficiency* criteria primarily dictate non-market provision, not redistributive criteria.² Further difficulties about these minority proposals concern the questionable assumptions that: (a) Community rating can be retained in a competitive, expanded insurance market and (b) that the compulsion element in insurance can be enforced.

2. Even if redistribution is accepted as the policy objective, the redistributive impact of a tax financed system of *basic* services for all, combined with greater entitlement for those on low incomes, is more redistributive on net tax/benefit criteria than very limited entitlement combined with tax subsidised private insurance.

expenditure. In the terminology of Nolan's review of funding models:

It is questionable, from the wider perspective of the public finances, whether health expenditure should be distinguished from other forms of public expenditure in this way. Removing a major element of expenditure from the direct control of the overall policy makers would leave other areas to bear the entire burden of adjusting to either exogenous influences or desired policy changes in the overall revenue/expenditure balance. In any case, it is arguable that State expenditure on the health services should be decided through the political process in a similar manner to expenditure on, for example, social security or education, rather than treated as a quite distinct form of social expenditure: while it obviously has particular features, health care does not appear *a priori* to clearly deserve special consideration compared with other such State expenditures (Nolan, 1988).

In any event, if the objective of a secure funding base for health *were* accepted, it is not clear that the fund proposed would be successful. The "exchequer contribution" to the fund would be affected by the wider fiscal context and would be subject to the discretion of Government.

One issue raised in the Commission's report about an insurance contribution model is the narrowness of the funding base for health care which it implies. This narrowness would, in effect, render the funding base less progressive. Further, in the variant of this approach described in the quotation above no reference is made to matching contributions by employers on behalf of employees. This is the norm in countries with insurance-based health systems: if no such features were to be included it would require very high contributions on individual subscribers. Conversely, if an "employer contribution" is envisaged it would be difficult to justify it in current Irish circumstances because of its possible effect on employment. Finally, the existence of public/social insurance regimes for health in some countries reflects the historical importance of social insurance in these countries rather than a deliberate and planned commitment to a specific method of health care financing. Social insurance schemes, which originated as Trade Union Friendly Societies or Benevolent Societies in the 18th century, gradually evolved into more comprehensive and State-based schemes and incrementally increased their role into *health* care provisions. Social insurance mechanisms of health care financing reflect *historical* patterns. The Council is not convinced by the arguments advanced in support of a social insurance system for health care.

(v) General Tax Financing

The Commission, having established to its satisfaction that private market provision could not fulfil the main funding role, proceeded to examine alternative public or tax based financing systems. One of these, a social insurance scheme, was advocated by a minority and was discussed above. A second taxation option was local taxation which was unanimously rejected, for which a theoretical

rationale would be difficult to identify and which, therefore, is not discussed further here. Thirdly, the Commission considered taxation from general taxes for which the majority of its members opted.

To consider the validity of this model the theoretical considerations outlined in the annex can be consulted. If health care is publicly financed and largely free at the point of use then the problems of consumer information, information about the future and so on are dealt with. None of the problems of insurance coverage among the poor or the chronically ill arise. On the supply side, health care can be explicitly rationed by administrative or political dictate. If health care suppliers are not subject to a fee for service remuneration system, the incentives to over-supply implicit in the private third party payment context will not exist. Tax based systems also avoid the significant administrative costs which must arise in private finance systems – billing, premia setting, actuarial work, advertising, regulation and so on. In principle, therefore, in the cautious assessment of Barr:

the strategy is feasible in both efficiency and equity terms (Barr, 1987).

However, the feasibility and efficiency advantages of this financing approach are contingent to some extent on *specific characteristics* of the health financing system which is put in place. For example, if doctors work under a fee-per-item of service system – as was recently the case in Ireland under the GMS scheme – there will be an incentive to over-supply in the absence of price (or other) controls on patient demand. Similarly, and more importantly, in the case of hospitals, if patients are not subject to charges and hospitals have open ended budgetary systems, then neither the patient nor the doctor have an incentive to economise on resources, leading to excessive utilisation and expenditure.

In relation to the *equity* aspects of publicly financed health care, it should first be noted that the health care system functions in a context of social inequality. This inequality is manifest in the health domain: a considerable body of international research has documented significant differences between socio-economic groups in health status, as measured by levels and patterns of morbidity and mortality (Carr-Hill, 1987; DHSS, 1980). Socio-economic health differences in Ireland have not yet been researched. However, preliminary analysis of mortality differentials has revealed (statistically significant) disparities in the *mortality ratios* between socio-economic groups (Nolan, 1990B). As the data in Table 9.1 indicates, the (standardised) mortality ratios for unskilled managerial males in 1981 was 163 and for professional/managerial males was. 55.³

3. A standardised mortality ratio of 100 for any category indicates that its mortality ratio is average.

Table 9.1
Standardised Mortality Ratios (SMRs) for Men Aged 15-64
Socio-economic Group, Ireland 1981

Socio-economic Group (Predicted) x 100	Actual Deaths	"Expected Deaths"	SMR =(Actual/ Expected)
(0) Farmers, etc.	806	1,022	79(a)
(1) Farm labourers & fishermen	170	198	86(a)
(2) Higher professional	101	184	55(a)
(3) Lower professional	101	128	79(a)
(4) Employers & managers	197	317	62(a)
(5) Salaried employers non-manual wage earners	77	109	71(a)
(6) – White collar	427	406	105
(7) – Other	501	482	104
(8) Skilled manual	742	819	91(a)
(9) Semi-skilled manual	260	222	117(a)
(X) Unskilled manual	630	387	163(a)
(Y) Unknown	619	356	174(a)

(a) Significantly different from 100 at 95% confidence level.

Source: Nolan, 1990B.

These data are strongly indicative of underlying differences in health status and may provide a significant *equity* rationale for publicly financed health care. However, it must be recognised that the relationship between public provision of health *care* and the pursuit of equality in health *status* is complex. In particular, public financing of health care must be accompanied by effective *access* to and *utilisation* of health care if the impact of public provision of health care on health status inequalities is to be maximised.⁴

4. There are two other complexities in the health care/health status relationship: (i) equalisation of health status may require *other* policies outside of the health arena – income distribution policies, for example; (ii) the impact of health care and health services on *actual health* is by no means straightforward.

Finally, to secure the equity advantage of public financing, a further condition must hold. The tax base from which services are funded must be progressive overall.

To highlight the relative merits of tax-based systems it is worth noting certain features of the NHS in Britain – the actual system closest to the model under consideration. One key feature of the extensive comparative research in the 1980s is the success of centrally controlled, publicly financed systems in containing total health care costs. In the compendium of country studies compiled by McLachlan and Maynard, only two countries, Canada and the UK, have *not* suffered a cost explosion; both systems are publicly financed systems and in both there is an explicit, global public expenditure constraint. This does *not* mean that these countries have not been subject to cost pressures, for as they point out:

however much health systems and policies may seem to differ from country to country all current policies have one major aim, cost containment... not just *unit costs* but also *total* expenditure in both public and private sectors (McLachlan and Maynard, 1982).

In short, experience suggests that public finance systems are more efficient in *macroeconomic* terms.

Turning to *micro*-efficiency, two further issues arise in modern health care systems – the regional allocation of resources and the allocation of resources to different types of medical care. On the first issue, in some publicly financed health systems centrally determined mechanisms have been developed to measure regional variations in population, needs and costs and to allocate resources accordingly. The experience of the UK shows that inequality in geographical resource distribution was significantly reduced in the period 1977 to 1985 as a result of a central allocation system (Bevan and Mays, 1987).

The second issue has proved less amenable to change in both public and private systems. The restructuring of systems away from institutional care has been an intractable problem as has the tendency to relative underfunding of certain areas of care – geriatric services and services for the handicapped, for example. Public, as well as private systems, have great difficulty in conceptualising, measuring and ranking *needs* and this contributes to the relative under resourcing of such areas. However, it is likely that tradition, unequal power among different groups of health care patients, and the professional preferences of providers also underpin the allocation of resources. In principle, a centralised decision-making system in a publicly financed regime should be better able to redress these imbalances than the diffuse decision-making system of a private financing regime. The Commission adopted this latter argument:

A further advantage of a public funding approach is that the State acting as central funder is most favourably placed to plan and organise the delivery of

a unified, integrated services for all categories of patient. We believe that this represents the best means of getting the most comprehensive service for a given level of resources. This is particularly relevant in the efficient use of highly expensive high technology medicine. In addition, the implementation of national policies, such as the substitution of primary care for institutional care, is more easily achieved under a single major health care funder (Commission on Health Funding, 1989).

It should be noted that restructuring of health care towards primary and community care and away from institutional care may take place under a public financing regime. However, the restructuring is dependent on *specific* incentives and arrangements as the Council's previous work on community care has shown (NESC, 1987).

The arguments in support of a public, tax financed system, while they are justified by theoretical criteria and by the comparative experience of various systems, are not absolute arguments. A final judgement about the choice of a system depends also on the *relative* effectiveness of one system over the available alternatives in achieving equity and efficiency objectives. Even if tax-financed systems do not fully achieve equality of access and utilisation they do so more effectively than other systems. Likewise in regard to the relative effectiveness of different systems in controlling total costs.

The Council's analysis here broadly endorses the tax financing proposal. However, it must be recalled that *tax/public financing* does not automatically entail direct public *production* and *provision* as the Commission pointed out. This distinction, in the Council's view, is crucial to an understanding of the problems, and the potential reform of the Irish health care system. Finally, in adopting the arguments in favour of a publicly financed system, the Council recognises that a role will remain for private finance in the total health care system.

4. TAX FINANCED HEALTH SERVICES – ELIGIBILITY

The current system of eligibility for publicly financed health services is summarised below in Figure 9.2. It comprises three tiers of eligibility: the lowest tier allows full eligibility, free-of-charge, to all health services. Categories II and III have correspondingly lower entitlements. In the context of a proposed tax financed system, the question arises as to what the appropriate system of eligibility for publicly financed services should be.

The Commission advocated a *two category* structure with the lower tier entitled, without charge, to specified "core" services and additional services. A higher tier is proposed with entitlement to the core services only (Figure 9.3).

Figure 9.2
The Existing Entitlements of Each Eligibility Category

CATEGORY I

Persons in Category I are entitled to a full range of public health services without charge:

- General practitioner services;
- All in-patient hospital services in public wards;
- Specialist services in out-patient clinics;
- Prescribed drugs, medicines and medical and surgical appliances;
- Dental, ophthalmic and aural services, including the supply of prescribed dental, optical and aural appliances;
- Maternity care and infant welfare services; and
- Maternity cash grant.

CATEGORY II

Persons in Category II are entitled to:

- All in-patient hospital services in public wards, at a daily charge of £10, subject to certain exclusions and limits;
- Specialist services in out-patient clinics, excluding dental, ophthalmic and aural services. There is a charge of £10 for the first visit in respect of any specific condition, subject to certain exclusions and limits;
- Refund of expenditure in excess of £28 per month on drugs prescribed for use within the month for adults and their dependants;
- Prescribed drugs and other requisites for certain long-term illnesses, as discussed in Chapter Fifteen; and
- Maternity care and infant welfare service, including ante-natal family doctor services, and post-natal family doctor services for mother and child for the first six weeks after the birth.

CATEGORY III

- Persons in Category III are eligible for services on the same basis as those in Category II, except that they are liable for hospital consultants' fees and are not entitled to the maternity care and infant welfare service.

UNIVERSAL ENTITLEMENTS

Certain services are available free of charge to all, irrespective of eligibility category. These include:

- Treatment for infectious diseases, including immunisation, diagnostic and hospital services;
- Certain child health services, including health examinations at national schools, and at clinics for children up to six years; specialist services for defects diagnosed at such examinations; and all hospital treatment in respect of dental, ophthalmic and aural conditions diagnosed at the examinations above;
- In-patient and out-patient services for children up to the age of sixteen years with specified long-term diseases and disabilities;
- Cervical smear screening (free to all women at health centres; free to medical card holders when attending their general practitioner); and
- Rehabilitation services, including vocational assessment and training for physically and mentally handicapped persons.

Figure 9.3
Proposed Eligibility For Health Services

CATEGORY I	CATEGORY II
CORE SERVICES	
Inpatient Hospital Services	
Outpatient Hospital Services	
Maternity and Infant Welfare	
Treatment of Infectious Diseases	
Child Health Examinations	
Cervical Smear Screening	
Rehabilitation for the Mentally and Physically Handicapped	
Additional Services	
GP Service	
Free Drugs	
Dental, Ophthalmic and Aural Services	
Maternity Cash Grant	

In this two-tier system, patients in the *higher* income category are entitled to all in-patient hospital services, including consultants' services. This is a significant departure from the current arrangements whereby those currently in category III must privately finance their access to consultants' services. An essential corollary of this eligibility pattern is that patients would be obliged to choose between public and private care. This contrasts with the present situation in which patients may utilise a *publicly financed bed* at the £10 daily charge and combine it with *privately financed consultants' services*.

The central reasons for this proposed structure are, firstly, that in a tax financed system persons at all income levels will be contributing to the financing of the services and it would be inequitable therefore to exclude them from entitlement to the "core" or essential services. Secondly, it is desirable, on equity grounds, to abolish the current Category III. In the Commission's words, the existence of this category "institutionalises unequal access to public hospitals by requiring persons in this category to obtain private consultant services". The argument is that a *requirement* that those with the highest incomes pay for consultants' services is also a *guarantee* that there will be unequal access to services.

The general eligibility structure proposed by the Commission is consistent with their financing proposals and with their emphasis on efficiency and equity. The Council, therefore, endorses the proposals in principle. However, any endorsement of the proposed structure must be conditional on an appropriate demarcation between the two proposed categories. The Council notes that this demarcation, which is not specified by the Commission, would have crucial implications for public expenditure on health and for other aspects of the health care system.

(i) GP Costs

The current distinction between Category I and Category II eligibility is based on the medical card income guidelines, summarised in Table 9.2. Under the proposed two-tier system these thresholds could be retained. It could also be argued, however, that the existing medical card thresholds should be revised upwards on two grounds. Firstly, GP costs in particular are excessive relative to income, for individuals and families above the threshold. Secondly, the thresholds interact with other means tests for Social Welfare, Family Income Supplement and Local Authority Differential Rents and, furthermore, medical card entitlement is an automatic 'trigger' to other entitlements (school transport, exemption from Health and Youth employment levies for employees).

In relation to the first of these points the Commission argued as follows:

The Commission does not believe that liability for the fees of general practitioners places an undue burden on persons outside Category I. We received no evidence from submissions to us or from other sources that this was the case (Commission on Health Funding, 1989).

Table 9.2
(A) Medical Card Guideline: Allowable Weekly Income, 1989

	Single Person Living Alone	Single Person Living with Family	Married Couple
Age	£	£	£
Under 66	72.00	62.00	103.50
66 – 79	77.50	67.00	115.00
80 and over	81.00	70.00	121.00

	£
Allowance per child under 16	12.00
Allowance for other dependents	13.50
Outgoings on house in excess of Reasonable expenses necessarily incurred in travelling to work, in excess of	12.00
	10.50

(B) Illustrative Weekly Allowable Incomes

Single Person Under 66, Rent of £20 per week	Elderly Couple(–80) with Non-Contributory Pension – No Mortgage	Married Male Employed, Wife, 2 kids, £80 per Month Mortgage
£80	£115	£159.50

This point was made in the context of their argument against *universally free* general practitioner services.

However, it is important to consider the relationship between utilisation of GPs and disposable income more closely. In particular, a case might be established that families (i.e. families with dependent children) on average or modest incomes may face GP costs which are significant relative to their incomes because of high GP utilisation rates for children. The data in Table 9.3 examines this issue by taking a

family of a couple with two children, one under 5 and one over 5, (and assuming GP visitation rates for 1988 for medical card holders). The calculations, which are merely illustrative, indicate that even on the basis of the utilisation rates for the poorer GMS patients, GP costs are small relative to their incomes. If the crude assumption is adopted that, per visit, the average cost per GMS prescription item is also incurred, the prescription medicines (20.42 x £6.31) add a further £129 annually. Total costs are still a small fraction of net income even when the net *disposable* criterion (housing costs deducted from income) is applied. On balance, therefore, it is likely that the relationship between GP related costs and family incomes is not problematic for those in the middle range of the income distribution. The Council considers that it would be difficult to sustain an argument for a significant general revision upwards of the GMS eligibility thresholds.

Table 9.3
GP Costs for Family on Average Earnings: Man, Wife, Children (one <5, one >5) with Small Mortgage, 1988

Income	£ p.a.
Gross Earnings	12267
Net Earnings	9253
Child Benefit	361
Net Income	9614
Net Costs:	
Man	43.50
Wife	71.90
Child 0-5 (female)	58.20
Child 5+ (male)	33.60
Total	207.20
GP Costs as % of Income	2.2

Notes: GP fees are assumed to be £10 per visit (surgery and domiciliary) and consultation rates for medical card holders are applied.

(ii) Category I/II Means Test – A Poverty Trap?

The second question concerns the interaction of GMS thresholds with other means tests: this raises more complex questions which cannot be fully examined here. Suffice it to note that a proliferation of means tests may give rise to 'poverty traps' and disincentives (Blackwell, 1988). Estimates prepared by Blackwell for 1988

suggest that marginal tax rates of 96%, 145% and 140% apply on weekly earnings of £110, £120 and £130 respectively for couples with 2 children. These outcomes are the net effect of the combined changes in taxation, PRSI, medical card entitlement and local authority rents. These estimates suggest that there may be a strong efficiency argument for careful consideration of Category I/II thresholds, or for greater co-ordination between separate means tests.

(iii) Free GP Services for All?

A different point of view about the Commission's eligibility structure is that expressed in a minority view, as follows:

I disagree with the recommendation contained in paragraph 11.56 that only medical card holders should be entitled to a publicly-funded general practitioner service. Many middle and low-income families outside of the General Medical Services scheme are deterred by price from utilising general practitioner services which they need. Such an inequitable situation can only be improved by the introduction of a free general practitioner service for all the population. The higher cost of this form of primary care would be more than offset by a corresponding reduction in the utilisation of hospital services. Indeed, a situation where one hundred per cent of the population would be entitled to Core Services largely free while, at the same time, less than 40 per cent would be entitled to an additional general practitioner service without charge, is quite clearly a complete contradiction of a stated desired policy of emphasis on primary health care to which General Practice is central (Commission on Health Funding, 1989).

It would be difficult to support these arguments. The "deterrence" by price to GP consultation is related to income and can hardly apply to the *entire* income distribution. There may be a case for a limited revision of the existing Category NI thresholds upwards, in the light of the 'poverty traps' argument noted above. However, neither the 'poverty trap' argument nor the 'deterrence' argument offer a valid rationale for universal GP coverage. There would, moreover, be budgetary costs associated with any significant extension of free GP services – costs which cannot be easily quantified.

The argument that universal access to GPs will reduce utilisation of hospital services has some merit in principle. However, the Council considers that the development of primary care is dependent largely on the management and organisational changes identified in the Council's earlier work (NESC, 1987). In particular, there is a need to develop and enhance General Practice and to integrate it more fully into the health care system.

In summary, the Council supports the principle of the two tier eligibility structure proposed by the Commission. However, there is a need to carefully specify the demarcation between the proposed categories in the light of data about utilisation

patterns at various income levels, and about the extent and severity of actual and potential poverty traps.

5. EFFICIENCY, INCENTIVES AND BUDGETS

Throughout the Commission's report an emphasis on efficiency is repeated in a variety of contexts. The Council does not re-iterate here all of the individual proposals with efficiency implications. However, the Council addresses a number of aspects of health policy where efficiency implications in particular arise.

(i) Incentives to Providers

In relation to GPs, the Commission considers the capitation system of remuneration which was first implemented in 1989. This system remunerates doctors a fixed amount per GMS patient on their panels – with the amounts differentiated by age, sex and geographical location. Separate fees per item of service are also paid for specified services. Evidence regarding the fee per item of service had indicated a tendency to 'oversupply' (Tussing, 1985). The significance of this pattern was its impact not only on direct GP costs in the GMS scheme, but also on the associated costs of prescribed medicines and follow-on referral for diagnostic and hospital services. The Commission therefore concluded that:

the revised remuneration system offers a number of potentially important advantages. In particular we hope that the incentive towards over visiting will be removed (Commission on Health Funding, 1989).

Consistent with this analysis, the Commission were careful to point to the arrangement in the capitation system of payment for specified procedures, and to call for monitoring of this arrangement to ensure economic use. The Council supports the Commission in this analysis.

A more general point concerning GPs remuneration within the GMS is the potential scope to develop a more structured HMO type GP service for private GP patients. The economic argument in favour of a capitation system applies also in principle to private GP practice. The lesson of HMO systems is that, in certain circumstances, more cost effective and medically more effective care can be obtained through HMOs organised at primary care level. In the Council's view, it would be a valuable initiative to experiment with a HMO type system as follows:

- (a) identify a high quality GP group practice in an area of large population;
- (b) establish on a pilot basis a 'capitation' system per private patient for this practice – using, if necessary, some incentives to patients to enrol, and modifying private insurance coverage for GPs to this end;
- (c) specify as wide a range of services as is medically feasible to be provided at the primary care level for the pre-specified capitation payment;
- (d) experiment with extending this concept to GPs becoming budget holders, and purchasing 'non-primary' care on patients' behalf from hospitals, consultants and other providers.

The Council's argument here is neither a critique of the Commission's analysis nor a generalised suggestion for HMOs, but a plea for experimentation to identify the specific and limited conditions in which a number of objectives can be pursued:

- development of a resource usage awareness at primary care level;
- initiation of competition, where appropriate, between providers of high cost care;
- establishment of a framework in which the relative costs of primary care and secondary care are made explicit for both public and private GP practice.

(ii) Hospital Budgets

The *second* and more important area of budgetary concern is in the area of *hospital budgets*. On this question the Commission noted the incremental nature of hospital budgets in Ireland and advocated the development and application of a case-mix approach to hospital budgets, which would include an assessment of the hospital's role and geographical catchment area. Activities such as out-patients services, teaching and research would be separately quantified and funded.

In brief, a case mix approach would entail a formal analysis of the patterns of illness, and the types of care received by hospital patients. This analysis of the "case mix" in hospitals is then put in the context of the *costs* which are associated with different "case mixes". Such a framework allows hospitals with a similar case mix to be compared in terms of resource usage, and facilitates changes over time in the case mix of hospitals to be identified – and their cost implications quantified. It also allows *intra-hospital* management to be improved by identifying differences in the case mix within sub-hospital units and allocating resources accordingly.

DRGs (Diagnostic Related Groups) have proven to be the most successful case mix approach in health systems internationally.⁵ DRGs comprise discrete and mutually exclusive groups of diagnoses entailing similar types of care and similar service utilisation. The US Medicare DRG regime contains 477 separate diagnostic related groups. When hospitals' activities are classified into DRG's, the DRG data is then analysed in conjunction with a detailed cost accounting exercise to arrive at unit costs of services data, and ultimately, at unit costs per patient in each DRG. The costs data is then used to derive "cost weights" for each DRG. These weights can be combined with hospitals data on the numbers of patients and the case mix, to derive an overall index of the *relative* "costliness" of the case mix in different hospitals.

An analysis of the case mix in Irish hospitals has been recently published. The study demonstrates that a DRG-based, case mix approach is applicable in the Irish acute hospitals system. The authors point out that the study:

provides a strong basis from which to pursue the introduction of a case mix measurement system within the acute hospital sector in Ireland. The range of possible management applications spans both the intra and inter-hospital level (Wiley and Fetter, 1990).

The Council recognises the considerable policy significance of the case-mix approach to budgeting. It requires that hospitals' budgets be based on actual *levels of activity* and *actual costs*. For both the budget holder and the funding agency the relationship between *costs* and the *level* and *mix of services* is therefore made explicit. The Council therefore endorses the Commission's recommendation that a case mix methodology, complemented by clinical budgeting, be used for hospital budgets, and the Council notes that the methodology is now available to apply this technique comprehensively throughout the hospital system.

(iii) Prices and Charges

A third element in the Commission's efficiency strategy is its recognition of a potential role for prices and charges in the health care system, including the public system. In the context of a largely tax financed system, there may be scope to use charges to achieve two objectives: (a) to limit trivial or unnecessary utilisation and (b) to encourage patients and providers to use particular *types* of care. The Council accepts that these two objectives provide a rationale for the use of prices and charges. In practice, of course, a balance must be sought: if charges are too *high* they may deter utilisation among those on *low* incomes and if they are too low they will not achieve their efficiency objectives.

(iv) Budgets/Budget Holders

A theme which recurs throughout the Commission's report is that of health care being provided on a *budgeted* basis. The concept is essentially that providers and managers at various levels in the system be given budgets which are appropriate for *specified quantities* of services, and allowed the discretion to deploy the budget to produce the services to the required standard. This approach must be based on a correct analysis of the *actual costs* of providing services – such an analysis of costs will in turn require a considerable improvement in management information about resources and their utilisation.

The implications of a 'budgeted' system are illustrated in specific recommendations. For example, at area or regional level, it is proposed that managers would have the scope within their pre-determined budget to "buy in" services from other providers (public or private) if it is more 'cost-effective' to do so in that particular area. Further, the many quasi-public bodies which provide particular services, and which are *de facto* publicly funded, would be seen as providers who are *contracted* to deliver specific quantities and types of services. At present, the relationship between these bodies and their public funders is one of a subsidy/grant giving type. The underlying concept (referred to as the "internal market" in current UK debates on the NHS) in the Commission's analysis is that

5. DRG is the abbreviation for Diagnostic Related Groups.

providers should 'compete' for budgets to deliver services. This process it should be emphasised is *not* privatisation; it could entail public hospitals competing *within* the public sector for a particular service in a region, or public/private competition, or private hospitals (for example) contracting out services to public hospitals. Competition, and the efficiency and flexibility gains it can produce in specific circumstances, has a role in a largely non-market, publicly funded health care system. This is a fundamental conceptual re-orientation to health care. The Council believes that it merits attention in the Irish context and that it should be applied where appropriate.

(v) Information, Research and Evaluation

The Commission's deliberations on this subject are contained in a separate chapter. In addition, research and information related recommendations arise in its proposals for the management, delivery and monitoring of services. The chapter on "The Role of Information..." concludes with eighteen individual recommendations. These recommendations are not itemised and assessed here.

To appreciate the importance of this aspect of the Commission's work it is helpful to conceptualise health care as a system, as shown in Figure 9.4. At each 'stage' in the system fundamental information needs arise if the system is to be funded, managed, delivered and monitored adequately. Basic epidemiological data and data on illness for instance are necessary to measure needs and to allocate resources accordingly. What resources are used, what alternative uses resources have, and what the actual detailed cost of specific services are, are the most central research questions and they require the development of modern, comprehensive management information systems. Measures of activities such as the quantity of consultations, number of home visits, number of examinations etc. are necessary to describe how resources are used. Finally, but more problematically, health care 'outcomes' must be defined and quantified – this aspect of health care management is least well developed and least amenable to standardised, simple procedures.

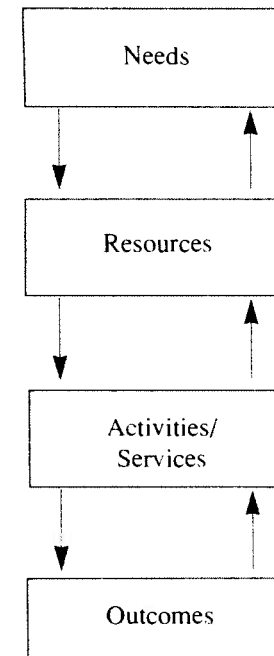
In brief, the Commission's report shows that at all levels of the system the information and research function is significantly underdeveloped. The Council therefore supports the emphasis on information and research, although the Council considers that there may be scope for discussion about the precise institutional mechanisms which will best fulfil the Commission's research objectives.

6. ORGANISATIONAL STRUCTURE

In the Commission's assessment, organisational and management aspects of the health care system are crucial:

The kernel of the Commission's conclusions is that the solution to the problems facing the Irish health services does not lie primarily in the system of funding but rather in the way that services are planned, organised and delivered (Commission on Health Funding, 1989).

Figure 9.4
The Health System



Accordingly, the Commission analysed the existing structure and offered proposals to significantly alter the legislative and organisational relationships within the system.

(i) The Existing Structure

Central to the arrangements is the role of the Regional Health Boards. The 1970 Health Act vests in them the Statutory authority to administer services in their respective regions. However, many agencies providing services do not report directly to Health Boards and are not funded by them. Voluntary hospitals, for example, which control a large share of acute hospital beds are funded directly by the Department. Other central agencies have a national role in policy – for example, Comhairle na N-Ospideal is the authorising body for the replacement or creation of medical consultant posts. At regional level the Boards sub-divide their programmes into Hospitals, Community and Special Hospital programmes, each programme with a manager reporting to the Regional Chief Executive Officer. The Act obliges each Board to appoint a Chief Executive Officer to whom, in practice, Boards delegate management responsibility.

Six deficiencies in the organisational system were identified by the Commission, as follows. Firstly, *political* and *administrative* responsibilities are intertwined. For

example, the Minister, whose role is primarily a policy one, is regularly involved in executive decisions about specific services. The Department of Health deals on a daily basis with details affecting individual services, voluntary organisations, and claims and entitlements of individual citizens. Health Boards – partly political in membership, concentrate on detailed executive work; voluntary hospitals and voluntary organisations – primarily “deliverers” of services – effectively make *policy* decisions about the type, quality and mix of services, because of the “degree of autonomy they possess” (Commission on Health Funding, 1989).

Secondly, the balance of activities and decisions as between *central and local* is inappropriate. For instance, the Department of Health’s role in relation to Community Care should have been the development of general policies and guidelines, and models of service provision, and the rigorous enforcement of these on a uniform basis throughout the regions. In fact, the Department’s deficiency in national policy development left a vacuum which resulted in a failure to shift resources to community care and away from institutional care. Thirdly, the health care system as a whole does not embody one specific unit with responsibility for *evaluation*: the importance of information and evaluation in contemporary health care has been discussed above. Fourth, there is inadequate *accountability* in the system. As characterised by the Commission, the Minister and the Department have extensive control over many *details*, but limited control over major resources and providers. Thus, the Minister/Department’s control on appointments in Health Boards and other agencies extends to the number, type and grade and the qualifications required. On the other hand, the Department’s control over Health Boards is difficult to define. Health Boards may refuse to accept a centrally determined budget because of the implications for certain services; the CEO does not have statutory authority to cease certain services to remain within a budget. In the final analysis, the Minister’s power under the 1970 Act to remove a Board from office has never been implemented and this sanction is effectively non-existent. A further example is the difficulty facing Health Boards in managing the acute hospitals sector. About 50% of acute hospital services are provided by voluntary hospitals (higher in the Dublin area) and in areas such as services for the disabled and handicapped, services are provided by the voluntary sector – many of these agencies are accountable not to the Health Boards but to the central Department.

A fifth deficiency is an inevitable outcome of the characteristics noted above – the absence of unified, integrated management of health services, at regional/local level. Contributing to these problems are:

- (i) the partial independence of the voluntary sector from regional management;
- (ii) the absence of regional responsibility for certain services;
- (iii) the programme structure which may engender competition between programmes for resources;
- (iv) the inadequate representation of service users.

(ii) The Proposed Structure

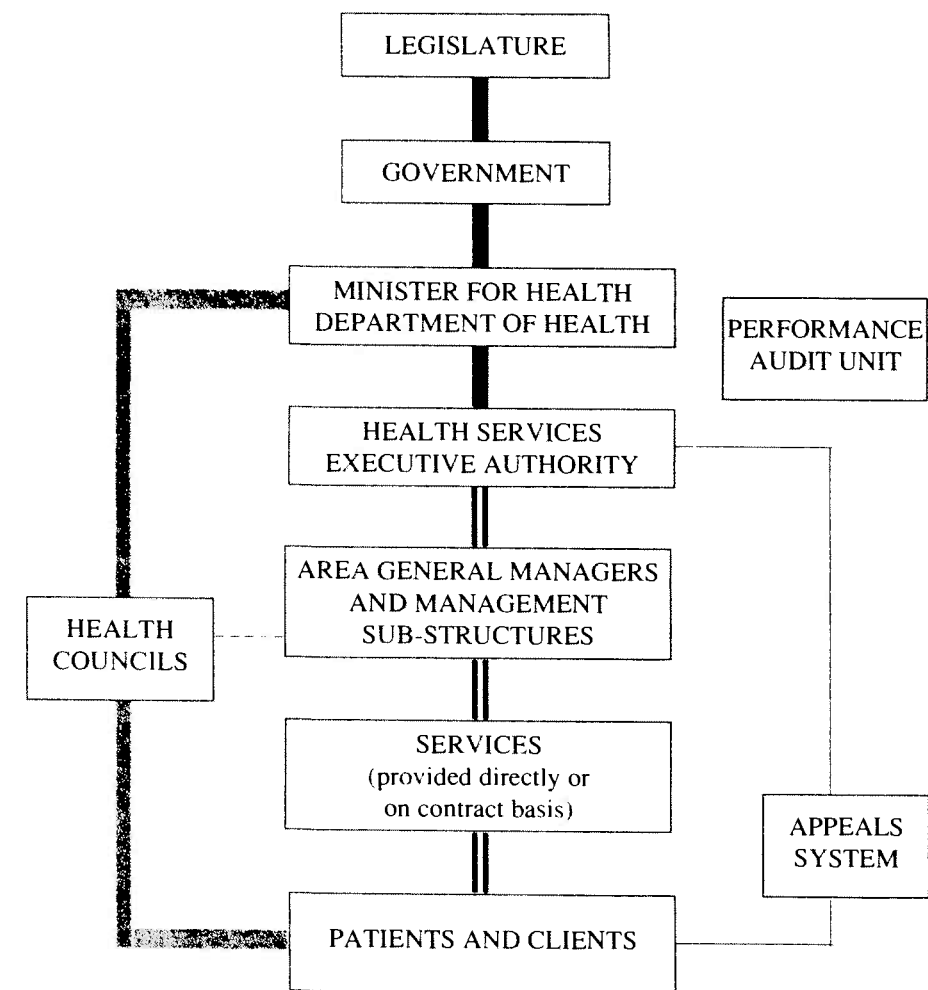
Figure 9.5 below, reproduced from the Commission’s report, summarises the Commission’s proposed structure. The key elements in the proposed structure are:

- Removal of the responsibility for day-to-day management from the Minister/Department and the establishment of a *Health Services Executive Authority* with responsibility for the management and delivery of services;
- A multi-annual budget, provided by the Minister and the Department, to the executive to provide a pre-determined set of services within a legislative framework;
- At regional level *Health Councils* would be established with consumer/political representation nominated in part by local authorities and with the specific role of advising the regional manager and providing feedback on service quality, community preferences etc.
- At regional level an *Area Manager* with a pre-specified Budget would have overall responsibility for the integrated provision and management of all services; the separate legal responsibilities of the Managers and the Health Councils should be established in legislation.
- A Performance Audit Unit, independent of the Health Services Executive, and separate from the Department, should be established to compile and publish data and evaluative material on the health services.

Underlying the specific structures proposed is a general view that at all levels in the health care system the *costs* of providing services must first be ascertained. Then, with costs known, the role of health care managers would be to deliver pre-specified quantities of services within the budget. For instance, the Area Managers, within their budget, would have discretion to contract particular services to separate agencies and to account for the quality and quantity of services ‘delivered’ by the agency. Similarly, the Health Services Executive would have freedom within the budget to alter regional and area boundaries in response to changing needs and priorities.

The Council supports the general diagnosis of the difficulties with the existing structure. In the Council’s view, however, it is by no means clear that all of the elements in the Commission’s proposed structure are consistent with their diagnosis. Firstly, the role of the Health Councils. It is not clear how, in retaining a political/representation function, the danger of local resistance to central policy and competition between regions for resources, can be avoided. Political representation takes place in a particular political culture which is highly localistic and competitive. It is likely that what the Commission referred to as a separation of ‘political’ from ‘administrative’ would not be brought about in this proposed structure. Furthermore, the logic of much of the Commission’s analysis of the health services would support a somewhat more centralised structure. On a priori grounds, it is not immediately obvious why a health care system for 3.5 million people in a small homogenous society (less than a region in the UK’s system) should have local political representation. In the absence of local councils,

Figure 9.5
The Proposed Administrative Structure



- KEY**
- █** : Service requirements are laid down by legislation or by ministerial directive on foot of legislation. Funds are voted by the legislature. The Department of Health supports the Minister in policy formulation and service review.
 - ▬▬▬** : Executive responsibility for the delivery of all health services.
 - - - -** : Mutual influence, cooperation and advice.
 - ⋮** : Independent appeals system for patients and clients.
 - : Input and consumer representation.
 -** : The Performance Audit Unit supports the Minister and Department in assessing the overall effectiveness of the health services

representation can and would be effectively made to whatever central authority or 'budget holder' was in place.

Secondly, the Commission's structure posits a very distinct categorisation of 'policy' on the one hand and implementation on the other. In reality it is more likely that policy evolves and develops out of experience of 'implementation' with many 'actors' in the policy system contributing to policy. The complete separation of *policy* (Minister and Department) from *execution* (Health Services Executive and Regional Councils plus Area Managers) may not be appropriate.

Thirdly, the establishment of the Health Services Executive would bring with it the danger of 'organisational capture': the process by which executive agencies develop their own interests, perceptions and policies and ensure that they *make* policy as well as implement it. The Irish public sector arguably contains many illustrations of this process whereby separate agencies at one remove from political accountability, become a 'lobby' for a set of interests and policies.

The Council accepts the Commission's critique of the organisational structure currently in place, but does not offer a definite view on the specific structure which is most appropriate. The Council considers it essential that the structure should facilitate the planning and management of the system as a whole, and should allow appropriate local autonomy to apply national policies in local contexts. In addition, the Council believes that the structures should have effective representation from service users.

7. THE PUBLIC/PRIVATE MIX

The relative status of public and private treatment in the acute hospitals sector has been a subject of particular controversy. A separate chapter on this issue is contained in the Commission's report, and recommendations which impinge on the relationship between public and private care arise in other chapters (Commission on Health Funding, 1989, Chapters 8 and 13).

(i) Should Private Hospital Care Exist?

The answer to this question, in the Commission's analysis, is pre-determined by the social and political context in which the health care system operates. It would be inconsistent with the values and preferences of the community as a whole if private health care were unavailable, provided a 'core' of health services is available to the population at large. The Commission, therefore, endorses this fundamental principle of choice and the Council likewise approves of the principle of freedom to choose private care, where necessary services are available to all. In the Irish case, however, a more specific and more difficult question arises: should private health care be available, as it is at present, in the public hospitals? Currently, many patients choose semi-private or private accommodation in public hospitals – others of course are in 'private' beds in private hospitals.

The argument has been made that this 'mix' is inequitable and inefficient and that public and private should be fully separated. It is argued that such semi-private/private accommodation in public hospitals is undercharged and, therefore, subsidised by the public sector. It may also be claimed that consultants give less than proportionate care and attention to their public patients to the benefit of those who are private/semi-private. Finally, it can be argued that consultants can use semi-private/private admissions with some autonomy, rendering it impossible to plan and organise admissions and bed usage overall. Against this point of view, and in support of a mix of public and private, three arguments can be made:

- (i) income from semi-private/private accommodation (£40m in 1988) is significant for the public hospitals;
- (ii) the consultants' obligations to public patients, are *more* likely to be honoured where their public patients are in the *same* location as their private patients;
- (iii) the separation of public and private treatment into distinct institutions would lead to the public institutions becoming stigmatised and residual ("a service for the poor is a poor service").

The Commission recommended that the mix of private/public in the public hospitals *should* continue, but that it should necessarily be accompanied by three additional changes. Firstly, the advantageous *access* of private patients should be eliminated through a *common waiting list for all patients*, based on medical need. Secondly, the full economic cost of private/semi private accommodation in public hospitals should be charged by Health Boards and voluntary hospitals – thereby removing any implicit subsidy. Thirdly, the consultants employed in the public hospitals should be allowed, as a general rule, to have private patients *only* in the hospital of their main employment. These three elements are essential in the Commission's analysis to an equitable and efficient co-existence of public and private care.

(ii) Subsidising and Financing Private Care – The VHI Tax Allowance

Currently VHI premia are tax deductible. The revenue foregone from this source in 1987 was £44m. The Commission acknowledges that private insurance has a complementary role in a publicly funded health care system and in that context the Commission evaluates the arguments for and against the retention of the tax relief.

The majority of the Commission favoured the abolition of the tax allowance for three reasons. Firstly, in a system where the State is funding a wide range of services for the population as a whole, it is difficult to justify simultaneous subsidisation for similar services. In the case of private care which is not available to all of the population (for example, because of the unit cost) then it would be inequitable to subsidise it on behalf of a segment (the higher income segment of the population). Secondly, there are limited instances where there is scope for the State to subsidise private care (new or developmental or innovative services) but tax allowances would not be the appropriate mechanism for such subsidisation.

Thirdly, tax allowances are regressive in their *income distribution* effects, and their effects on the *health and health care* of beneficiaries is dependent on the private choices of patients and providers.

The Council accepts the logic of these arguments against the tax allowance. Furthermore, the Council's views on tax reform and in particular on the need to broaden the tax base would lead it to the same conclusion.

(iii) Consultants and the Public/Private Mix

Medical consultants are at the cross-roads between public and private care, and their role is crucial in how the mix of public and private care actually operates. At present some consultants – 112 out of a total of 1141 – work exclusively in private practice; the large majority of them are employed in public hospital service. Those in the public hospital service are employed on a *salaried* basis (with additions to a basic salary for "on call" responsibilities, and work above the scheduled commitment) and are free to undertake private work on a fee-per-item-of-service basis.

The question addressed by the Commission is whether consultants in public hospital service should be free to combine private and public commitments. On this question, the Commission considered that the abolition of the right to private practice would lead to an exodus of the more qualified consultants into private care and a diminution in the quality and availability of care in the public service. Therefore, the Commission accepted that private work should be open to consultants in the public service, but confined to the hospital of their main employment (unless expressly permitted). In addition, the Commission proposed that consultants' contracts should be "tailor made" to each institution and speciality and should explicitly state the public element in the contract. Further, a system of monitoring the adherence to the public commitment would be necessary, in the Commission's view. For these administrative devices to work, the incentives facing consultants would also need to be altered somewhat. To this end the Commission proposed a mechanism, common to private insurance in other countries, whereby health insurers fix maximum chargeable fees for consultants' services (and inform subscribers of these maxima and of the consultants who will abide by them). In summary, the Commission's scenario in regard to the consultants' role in private care is to facilitate their continued private work but within administrative limitations.

(iv) Overall Effect of Proposals on Public/Private Mix

A number of individual proposals affect the scope, role and availability of private care in the publicly funded system proposed by the Commission. In the Council's view, the overall, *combined* effect of these proposals must be considered:

- the operation of a common waiting list for public and private patients;
- the application of the full economic cost of private care in public hospitals;

- administrative limitations on private practice among consultants in public service;
- the abolition of the VHI Tax Allowance.

These proposals are all aimed at combining the freedom to choose private care with the need to have an equitable system of access to and financing of public and private care. The overall impact on the public/private mix will also be affected by many other organisational and management proposals made by the Commission, notably on the funding of hospital services. General social and economic changes in population, incomes, health care costs and other variables will also impinge on the demand for private care. It is difficult, therefore, to forecast precisely the scale and functioning of the 'private' sector in the health care system proposed by the Commission, which would be significantly different in its financing, management and organisational characteristics.

The Council accepts the potentially complementary role of private finance in a tax financed health care system and endorses the principle of freedom to choose private care. In addition, the Council is concerned that whatever structural linkages between private and public care are devised there should be equal access to hospital care (based, as far as can be determined, on medical need). The Council would regard as fundamentally at variance with the principle of equity a situation in which persons availing of private care would have earlier or easier access to necessary hospital services than public patients.

In principle, the Council supports the Commission's strategy to retain a 'mix' of private and public care within the regime proposed – a common waiting list, administrative control of publicly employed consultants' private practice, economic pricing of private care in public hospitals, and abolition of the VHI tax allowance. Removal of the tax allowance is broadly consistent with the Council's previously expressed views about tax reform and, in particular, about the need to broaden the tax base by the elimination of tax allowances. Two sets of issues arise in relation to this strategy; the first is concerned with *feasibility*.

Under the regime proposed by the Commission a common waiting list would be used to filter access to hospital beds – consultants however would be involved in the compilation and administration of such a list. Can this 'list' then be an effective instrument, if consultants have an incentive (on their private patients' fee per item of service insurance) to admit private and not public patients? Further, to what extent can medical need and medical priority be *objectively* decided?

A further set of issues concerns the impact of the proposals on the effective demand for private care. It could be argued that the implementation of all of the Commission's proposals would make private care simultaneously more costly, less accessible and less advantageous. The proposals concerning the public/private mix must also be considered, in the Council's view, in the light of the proposed

extension of free consultants' services to those currently in Category III who currently have free hospital treatment. Arguably, the proposed eligibility structure combined with the proposed relationship between public and private care would result in an increased demand for public hospital care, with potential public expenditure implications.

A number of issues arise here. First, the impact of the Commission's proposals on the demand for public hospital beds must be considered in the light of the *overall structure for the health care system* proposed by the Commission. For instance, the Commission also made a series of recommendations to restructure health care towards community-based non-hospital care. In addition, the Commission envisaged hospital utilisation being managed more rigorously by proper admissions routines and other means.

Second, the impact of extending eligibility to consultants' services may not be significant. Under the *current* eligibility arrangements there is already universal entitlement to public hospital beds. The effect of the Commission's proposals is to prevent patients combining 'free' hospital beds as public patients with fee-paying, private access to consultants' services.

Third, it may be misleading to assume that private hospital bed utilisation under current arrangements is an 'objective', independent measure of the demand, or need, for hospital beds – a demand which will automatically convert into public bed demand if the eligibility and financing regime is changed. On the contrary, some of the existing utilisation of private hospital beds is 'supplier induced'.

Fourth, any judgement about the impact of the Commission's proposals is critically dependent on the responsiveness of the demand for private hospital care to changes in its price. This point is discussed separately below.

In the context of the abolition of the VHI tax allowance, the cost of a given amount of health insurance will increase, with the amount of the increase for a subscriber contingent on the subscriber's marginal tax rate. The Commission's analysis of the impact of this proposal is based on the view that the price elasticity of demand for health insurance is not significant. This deduction is based on the observation that VHI membership grew rapidly over an extended period of real increases in premia and that some countries without tax relief show steady support for private health insurance. However, the Commission's reference to VHI premia takes no account of the impact of the tax allowance on the *net* cost of VHI insurance – and the period under consideration was one of significant growth in marginal tax rates. Of equal significance is the *income elasticity* of demand for private health insurance – an issue not addressed by the Commission. If this elasticity is high and positive, then in the medium-term the growth in real personal incomes may sustain demand in the face of the abolition of the tax allowance. Other factors will also affect the future level of demand for private health insurance – for example, the competitive

regime in place after the completion of the EC internal market, and the possible growth of employer-funded health insurance.

These observations on the demand for health insurance all point to the absence, in the Commission's report, of a formal statistical analysis. A fully elaborated model of the demand for health insurance is necessary, in the Council's view, to an adequate understanding of the likely impact of this aspect of the Commission's proposals.

In relation to the public finance aspects of the tax allowance, it gives rise to tax expenditures and these should be viewed, like direct expenditures, as part of the total resource commitment to health. If the tax allowance – and the consequential tax expenditure – is abolished a number of options arise regarding the treatment of the tax expenditures. First, if it is considered appropriate that the total resource allocation to health should decline then the abolition of the allowance should simply be treated as "revenue saving" to the exchequer. Second, if the contrary judgement – that no overall reduction in resource allocation to health should arise – is adopted, then the revenue generated by the abolition of the tax allowance would be allocated to health care as a direct expenditure. Third, the revenue saving could be used to reduce marginal rates of tax. One of the factors to be considered in deciding between these options is the extent of any increased demand on the public hospitals system arising from a decline in the demand for private care.

Finally, it is possible that the Commission's proposals could result in a less prominent role for private hospital care than under the current 'mixed' system. Such a development would not of itself be objectionable: in fact, it could enhance the equity of the overall system. However, in the light of the uncertainty about the feasibility and the impact of the Commission's proposals to retain a 'mix' of public and private care the need to consider the alternative of a greater separation of public and private might arise. The Council does not attempt to spell out here the institutional profile of such an alternative.

8. COSTS/RESOURCES

The public and political pre-occupations which led to the establishment of the Commission on Health Funding focussed in many respects on the level of public expenditure. This focus is reflected in the Commission's terms of reference and in its emphasis on the management and efficient use of resources.

(i) Health Spending and National Income

Contemporary analysis of health spending in relation to income, is frequently expressed in terms of the cross section relationship between health spending as a percent of GDP and GDP per capita. In the Commission's report, and in other recent publications, this relationship is reported in a scatter diagram, accompanied by the linear regression function with health spending as % of GDP as the dependent variable (Tussing, 1985; NESC, 1986B; Office of Health Economics,

1987). This conventional approach reveals that Ireland's health expenditure is, statistically, exceptional; Ireland is an 'outlier' on the regression line with health spending greater than that predicted by the regression equation.

Does this provide a secure basis for the argument that Ireland's expenditure is 'too high', or that Ireland should apply a statistical norm? The Commission's views on these issues were, emphatically, that the widely quoted comparisons of the relationship between health spending and national income could not be used as the basis for identifying an appropriate level of health funding for Ireland. Their rationale for this view was that, each country can, and does, make decisions about health expenditure in line with its perceived priorities and that, there are definitional and conceptual problems in international comparisons. The first of these points is unassailable in the Council's view. The Council accepts that an 'appropriate' level of total health spending relative to other spending cannot be analytically chosen on any 'objective' basis. The second point pleads the existence of definitional/conceptual problems. However, a careful scrutiny of the comparative material considered by the Commission (OECD, 1987A) shows that the concepts and measures across countries have in fact been significantly standardised and that analysis is not limited by what the Commission referred to as "problems of comparability".⁶

The Council wishes to draw attention to more *fundamental* conceptual issues in the health spending – national income comparative research (Parkin, 1989). Two such issues are mentioned here. In the first instance, it is methodologically incorrect to apply microeconomic demand theory, with its associated 'demand elasticity' concept, to aggregates of income and expenditure over an entire economy. There are also technical problems in the way the *volume* of health care is assumed to be proxied by *expenditure*, and in the assumption that health care is a homogenous good across countries and over time. Secondly, the results of the statistical analyses vary significantly according to whether exchange rates, GDP Purchasing Power Parities, or Health Care Purchasing Power Parities are used. Parkin compared the results of statistical analyses using the different measures and found that:

- (a) the statistical relationship between income and health spending is weakest when the latter is measured using health care Purchasing Power Parities – the measure of the volume of health care;
- (b) when health care PPPs are used there is little correlation between income and health spending – health care appears to be "a necessity, not a luxury";
- (c) the status of individual countries in the comparison alters when health expenditure is measured using health care PPPs "Ireland, which apparently 'overspent' when exchange rate comparisons were used also seems to spend the 'right' amount... the USA moves from overspending to underspending..." (Parkin, 1989).

6. The OECD has compiled and published volumes of standardised health data on needs, resources/expenditures, etc.

In other words, the conventional measure of the national income – health spending correlation, with its positive income elasticity, may be misleading. The reason for the relationship is the higher *relative* price per unit of health care in higher income countries.⁹

These technical points are relevant to policy. The argument above essentially is that health care is not a 'luxury' good, and therefore the demand for health care and expenditure on health should not inevitably rise more than proportionately with income. This applies to private and public demand for health. It follows that it is a correct policy stance to contain *total* health spending, both *public and private*. By attempting to contain private, as well as public health spending, policy would not be contradicting an underlying growth in consumer demand for health.

(ii) Recent Health Expenditure Trends

The Commission documented the growth and composition of health care expenditure in Ireland. The picture is one of long-term cumulative growth in public expenditure on health; from 3.2% of GNP in 1960 to 6.7% in 1975 and 8.3% in 1980. *Private* expenditure on health hovered around 1.5% of GNP during the 1970s but increased to 2.1% of GNP in 1987.

The comparative extent and causes of this growth are reported in the OECD's data in Table 9.4. Over the quarter century from 1960 to 1984 Ireland's *real* expenditure grew at an annual rate of 7.5% – significantly *more rapidly* than the OECD average of 5.9%. This growth rate of 7.5% is decomposed (additively) in the two final columns of Table 9.4 into population changes and expenditure changes due to increased utilisation and more intensive utilisation of health care. In Ireland's case the components are 0.9 demography and 6.6 utilisation – the increased expenditure is due only in small part to the increasing population over the period.

Trends in expenditure in this decade are reported in Table 9.5 and in the accompanying graphs. Evidence of significant retrenchment is clear. By 1989 expenditure was significantly below that for 1980; real gross expenditure in 1980 was approximately 14% higher than in 1989, and 18% higher when the per capita adjustment is made. Since 1985, public health expenditure has been reduced by 1.3% of GNP. That this expenditure reduction has been translated into reductions in medical care resources is evident from the data in Tables 9.6 and 9.7. In total, health board employees declined from a 1982 peak of 58,130 to 50,671 in 1988, a decline of 14%. Later in the decade the numbers of some medical professionals declined, notably a significant decline in nurses from 25,000 to 23,127 in the year from 1987 to 1988 and a smaller decline for non-consultant doctors in the same year. Primary care personnel numbers continued to grow, however. The numbers of GMS doctors, public health nurses and Health Board dentists are all noticeably higher at the end of the decade than at the beginning.

Table 9.4
Decomposition of Health Expenditure Increases in OECD Countries

	Hospital Exp.	GDP Deflator	Health Prices	Relative Prices	Real Exp.	Demo-graphy	Utilisation Intensity per person
(Compound Annual Growth Rates 1960-1984)							
Canada	12.5	6.1	5.6	-0.5	6.5	1.4	5.1
France	15.3	7.5	6.9	-0.6	7.9	0.8	7
Germany	10.1	4.3	5.6	1.2	4.2	0.4	3.8
Italy	17.6	10.5	10.5	0	6.5	0.5	5.9
Japan	16.8	5.7	6	0.3	10.2	1.1	9.1
UK	13.1	8.7	8.3	-0.4	4.4	0.3	4.1
US	11.8	5.1	6.2	1	5.3	1.1	4.1
Big 7 Average*	13.9	6.8	7	0.1	6.4	0.8	5.6
Australia	13.7	7.2	9.5	2.2	3.8	1.6	2.1
Austria	11.3	5.1	8.3	3	2.8	0.3	2.5
Belgium	11.8	5.4	6.3	0.9	5.2	0.3	4.9
Denmark	14.1	8.2	8.2	0	5.4	0.5	5
Finland	15.4	8.8	8.1	-0.6	6.8	0.4	6.3
Greece	18.3	10.3	9.3	-1	8.3	0.7	7.5
Iceland	34.8	27.4	30.2	2.2	3.5	1.3	2.2
Ireland (a)	18.2	10.3	10	-0.3	7.5	0.2	6.6
Netherlands (a)	13.7	6.2	8.4	2.1	4.9	1	3.9
Norway	14.5	7.1	8.4	1.3	5.6	0.6	5
Spain (b)	21.8	12.1	13	0.8	7.7	1	6.7
Sweden	13.7	7.3	6	-1.2	7.3	0.5	6.8
Switzerland (c)	12.1	5	6.7	1.7	5.1	0.9	4.2
13 Country Average*	16.4	9.3	10.2	0.9	5.7	0.8	4.9
20 Country Average*	15.5	8.4	9.1	0.6	5.9	0.8	5.1

Sources: *Financing and Delivering Healthcare*. OECD, Paris, 1987.

Notes: *Arithmetic average of relevant countries: a) 1960-1983; b) 1964-1984; c) 1960-1982.

7. Why higher relative prices for health care exist in higher income economies is a matter for further analysis.

Table 9.5
Public Health Expenditure

	Gross as % of GNP	Net as % of GNP	Real Gross	Real Gross Per Capita
	(1)	(2)	(3)	(4)
1980	7.3	6.7	1105	325
1981	7.0	6.4	1063	309
1982	7.1	6.4	1093	314
1983	7.2	6.5	1112	317
1984	6.9	6.3	1080	306
1985	7.0	6.3	1094	309
1986	6.9	6.3	1103	312
1987	6.5	5.8	1069	302
1988	6.2	5.3	1025	290
1989	5.7	5.0	965	275

Sources: Revised Estimates for Public Services; Department of Finance Central Statistics Office.

Notes: Real expenditure is in constant 1985 prices; deflator is for net current public expenditure.

Table 9.6
Medical Care Personnel 1980-88

	H Board Employees	Nurses	Consultants	NCHDs	GMS GPs	Public Health Nurses	H B Dentists
1980	55.647	N.A.	987	N.A.	1,319	N.A.	N.A.
1981	58.030	N.A.	N.A.	1,628	1,375	N.A.	214
1982	N.A.	N.A.	994	1,626	1,418	1,252	N.A.
1983	N.A.	N.A.	1006	1,630	1,440	N.A.	N.A.
1984	57,583	25,261	N.A.	1,824	1,463	N.A.	329
1985	N.A.	N.A.	1006	N.A.	1,486	1,379	239
1986	N.A.	N.A.	1021	N.A.	1,512	N.A.	N.A.
1987	56,262	25,000	1020	1,907	1,530	1,282	N.A.
1988	50,671	23,127	1029	1,856	1,568	1,282	258
1989	N.A.	N.A.	1100	1,878	N.A.	1,289	N.A.

Source: Health Statistics, Dept of Health (annually).

Notes: Dentists are whole time equivalents. Data for consultants are for posts filled and refer only to public hospital service. The columns are not additive as the categories overlap. N.A. is not available. NCHDs are Non-Consultant Hospital Doctors.

Figure 9.6
Health Expenditure Per Cent of GNP

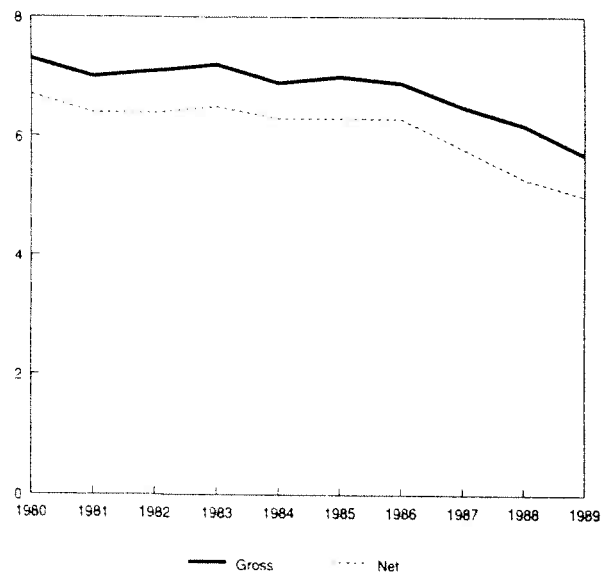


Figure 9.8
Current Health Expenditure Per Capita

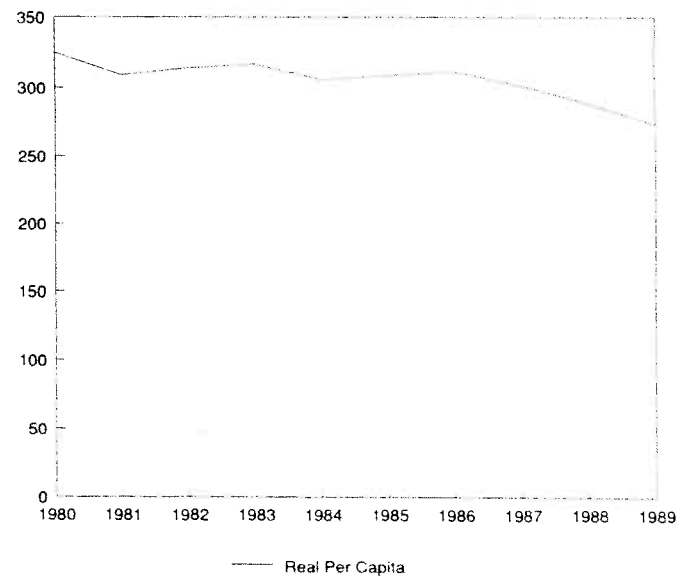


Figure 9.7
Current Health Expenditure (1985 prices)

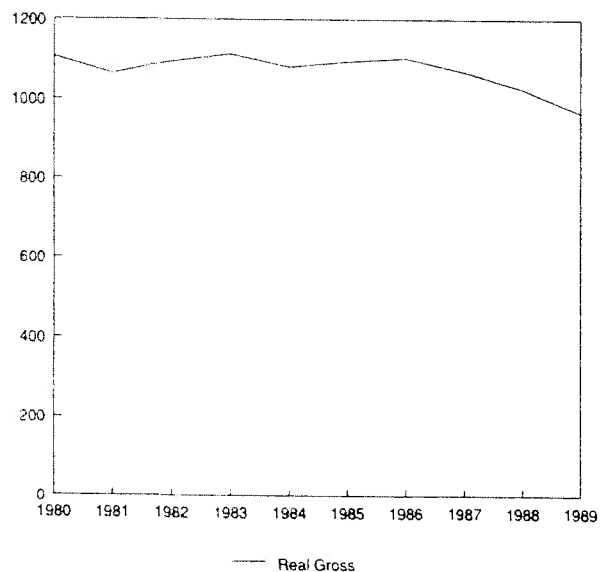


Table 9.7
Hospitals and Hospital Bed Numbers 1980-88

	No of Acute Hospitals	Acute Hospital Beds	Average Length of Stay	Private Hospitals Beds	Private Hospital
1980	141	17,665	9.7	16	1,518
1981	139	17,668	9.4	16	1,538
1982	138	17,582	9.0	16	1,498
1983	137	17,633	8.6	16	1,525
1984	136	17,335	7.5	16	1,522
1985	131	17,223	7.5	18	N.A.
1986	127	16,876	7.4	20	N.A.
1987	121	15,225	7.3	20	N.A.
1988	107	13,632	7.0	N.A.	N.A.

Sources: Health Statistics, Dept of Health, annually.

Notes: Totals for the first two columns exclude private hospitals; N.A. is available; figures for private hospitals for 1986 and 1987 are estimates.

A consistent picture of decline is reported in the data on acute hospitals and hospital beds. From 1981 a continual decline is in evidence, so that the 1988 beds total is approximately 30% less than the 1980 total. The total number of acute hospitals in 1988 was 107 compared to 141 in 1980.

The column on *private* hospitals and private hospital beds shows a picture of growth towards the end of the decade in the number of hospitals; corresponding totals for beds in the private sector are not available. This tentative indication of divergent trends in public and private provision is confirmed by Wiley's analysis of the public/private mix in Irish health. Her evidence shows a relative shift towards semi-private and private accommodation in hospitals, and also towards greater private practice among consultants (Wiley, 1987). Confirmation of these patterns can be seen in these figures compiled by the Commission. Private health expenditure, in total, has been rising continuously during the decade. A shift has therefore taken place in the *mix* of health care provision, from public towards private (Table 9.8).

Table 9.8
Public and Private Health Expenditure

	Private Health Expenditure		Public Health Expenditure	
	£m	% of GDP	£m	% of GDP
1980	113.5	1.2	750.5	8.0
1983	228.5	1.6	1119.2	7.6
1986	323.4	1.7	1312.9	7.1
1987	379.8	1.9	1317.6	6.7

Source: Report of the Commission on Health Funding.

Notes: Public refers to net total (capital and current).

(iii) The Future of Public Health Expenditure

Does the evidence above of reductions in public health spending allow us to draw any specific conclusion regarding the current level of public health spending? On balance, the Council considers that it is difficult to make the case that overall increases in public health expenditure are justified. This is so for a number of reasons.

First, the rationalisation of hospitals and hospital bed provision has long been recommended on both medical and economic grounds.

Secondly, in the mid nineteen eighties (admittedly *prior* to hospital bed retrenchment) Ireland's acute bed provision was slightly *higher* per capita than the

OECD average. This would imply a somewhat higher provision when Ireland's younger age profile is taken into account (OECD, 1987A).⁸

Thirdly, there is no evidence to suggest that as the numbers of the elderly have risen and the numbers of births (and of children 0-4) has fallen that resources have been re-allocated accordingly, implying some scope for better reallocation of resources.⁹

Fourthly, the Commission documented significant structural deficiencies in the management of the health care system which result in greater hospitalisation than necessary and an inefficient use of hospitals and hospital beds. These deficiencies include a weak primary sector which unduly 'refers on' to hospital, inadequate community services for the highest utilisation group (the elderly), absence of admissions policies in the acute hospitals, and generally weak management of the acute hospitals.

Fifth, the *mix* of resources, as well as the level of resources is important. This highlights the fact that virtually all recent debate about health care resources has been about hospitals and hospital beds. It might be the case, for instance, that increases in particular categories of *personnel* (such as doctors or nurses) would be more desirable than increased hospital bed numbers.

Finally, it must be acknowledged that any definitive discussion of the *level* of health care spending would require more detailed information and analysis than is possible to provide here. However, it would be difficult in the Council's view to sustain the argument that public health spending should increase *before* the reforms proposed by the Commission are put in place.

(iv) Health Expenditure – Institutional and Community Care

The Commission's analysis of the health care system adopted much of the thrust of recent commentaries which emphasise the need to *restructure* the system of care towards non institutional provision in the community. This emphasis derives, in the Commission's and in other analyses, not simply from the need to reduce hospital bed utilisation, but from the *positive* economic and medico-social arguments in favour of community based care for the elderly, the handicapped, the physically and mentally disabled, children, and the psychiatrically ill. The Council's earlier work on this subject documented the progress to date in this restructuring and outlined broad proposals for more rapid progress (NESC, 1987).

Development of community care in the future must take place in a fiscal context markedly more restrictive than in the late sixties and seventies when the community care strategy was first formulated. The question arises, therefore, as to whether the necessary control of public health expenditure will result in resources

8. Standardised detailed bed/population ratio are difficult to compile because of institutional differences between countries and complex variations in classifications of bed types.

9. From 1981 to 1986 the population aged 0-4 fell by 7.2% and the population aged 65+ rose by 4.5%.

being unavailable to develop community care. An argument can be made, in other words, that community care can develop in the future only if additional resources are provided.

In *general* terms the Council would not accept such an argument. Firstly, it is important to recognise that when public health expenditure was *growing rapidly* (a virtual doubling in real terms over the 1971-81 period) significant restructuring did not take place. Table 9.9 records the constant share of community care programmes over the period 1976-1988 which spans sub periods of growth, stagnation and retrenchment in total expenditure. Figure 9.9 contrasts these three sub periods and shows, notably, that during the period of rapid growth 1976-1980, real increases in community care resources were *less than half* of the increases recorded for other programmes. These data have prompted the following observation.

For advocates of community care who *now* argue that its development requires an 'injection' of resources, or "seed" money, the past pattern of expenditure raises some uncomfortable questions. If restructuring did not take place when resources were growing, does this mean that 'community care' has *really* been the policy? Could it be that increased resources are not now, or never have been, the obstacle to a fundamental shift, and that the obstacles lie elsewhere? (Mc Cashin, 1990).

The Council considers that the restructuring of health care, which necessarily entails reallocation of resources, requires management and organisational and other changes, in the absence of which, additional resources for community care will be ineffective. In the future, the Council accepts that in *specific instances* increased expenditure in the short term may be justified to facilitate transition situations or new initiatives, but only where long term savings have been clearly identified and *quantified* (for example in making a transition in the catchment area of a psychiatric hospital towards community services with the aim of closing the hospital or greatly reducing its role). However, the Council does not support *general* claims for additional resources for restructuring.¹⁰

9. SUMMARY OF COUNCIL'S POLICY

In the light of the report of the Commission on Health Funding, which the Council has considered, the Council proposes the following key elements for health policy in the period ahead.

- (1) Finance: A general tax financing strategy should be pursued with an ancillary role for private finance.

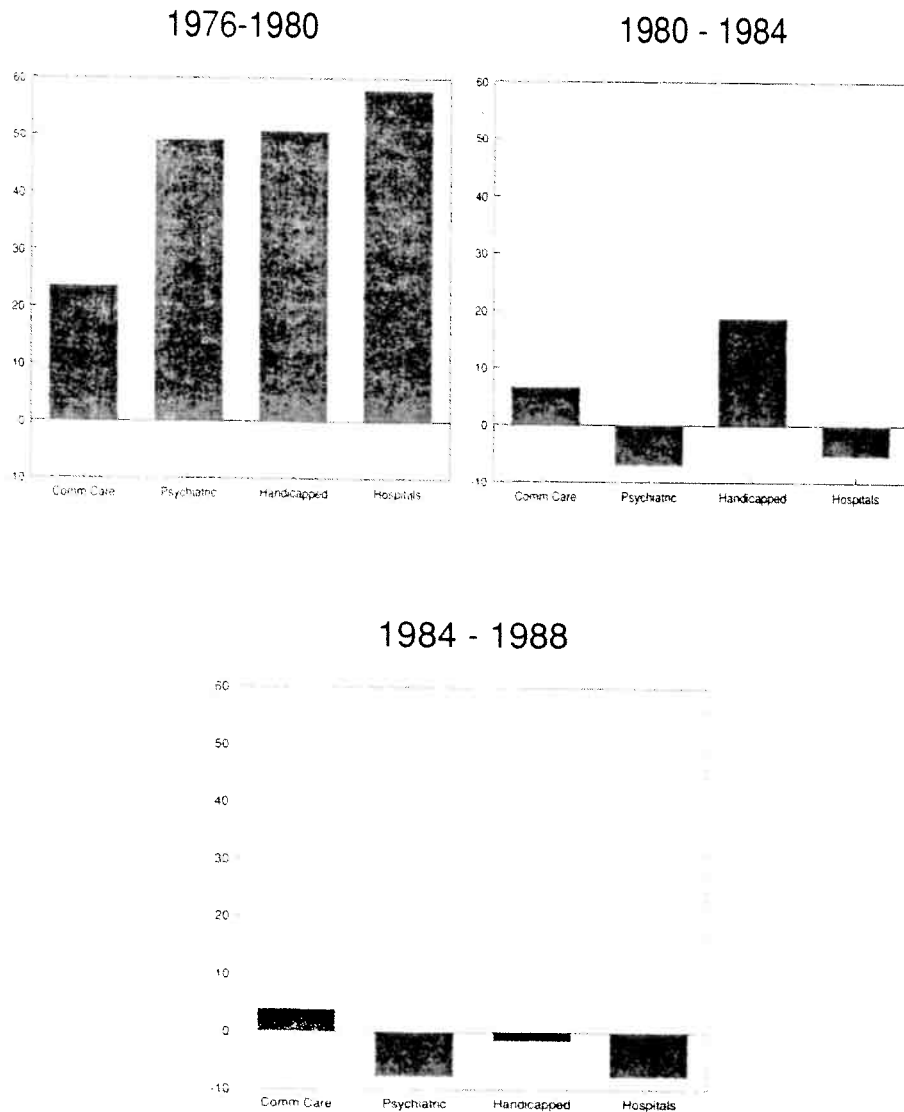
10. The Department of Health has indicated that in its view additional capital investment of the order of £30m will be required over a four year period if its community care policies are to be implemented. (Department of Health communication to NESCS).

Table 9.9
Estimated Expenditure on Health Services by Sub-Programme 1976-1988 in Constant (1980) Prices

Sub-Programme	Estimated Non-Capital Expenditure												
	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
Community Protection	10.9	12.1	13.4	14.6	13.0	12.9	12.1	11.8	11.1	11.9	11.9	10.6	10.4
Community health services	80.5	73.8	82.3	84.8	90.4	95.1	105.1	94.5	92.6	97.2	100.9	100.4	101.3
Community welfare	30.0	43.8	42.9	44.1	46.8	45.2	52.9	53.9	56.4	58.7	56.5	55.3	54.7
COMMUNITY CARE	121.4	129.7	138.6	143.5	150.2	153.2	170.1	160.2	160.1	165.8	169.3	166.3	166.4
Psychiatric	62.7	73.8	79.4	74.4	93.5	87.4	88.2	88.6	86.9	87.3	91.2	85.3	80.1
Handicap	39.6	47.8	53.0	55.0	59.7	54.2	67.2	72.8	70.9	73.1	72.5	71.6	69.8
General hospital	249.1	274.0	304.6	345.0	393.8	378.8	373.3	410.4	372.8	379.3	367.5	353.5	343.9
General support	38.7	38.6	37.3	37.6	34.8	35.5	35.4	36.6	36.2	36.2	36.1	34.8	34.5
Gross non-capital total	511.5	563.9	612.9	655.5	732.0	709.1	734.2	768.6	726.9	741.7	736.6	711.5	694.7

Source: Department of Health.

Figure 9.9
Growth Rates of Health Care Programmes



- (2) **Eligibility:** A two tier system of eligibility is appropriate with all persons entitled to publicly financed necessary services, and the lower income groups entitled to necessary and certain other additional services.
- (3) **Efficiency:** Efficiency should be rigorously and generally pursued throughout the health care system: in particular hospital managements should deploy DRG systems; specific medical disciplines should function within a clinical budget framework; services should be provided on a budgeted basis; the information, research and evaluation functions should be considerably enhanced – a priority should be given to the establishment of the unit *costs* of services.
- (4) **Organisation and Management:** The central functions of policy making and legislation should be strengthened, and the local functions of implementation and delivery should be improved; the appropriate apportionment of responsibilities as between central and local agencies is essential; locally based managers should have overall executive responsibility within a budget properly calculated to provide a pre specified quantity of services.
- (5) **Public and Private Hospital Care:** Privately financed care should have a complementary role; if possible this complementarity should be achieved by a 'mix' of public and private care in public/voluntary hospitals, without subsidising private care by means tax allowances or under pricing of private care; if an equitable and efficient interplay of public and private cannot be administered a greater separation of public and private should be considered; it is crucial that publicly and privately financed hospital patients should have equal access to necessary hospital care.
- (6) **Expenditure:** Real increases in public expenditure should be considered only when the system has been reformed; no analytical technique can specify what the appropriate level of public expenditure on health should be.

1. INTRODUCTION

In this chapter the Council raises some general issues about education policy. The discussion is not based on specific studies undertaken by the Council. However, the Council considers that a number of strategic questions regarding the future of the education system must be addressed for a number of reasons.

First, the demographic structure of the population is changing, with potentially significant implications for the future pattern and level of public expenditure on education. Secondly, the Council's analysis of the medium-term fiscal context and of the consequent need to contain overall public expenditure, indicates the importance for large segments of public expenditure of efficiency in the use of resources. Thirdly, there is evidence that certain widely agreed and long-term policy objectives are not being attained – notably, equality of opportunity in education and a 'comprehensive' model of education at second level. Fourth, and finally, the education system will function in a labour market context significantly different to that which prevailed when current policies and institutes were devised. For example, the period of second level schooling at senior cycle may need to be reviewed in the light of EC-wide practice. Furthermore, the single European market will facilitate greater labour mobility between EC member states with consequently greater EC – wide harmonisation in educational qualifications and recognition; the education system may also require adaptation in the context of continuing long-term unemployment.

At present the OECD is undertaking a review of Irish education. In the light of this review the Council intends at a future date to address fundamental aspects of education policy. This chapter offers a preliminary identification of the issues which the Council will address in its future work and which the Council believes merits wide discussion and debate. To set the discussion in context a sketch is given in section two below of the organisation, scale and resources of the formal education system.

2. THE EDUCATION SYSTEM

Table 10.1 below summarises the key features of the system according to the familiar sub-division of primary, second level and third level.

(i) Size and Structure

The primary level system comprises over 3,600 schools which caters for 568,157 pupils. Overwhelmingly these schools are 'aided' i.e. funded by the Central

Table 10.1
The Irish Education System 1988/89

	Pupils	Schools Colleges	Current Public Expenditure £m (Gross)	Capital Expenditure £m Gross
PRIMARY	568157	3607	455	16
SECOND LEVEL			479	19
Secondary	213923	498		
Community	31651	47		
Comprehensive	8837	16		
Vocational	84423	251		
Other	2916	31		
TOTAL	341800	843		
THIRD LEVEL			233	11
Universities	35820	7		
Teacher Training	1659	7		
Vocational/Technological	9382	11		
Regional Technical Colleges	13886	9		
Other	2223	17		
TOTAL	62970	51		
GRAND TOTAL	972927	4501	1167	46

Notes: Figures are totals for 'aided' and 'non-aided' sectors. Secondary includes secondary "tops". Universities includes non-university HEA institutions. Expenditure data are 1989 figures from Revised Estimates for Public Services 1989. Expenditure data do not include the sub-head for Office of the Minister for Education.

Exchequer but administered and managed at local level, with ownership of the school buildings and sites vested in Diocesan and Church authorities. The site costs are met entirely privately and a small (variable, from case to case) portion of the construction costs likewise. Teachers' salaries are totally exchequer funded and a grant per pupil is paid in respect of non salary current costs. In 1989, current public expenditure on primary education was £455m, and capital expenditure £16m.

The post-primary system catered for 340,000 pupils in 1988/89 divided as follows: 498 Secondary schools with almost 214,000 pupils, 251 Vocational schools with 84,423 pupils and 63 Community and Comprehensive schools with approximately 40,000 pupils.

Secondary schools include 58 fee-paying schools which cater for both Catholic and Protestant denominations. In the case of such schools, capital and capitation grants are not paid. Vocational schools are wholly state-funded and are under the control of Vocational Education Committees. In the case of Secondary, Community and Comprehensive schools, individual Boards of Management operate with Trustee, parental and teacher representatives.

In the University system the traditional Universities comprise 58% of the pupil enrolment. The bulk of these pupils in turn are in the National University of Ireland federation of colleges – of which there are three. Central Government gives significant support in respect of capital grants in Universities and in addition the bulk of their current income comes either directly or indirectly from the State. The nine Regional Technical Colleges are the second largest segment of the higher education system. These Colleges have a distinctively vocational and applied remit; their capital costs are met by the State with contributions from the European Regional Development Fund while their current costs are met by the State and the European Social Fund. Management of these RTCs is via a management board which represents the VEC structure as well as the Department of Education and regional educational interests.¹

In addition to the mainstream formal education system sketched above, there are now also extensive adult and informal and continuing education sectors. These sectors play an increasingly significant role in widening access to education and in providing opportunities for on-going skill development and renewal. Future analysis of education policy should encompass these sectors also.

(ii) Expenditure

Table 10.2 gives a breakdown of expenditure on education both public and private in 1989.

Total private expenditure on education in 1989 is estimated at £174m; total public expenditure was £1,260m. In all education expenditures amount to 7.0% of GNP – a very significant element in the economy overall. The economic significance of education, as reflected in these figures, provides a clear rationale for a fundamental review of education policy.

3. EDUCATION – POLICY AND OBJECTIVES

The economic and social importance of education, indicated not least by the public expenditure commitment entailed is not matched, in the Council's view, by clear statements of medium-term management objectives. Policy formulation is also constrained by the year to year budgetary system. Neither of the two official policy overviews of education in the 1980s contained *explicit* statements of *targets and*

1. The description of the system would be significantly more complex if the various types of adult education, community education, training and rehabilitation were included in the discussion.

objectives (Department of Education 1980; Department of Education 1984). Consequently, in the Council's view, it is impossible to measure the extent to which the education system is functioning efficiently, or the extent to which the system can effectively plan for curricula or structural change.

Table 10.2
Expenditure on Education 1989

	£m
(1) Total <i>Private</i> /Household Expenditure	174
(2) Public Expenditure (Current & Capital)	
Primary	471
Second Level	498
Third Level	244
Central Administration etc.	47
Sub Total - Public	1,260
(3) (2) + (1)	1,434
	%
(4) Total as % of GNP	7.0
(5) Private as % of GNP	0.9
(6) Public as % of GNP	6.2

Notes: Private expenditure was calculated on the basis of the 1987 Household Budget Survey data on weekly expenditure: the education/training items were aggregated and grossed up to a national total for all private households; the 1987/89 CPI increase was applied. The figure must be taken as approximate. Public expenditure includes both current and capital.

The standard reference work on the history and structures of Irish education observes, for example, that:

“With the many changes involved in the recent history of Irish education it is noteworthy that legislative measures have been few and that they have tended to be confined to giving a statutory basis to various new institutions” (Coolahan, 1981).

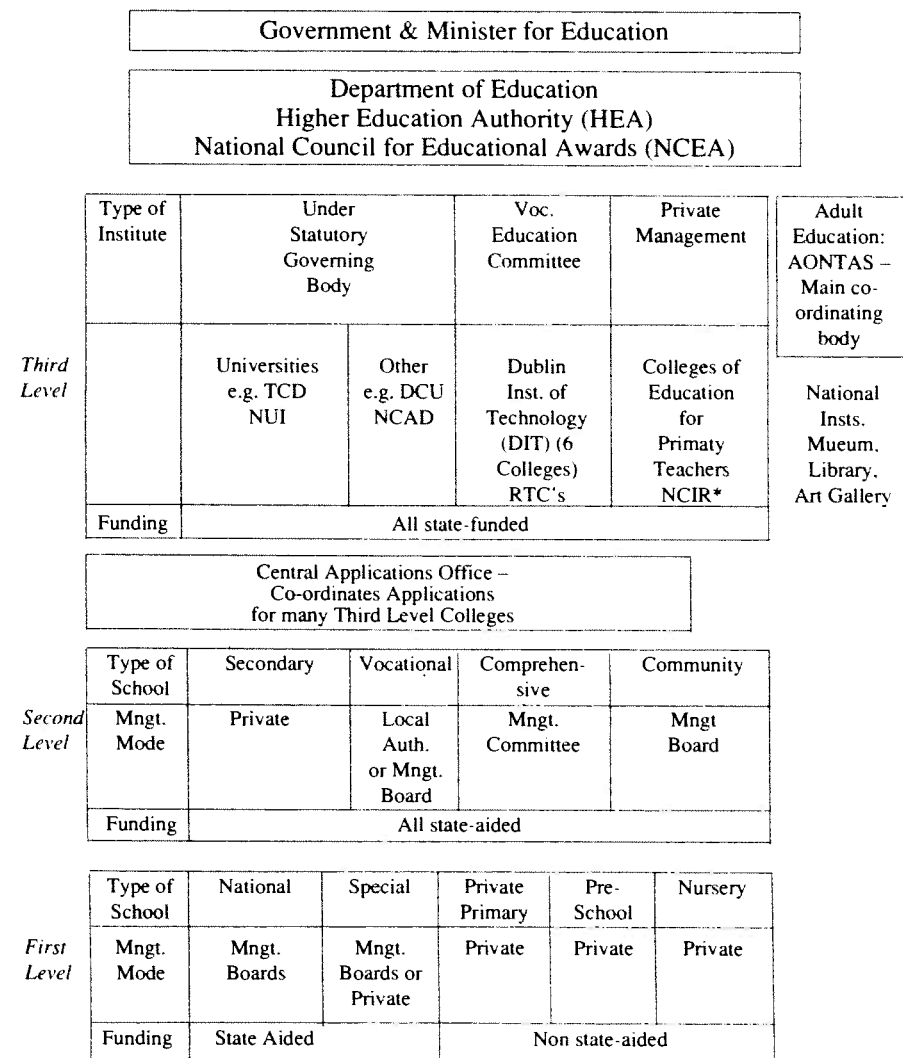
This absence of legislation is accompanied by a reliance on centralised administration of the system and a lack of informed debate, according to Coolahan:

“... A notable feature of the Irish education system is the paucity of educational legislation. The system relies heavily for its mode of operation on rules, memoranda and circulars issued on the authority of the Minister for Education. Apart from brief mentions in national economic programmes the State has been reluctant to issue white or green papers on education which would set forth planning in a co-ordinated manner. The long awaited white paper on educational development published in 1980 has inhibited informed educational debate ...” (Coolahan, 1981).

4. STRUCTURES

Figure 10.1, reproduced from Coolahan's text on Irish education, summarises the complex organisational structure of Irish education. The Council considers that some important issues arise about the relevance and effectiveness of the structures to the contemporary situation.

Figure 10.1
The Structure of the Irish Education System



* The National College of Industrial Relations is included here, although it receives only very limited state funding.

(i) Overall Management

Firstly, aside from political and ministerial responsibility for the entire system there is no one part of the structure which brings together *all* of the interests to have an overview of the system, and to develop responses and policies about the relationship between different levels in the system. For example, as the demographic decline in the primary school population unfolds and enrolments in second and third level grow, a crucial question arises as to how to allocate the 'savings' from the falling demand at primary level. On the one hand, the demographic decline could be used to 'naturally' effect a reduction in pupil teacher ratios at primary level. On the other hand, the unit cost per pupil is higher at second level because of the subject range and the facilities required, and considerably higher at third level and, arguably therefore, the 'savings' will be used at the second and third levels where pupil numbers are continuing to rise. The merits of either point of view are not at issue here: the issue, in the Council's view, is the absence of a forum within the educational system where these priorities and choices can be discussed. Sectors within the education system may be more likely to *compete* for resources where no overall management and consultation framework exists.

A further example of the need to bring the various elements together are certain aspects of the relationship between second level and third level. In particular, with the rapid growth in demand for places in third level institutions the role of the "points systems" of the various colleges in rationing limited places has become very important.² However, the points system may have become pre-eminent in its influence, with students and schools at second level orienting their curricula and school organisation towards the academic achievements necessary for the accumulation of 'points'. This is a rational response in the current structure which links second level to third level. It may result in two problems, however. First, it may reinforce the traditional 'academic' ethos of second level education at the expense of vocational elements. Secondly, it gives rise to 'credentialism' in the labour market, whereby increasingly higher formal qualifications are required for any given type of employment. These issues can only be resolved in a structure which has some responsibility for the organisation and effectiveness of the system as a whole, and which requires diverse educational interests to agree on overall educational objectives, and policies.

(ii) Structures At Second Level And First Level

In 1985 the then Government issued a Green Paper on the reform of management structures at second level (Department of Education, 1985). The Green Paper proposed the establishment of Local Education Councils. These Councils (13 in all) were to be representative of local authorities, schools, parents and teachers,

2. The 'points systems' are methods of scoring Leaving Certificate examination results and compiling them into a composite total of points. Colleges and faculties/Departments within Colleges specify required amounts of points for entry to courses.

with total membership of 30-32. Wide ranging responsibilities were envisaged for the Councils, including:

- provision and planning of second level education
- payment of teachers
- maintenance of schools
- payment of capitation grants
- provision and co-ordination of youth services
- provision of adult education.

Under these proposals community, comprehensive and vocational schools would all have representative Boards of Management, and voluntary secondary schools would have boards consisting of Trustees and other members (including Local Education Council representatives). One implication of the Green Paper's proposals is some rationalisation of existing Vocational Education Committees.

These proposals have not been implemented although there has been some rationalisation of post primary schooling in recent years. The proposals appear to the Council to offer the prospect of more unified, more efficient and more representative management of second level education. As the Green Paper pointed out:

It is considered that the establishment of a regional body for educational (and other) services fulfilling the same functions in relation to all second-level schools and the management of these schools by local Boards of Management would eliminate friction based on the management structure of schools and would provide a better framework for the rationalisation of post-primary facilities and for the delivery of other services (Department of Education, 1985).

The absence of debate on these proposals and the failure to develop management structures along these (or similar) lines is a matter of concern to the Council. However, the proposals themselves beg a wider question about educational structures: are there grounds for a more sweeping re-organisation which would incorporate *primary and second level* schooling? The Green Paper stated that consideration had been given to this issue, but that it would be better to proceed with reform at second level initially and leave consideration of primary schooling "to a later date". The Council considers that it would be desirable to examine the merits, or otherwise, of a more thorough integration of primary and second level educational structures at local level.³

(iii) Accountability and Representation

The Council considers that in the education system no less than in health care (which is the subject of Chapter 9), the principles of consumer representation,

3. The Green Paper proposed that representatives of the primary schools in the LECs jurisdictions would be included as members of the LECs.

participation, and accountability should be reflected in management and decision making structures. In the Third Level sector students (and parents) exercise a degree of choice in relation to institutions and courses, and as 'consumers' they are organised and formally represented (through Students Unions) in the educational system.

In the primary school system, in any one locality there is likely to be *one* school. If parents are unhappy about any aspect of the school's functioning or performance they may have little effective alternative. The management boards of primary schools contain parents' representatives, but the rules prescribe that only the Chairman of the board (Diocesan Nominee) may correspond with the Department of Education. Furthermore, the parents' representatives have no automatic right to convey feedback to the parental constituency. Unlike the systems of entitlement to health and social welfare services there is no formal 'appeal' mechanism for parents.

At second level, parents are primarily concerned with school 'quality' in the broadest sense-quality of teachers, breadth of curriculum, school amenities and overall standards. Parents and pupils, however, have no formal system whereby they obtain factual and evaluative data about schools, in order to make appropriate educational choices. There is no one statutory agency at local or regional level responsible for providing detailed information about schools and educational matters to pupils and parents.

The absence of accessible data on schools, of the type indicated above, touches on the issue of accountability. How can the effectiveness of the educational system be ascertained, and accountability then enforced, if systematic data on the performance of the system is not available? For example, if particular schools have high 'drop out' rates, or reveal other possible symptoms of inadequate performance, how can this be assessed, and measures put in place to ensure an improvement?

In the Council's view, there is a need to consider the role of information systems and 'performance indicators' within the education system. The use of such analytical techniques would allow educationalists to account for resources used and to assess the effectiveness of the education system.

5. EQUALITY

In the Council's previous comments on the education system it has reiterated the view that access to second and third level education should be based on *educational* criteria. All socio economic groups should have equal opportunity in education (NESC, 1986B). Official documents on education record this view also (Department of Education, 1980; Department of Education 1985). Notwithstanding the stated commitment to equality of opportunity, inequalities persist and are significant, as the Council has previously observed (Whelan and Whelan 1984).

The official commitment to egalitarian objectives in education dates to the mid nineteen sixties, after the extent of social inequalities in access to education were first documented in the Investment in Education report. Specific policy instruments were devised and implemented to ameliorate these inequalities: a scheme of free education at second level was introduced; a means tested grants scheme for Third level students was implemented; school transport for first and second level pupils was made available.

A cumulative rise in the standard of living since the nineteen sixties, combined with these policy measures, have clearly contributed to an overall improvement in access to the upper reaches of the education system. For example, the Council's redistribution studies showed that the proportion of 'grant aided' students in Third level has increased and that the financing of education has become more progressive, with a relative diminution in State support to third level and fee-paying second level education (NESC, 1988). Notwithstanding these significant improvements a number of key policy issues arise about the continuing disparities in educational opportunities.

In the first instance, specific policy instruments are in place whose *explicit* aim is to improve equality of opportunity in education. However, there may be inherent limits in the extent to which these instruments of *educational* policy can affect the social distribution of educational opportunities. The role of wider social (and other policies) may need to be examined in this regard. For example, policies in respect of housing, income distribution or income maintenance may now be more effective in further equalising opportunities.

Much of the debate and analysis of 'equality' in education focuses on the upper reaches of the system – senior cycle second level and third level. However, it might be argued that a greater long-term impact on educational opportunities is made at the primary level – that attempts to sustain equal opportunity at second level or third level are, in a sense, "too late". The policy implication of such a perspective would be a very concerted effort to allocate resources towards primary education and, within primary education, to 'positively discriminate' in favour of disadvantaged pupils. At present under the current Programme for National Recovery there is a limited policy of favouring disadvantaged pupils in primary and post primary education.

Finally, in relation to equality of opportunity the need to critically re-examine the financing of Third Level education should be noted. The details of the current arrangements in Ireland have been well documented and analysed (Barlow, 1981; Tussing, 1978). Many commentators internationally are critical of the grants regimes in force in Ireland and the UK.

In the *Programme for Action in Education 1984-1987* the Government adverted to the issue of third level financing. It noted that it might be desirable that the share of

third level costs met by fees should greatly increase and that, in that context, a student loan should be introduced:

It has been suggested that students should be required to meet a greater share of the costs and that fees should bear an increasing proportion of the cost. In order to assist students to meet fees of this order, it has been suggested that a student loan scheme be introduced. The question of loan schemes is an extremely complex one involving basic decisions of principle as well as questions of practicability. The Government is considering the feasibility of introducing a loan scheme to be operated in tandem with the existing higher education grants scheme and an announcement in the matter will be made in due course (Department of Education, 1984).

The Council notes that no overall appraisal of the existing mechanisms of financing third level education or of the possible merits of a loans scheme has been undertaken. In calling for a reappraisal of third level financing the Council is not presuming that this aspect of the overall education system is the key to equality of opportunity. However, financing arrangements are one of the means available to Government and their effectiveness must be ascertained.

6. COMPREHENSIVE EDUCATION

One of the declared aims of education policy from the mid nineteen sixties onwards was the development of a "comprehensive" and "community" approach to second level education (Coolahan, 1981). This was intended to achieve two key inter-related objectives:

- to eliminate the social differentiation in the access to and participation in different types of schools – vocational schools and secondary schools, for example;
- to break down the rigid separation between "practical" and "academic" education at second level and to develop a common, comprehensive curriculum in all schools.

It was envisaged that these reforms would be achieved through school amalgamations and co-ordination, curriculum development and expansion, and the establishment of new comprehensive and community schools at second level.

In 1970 the official document *The Community Schools* (Department of Education, 1970) set out the comprehensive policy. It envisaged not only elimination of the barriers between the curricula of secondary and vocational schools, but the creation of a more unified post primary system based on school amalgamations and the provision of new schools where appropriate. Specifically, where existing schools had enrolments below a certain level state community schools with comprehensive curricula were to be developed, either as new schools or as 'Hybrids' of existing secondary and vocational schools. This plan culminated in the identification of 30 centres as being appropriate locations for community schools – in 26 of the centres

this required amalgamations of schools. A recent study provides grounds for concern that this comprehensive policy has not been fully implemented (Barber, 1989).

The Council considers that the structure, curriculum, and organisation of primary and second level education should be reassessed as they are crucial to the attainment of economic and social objectives. The Council notes that a number of major reviews of primary and post-primary education have recently taken place under the aegis of the NCCA and that some curricular and organisational changes are to take place in both sectors as a result. Significant reforms are also in place at Junior Cycle level of post-primary education culminating in a new Junior Certificate examination in 1992. Other changes are being planned at Senior Cycle. An increase in the length of the Senior Cycle to incorporate six years of post-primary education is one initiative which merits consideration.

7. CONCLUSIONS

The Council considers that education policy is crucial to long-term economic and social development. It is important, therefore, that an overall review of education in its widest sense be undertaken, and that analysis and debate on the objectives, structures, curriculum and other aspects of education should take place. In this note the Council has merely offered a *preliminary* identification of issues which must be examined, pending the publication of the OECD study on Irish education which, it is understood, will be published in the near future.

In the future, the Council will consider more fully the role of the education system in the economy and society as a whole and will initiate research and analysis on education. Changes in demographic patterns, in the economic environment and, in particular, in the labour market, are cumulatively reshaping the context in which the education system must function. To appreciate the significance of this changing environment and to develop an educational strategy for the future it will be necessary to undertake policy review and analysis.

THE MANAGEMENT OF PUBLIC EXPENDITURE

1. INTRODUCTION

Before discussing issues of management it is important to indicate why the management of the public sector is considered relevant in a report which has a strategic medium-term focus. *First*, since the public sector forms such a significant part of the economy, its level of efficiency and effectiveness is a key determinant of the efficiency of the economy as a whole. *Second*, the importance of structural adjustment and resource reallocation in sustaining the current economic recovery was emphasised. Nowhere is this more important than in the public sector, both the changes necessary in the public sector per se, but also in the incentives which are provided by the public sector for resource reallocation within the economy as a whole. This will require considerable adjustment in many policy areas which will place a heavy burden on management in the public sector.

Third, the growth of the public sector and the variety of vehicles through which the Government intervenes in the economy makes the task of managing the public sector much more complex. This complexity has led to a whole crop of new concepts and ideas and some old ideas dressed up in new clothes regarding the management of the public sector. It is important that these are identified and evaluated for their relevance and appropriateness to the Irish situation.

Finally, a policy of public expenditure retrenchment has been in operation since 1987 during which period current public expenditure has fallen by over 11 per cent in real terms. The Council recommends that current public expenditure remain constant in real terms over the period to end 1993. A stage comes in a retrenchment process when programmes, having suffered retrenchment for a number of years, may need to be abandoned rather than become paralysed through further real reductions. Continued restraint will therefore require clear articulation of priorities which may require change in the management process.

This chapter deals with the management of public expenditure and the next deals with the management of public enterprises. In order to provide a broad backdrop to the issues considered in this chapter, we provide a brief statistical overview of the evolution of public expenditure since the mid 1960s and conduct a brief examination into the recent period of public expenditure retrenchment. In Section 3 we clarify the concepts of management, planning and control. Section 4 considers the issues associated with bringing expenditure into line with macroeconomic requirements and changing priorities. Section 5 examines measures designed to

enhance the efficiency and effectiveness of public expenditure. The management of tax expenditures is the subject of Section 6. Section 7 concludes with an overview.

2. A STATISTICAL OVERVIEW

(i) Definitional Considerations

In discussions of government spending many definitions are used, ranging from State expenditure through to Government expenditure to public expenditure. The term government expenditure usually refers to central government expenditure and excludes local authorities and other public agencies. Public expenditure or expenditure by public authorities is generally taken to include expenditure by central government and by local authorities. It sometimes includes public enterprises although the manner in which these bodies are consolidated into public sector accounts varies enormously. In the Irish case, the public authorities sector as defined for National Accounts purposes, includes central Government, extra-budgetary funds and all local authorities but does not include the semi-state bodies. However, it does include transactions between semi-state bodies and the public authorities sector.

The budgetary classification of expenditure covers expenditure by central Government only but does include transactions with local authorities and semi-state bodies. Aside from the institutions covered there are issues about how expenditure is presented. Expenditure can be treated on a gross or net basis with the difference accounted for by charges or levies raised in connection with the supply of certain public services. In addition to the accounting treatment of various items of expenditure it is also important to realise that the scope of public sector activity extends beyond expenditures and revenues as estimated by national accounts. A fuller account of the role of the public sector focuses on what have become known as off-budget activities. One very significant area of off-budget activity is that of public enterprise activity. This, for example, permits a degree of Government control in certain areas while also allowing market forces to have some influence. Other forms of off-budget activity are tax-expenditures and loan-guarantees. These are sometimes preferred because of their incentives and redistributive effects, although some argue that these are moved off-budget in order to escape budgetary retrenchment. A final area of off-budget activity is regulation which is frequently a substitute for direct Government expenditure or taxation measures.

In general, the most appropriate definition to use in any particular case depends on precisely what it is required to measure and the reason for doing so. The purpose of this chapter is to provide a broad background to a discussion of the planning and control of expenditure. It is also useful to present the material in a reasonably long-term perspective thus requiring a consistent data series going back a few decades. The National accounts data are the most appropriate for this purpose and it is with

these that the analysis begins. Budgetary data are used for evaluation of more up-to-date issues. In the case of public enterprises it is more appropriate to consider their contribution to GNP. This is done in the next chapter.

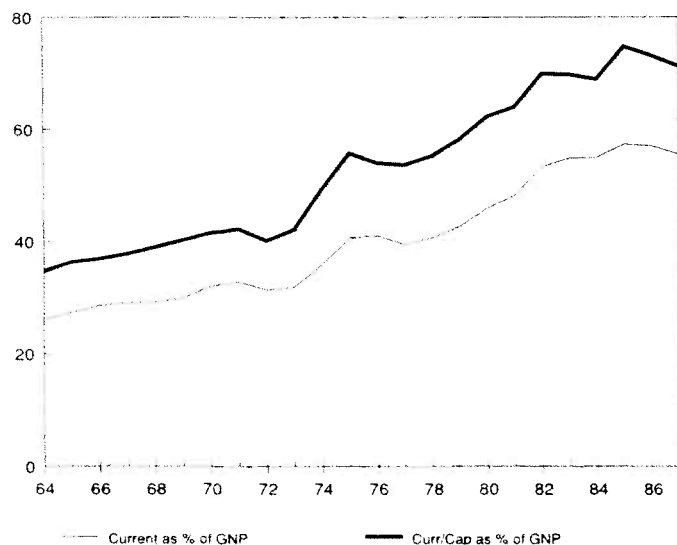
(ii) Evolution of Expenditure 1964-1987

One of the most pervasive features of OECD countries over the past three decades has been the rapid growth in the degree of Government involvement in their economies. Ireland is, therefore, not unique in its experience in this regard. Some indication of the increasing pervasiveness of Government involvement can be gleaned from Table 11.1 and Figure 11.1 which show the growth of current and capital expenditure as percentages of GNP from 1964 to 1987. Both current, and current plus capital expenditure, more than doubled their share of GNP over this period.

Table 11.1
Expenditure of Public Authorities 1964-1987

*Year	Current £m	Current and Capital £m	GNP £m	Current as % of GNP	Current and Capital % of GNP
1964	239.9	316.2	913.1	26.3	34.6
1965	269.2	355.1	981.3	27.4	36.2
1966	295.0	379.6	1031.0	28.6	36.8
1967	327.3	424.5	1124.6	29.1	37.7
1968	371.6	496.2	1270.9	29.2	39.0
1969	436.5	587.1	1460.7	29.9	40.2
1970	522.6	680.6	1637.8	31.9	41.6
1971	611.1	788.8	1870.8	32.7	42.2
1972	718.0	920.8	2269.4	31.3	40.1
1973	864.1	1145.8	2721.5	31.8	42.1
1974	1088.7	1503.1	3040.6	35.8	49.4
1975	1542.1	2115.0	3796.3	40.6	55.7
1976	1895.7	2493.3	4617.2	41.1	54.0
1977	2210.4	3001.0	5595.0	39.5	53.6
1978	2656.2	3607.2	6528.6	40.7	55.3
1979	3257.8	4445.7	7633.9	42.7	58.2
1980	4134.3	5606.7	9002.6	45.9	62.3
1981	5236.5	6951.5	10854.4	48.2	64.0
1982	6643.7	8706.6	12454.6	53.3	69.9
1983	7459.7	9486.6	13595.2	54.9	69.8
1984	8128.0	10197.9	14790.8	55.0	68.9
1985	9001.2	11727.9	15698.3	57.3	74.7
1986	9544.5	12231.1	16728.2	57.1	73.1
1987	10021.1	12852.7	18033.0	55.6	71.3

Figure 11.1
Expenditure of Public Authorities 1964-1987



In addition to distinguishing between current and capital expenditure it is also useful to identify the purpose for which the expenditure is incurred. This is done in Table 11.2 with individual programmes grouped in a way which is more in line with public finance principles. Four major government functions are identified: the provision of public goods; the provision of merit goods; expenditure on income support; and the provision of general economic services. The data in the table include both current *and* capital expenditure.

There are a number of particularly notable points in Table 11.2. Public debt as a percentage of GNP increased from 5.9 per cent in 1975 to 19.2 per cent in 1987. Income maintenance expenditure increased from 5.9 per cent of GNP in 1965/66 to 15.1 per cent in 1987. Expenditure on merit goods increased from 11 per cent in 1965/66 to 19.2 per cent in 1987. Expenditure associated with the welfare state thus increased by 17.4 percentage points of GNP, and together with public debt accounted for 92 per cent of the total increase between 1965/66 and 1987.

It will be recalled from Chapter 1 that total current spending fell from 48.3% of GNP in 1986 to 39.6% in 1989. It is the purpose of this section to examine the evolution of some of the aggregates in greater detail. We begin in Table 11.3 with the evolution of non-capital supply services expenditure by functional category;¹ in order to provide a backdrop to the 1986-89 period, data are provided back to 1983.

Table 11.2
Distribution of Public Authorities Expenditure
(Current and Capital) by Programme 1965/66 to 1987
% of GNP

	1965/66	1970/71	1975	1980	1984	1987
The Traditional Domain						
<i>I Public Goods</i>	4.3	4.5	6.1	6.1	6.7	6.6
1 Defence	1.4	1.3	1.8	1.9	1.8	1.6
2 Other Central Gov. Services	2.9	3.2	4.3	4.2	4.9	5.0
The Welfare State						
<i>II Merit Goods</i>	11.0	13.1	17.9	19.6	19.4	19.2
1 Education	4.1	5.2	5.9	6.3	6.8	6.9
2 Health	3.2	4.5	6.3	8.3	7.7	7.2
3 Housing	2.8	2.4	4.0	3.5	3.2	3.6
4 Community and Social Services	0.9	1.0	1.7	1.5	1.7	1.5
<i>III Income Maintenance</i>	5.9	7.5	10.4	10.5	14.8	15.1
The Mixed Economy						
<i>IV Economic Services</i>	11.0	12.0	15.7	13.6	11.8	10.7
1 Agriculture, Forestry and Fishing	4.9	5.4	4.0	3.2	2.8	3.4
2 Mining, Manufacturing and Construction	1.6	1.9	2.2	2.9	2.5	1.8
3 Transport and Communication	3.6	3.5	4.4	4.9	3.3	2.6
4 Other Economic Services	0.9	1.2	5.1	2.6	3.2	3.2
<i>V Public Debt</i>	4.2	5.7	5.9	12.1	16.1	19.2
<i>VI Total Expenditure</i>	36.3	43.0	56.1	62.2	68.9	71.3

Source: National Accounts, various issues.

1. Non-capital supply services expenditure is effectively the day-to-day spending of Government excluding interest payments on the public debt.

Table 11.3
Evolution of Non-Capital Supply Services Expenditure,
1983-90 by Functional Category

	1983	1984	1985	1986	1987	1988 (2)	1989 Pro. Out- turn	1990 Budget Est.
	- (£million) -							
Pay and Pensions	2175	2335	2500	2625	2759	2845	2914	3096
Social Welfare Transfer								
Payments	1799	1991	2186	2385	2486	2452	2542	2631
Other Non-Pay	1772	1946	1803	1951	1880	1885	1803	1903
Gross Supply Service								
Expenditure	5746	6272	6489	6961	7125	7182	7259	7630
Appropriations in aid of								
PRSI Receipts	1095	1250	1326	1350	1507	1635	1662	1873
Net Supply Service								
Expenditure (1)	4651	5022	5163	5611	5618	5558	5597	5757
	- (Per Cent of Total) -							
Pay and Pensions	37.8	37.2	38.5	37.7	38.7	39.6	40.1	40.6
Social Welfare Transfer								
Payments	31.3	31.7	33.7	34.3	34.9	34.1	35.1	34.5
Other Non-Pay	30.8	31.0	27.8	28.0	26.4	26.2	24.3	24.9
Gross Supply Service								
Expenditure	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
	- (Volume Growth, Per Cent) (3) -							
Pay and Pensions		-1.1	1.5	1.1	1.8	1.0	-1.5	3.1
Social Welfare Transfer								
Payments		1.9	4.1	5.1	1.0	-3.4	-0.3	0.4
Other Non-Pay		1.1	-12.1	4.2	-6.6	-1.8	-8.0	2.4
Gross Supply Service								
Expenditure		0.6	-2.0	3.1	-1.3	-1.7	-3.4	1.1
Net Supply Service Expenditure		-0.5	-2.5	4.6	-3.1	-3.3	-2.1	-0.9

Sources: Estimates for the Public Services (various years).

Notes: (1) Excluding Local Loans Fund Subsidies.
(2) Excluding Posts and Telegraphs vote.
(3) CPI used to deflate Pay and Pensions, and Social Welfare Transfer Payments; Public Authorities Net expenditure deflator used for other aggregates.

The table distinguishes between pay and pensions, social welfare transfer payments and other non-pay spending and shows how these categories have evolved in nominal terms, relative to gross supply services expenditure and in real terms.

There are significant differences in the evolution of the three categories of gross supply service expenditure. Between 1986 and 1989, gross expenditure fell by 6.3 per cent – in real terms. This was due predominantly to an overall real fall in ‘other non-pay’ expenditure of almost 16 per cent. The category ‘other non-pay’ is heterogeneous and contains subsidies and grants and expenditure on goods and services other than pay. The other two components showed divergent trends. Pay and pensions *grew* by 1.3 per cent over the three year period while expenditure on social welfare transfers *fell* by 2.7 per cent.

As a result of these divergent movements, pay and pensions increased their share of total expenditure from 37.7% in 1986 to 40.1% in 1989, while other non-pay expenditure dropped over three percentage points. Social welfare transfer payments increased their share by almost one percentage point.

One final feature of Table 11.3 to note is the distinction between gross and net expenditure. The difference between these two aggregates comprises, inter alia, PRSI receipts and payments for services. The reduction in net supply services expenditure outstripped that of gross expenditure over the 1986-89 period; an 8.7 per cent per annum fall in real terms for net expenditure by comparison with 6.3 per cent for gross expenditure. The difference is accounted for by the evolution of appropriations-in-aid and PRSI receipts, which increased by almost 20 per cent in nominal terms over the period, equivalent to approximately two per cent in real terms.

Table 11.3 also presents the expected 1990 outturns based on the revised estimates. Gross expenditure is budgeted to increase by over 5 per cent in nominal terms, equivalent to somewhat over one per cent in real terms which is the first real increase since 1986. The principal contributors to this increase are pay and pensions with an expected real increase of 3.1 per cent and other non-pay of 2.4 per cent. Net expenditure is budgeted to fall in 1990 but by considerably less than that experienced in the last three years. Appropriations-in-aid are budgeted to increase in nominal terms by almost 13 per cent.

Turning now to the evolution of gross supply service expenditure by programme in Table 11.4, it can be seen that significant differences emerge between the various programmes. Between 1986 and 1989 economic services, infrastructure and security experienced total real reductions of 11.3 per cent, 5.2 per cent and 4.7 per cent respectively. Reductions in social services, by contrast, were considerably below average, a 2.5 per cent real reduction per annum. Nevertheless, social services accounted for 54% of the real reduction in gross supply services

expenditure. This, of course, is due to the fact that social services expenditure accounts for such a large proportion (almost three quarters) of gross supply services expenditure.

Table 11.4
Evolution of Non-Capital Supply Services Expenditure,
1983-90 by Programme

	1983	1984	1985	1986	1987	1988	1989	1990 (e)
– (£million) –								
Economic Services	607	665	726	788	749	685	646	634
Infrastructure	82	90	60	62	61	60	61	68
Social Services	4175	4536	4637	4939	5157	5180	5360	5596
Security	529	568	622	688	667	687	697	764
Other	353	413	444	484	491	581	495	568
Total Gross NCSSE	5746	6272	6489	6961	7125	7193	7259	7630
– (Per Cent of Total) –								
Economic Services	10.6	10.6	11.2	11.3	10.5	9.5	8.9	8.3
Infrastructure	1.4	1.4	0.9	1.0	0.8	0.8	0.8	0.9
Social Services	72.6	72.7	71.4	70.9	72.4	72.1	73.8	73.3
Security	9.2	9.0	9.6	9.9	9.4	9.5	9.6	10.0
Other	6.1	6.6	6.8	6.9	6.9	8.1	6.8	7.4
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
– (Volume Growth, Per Cent) (1) –								
Economic Services		1.3	3.2	3.8	5.5	-12.5	-11.7	-8.4
Infrastructure		1.5	-36.9	-1.1	-6.5	-5.4	-3.7	22.6
Social Services		5.0	-3.3	1.9	-0.7	-3.3	-4.6	-2.7
Security		-0.7	3.6	5.8	-7.8	-1.6	-4.6	2.0
Other		8.2	1.7	4.3	-3.5	13.9	-12.9	12.6

Source: Estimates for the Public Services (various years).

Notes: (1) Public Authorities Net Expenditure deflator used to deflate as Nominal Variables.

Some general points should be made here. The data presented are at a high level of aggregation and are the result of a host of underlying influences pulling in a variety of directions. For example, social expenditure programmes are the subject of three main influences: rates of payment, eligibility criteria and demographic factors.

Some of the changes in expenditure outlined above therefore derive from autonomous factors such as demographic change and changes in unemployment and from discretionary changes in policy. Any conclusions about the contribution of individual programmes or expenditure areas to overall fiscal retrenchment should, therefore, be treated with extreme caution.

3. PLANNING AND CONTROL CONCEPTS

Control or, more frequently, the absence of control, is frequently applied to public expenditure. Some examples should clarify the various meanings attached to control. Absence of control can mean that Government is unable or unwilling to restrain the overall growth of public expenditure. This was frequently the case in respect of over-runs on public expenditure during the late 1970s and first half of the 1980s. Even when expenditure is kept in line with plan or budget, assertions can be made about the lack of control – viz. that expenditure should be different from what it is but is constrained by rigidities in the fiscal system. Equally, one may have an expenditure programme, the level of which can be varied relatively easily, but on which the rate of return is unknown, which also indicates lack of control.

The management of public expenditure covers both the planning and control of public expenditure. Planning involves: (i) deciding on the overall expenditure totals, and ensuring that they are in line with macroeconomic and budgetary requirements; (ii) the determination of priorities and the allocation of expenditure to reflect those priorities; and (iii) the deployment of expenditure to achieve certain objectives. Control involves: (i) monitoring out-turns in line with plans and ensuring that deviations give rise to corrective action; (ii) ensuring that public expenditure provides value for money in terms of both efficiency and effectiveness.

Planning and control are opposite sides of the same coin, control is not possible without planning and planning is likely to be ineffective in the absence of appropriate controls.

Using more traditional budgetary concepts, three types of control are sometimes distinguished. *Firstly*, there is financial control, which is designed to ensure that public funds are spent only for those objects or purposes specified and that appropriations are not exceeded. The emphasis is on the legal regularity of the public expenditure process and on preventing the misappropriation of public funds. *Secondly*, there is managerial control, which is concerned primarily with efficiency, i.e. combining various resources to carry out an approved set of activities in an efficient manner. Both financial and managerial controls take the objectives of Government expenditure, their design and specification, and the level at which they are carried out, as given.

The third type of control which can be identified is that of *strategic control*. This brings into the budgetary process precisely those decisions (about programme objectives, specifications and levels) which are taken as given in the financial and managerial control functions. The other side of the strategic control coin is that of strategic planning which involves establishing and specifying objectives, choosing among alternative programmes to achieve these objectives and allocating resources among those programmes. A strategic planning and control perspective looks at public expenditure not simply as money totals, but as the means through which Government seeks to achieve its objectives, i.e. as the means through which budgeting and policy making are linked. We now use the concepts outlined here to discuss the management of public expenditure in Ireland.

4. ALIGNING EXPENDITURE WITH MACROECONOMIC REQUIREMENTS AND CHANGING PRIORITIES

(i) Rigidities in the Fiscal System

One of the principal budgetary tasks of Government in the 1980s was to bring public expenditure into line with overall macroeconomic requirements. In the early to mid 1980s, limited success was achieved in reducing fiscal imbalances despite efforts to achieve fiscal retrenchment. Notwithstanding public policy announcements of fiscal restraint, several obstacles, of an economic, institutional and political nature, blocked the restoration of fiscal balance.

These obstacles severely attenuated the discretionary power of Government. In the economic and social sphere (as distinct from the political) the obstacles derived from the fact that expenditures were very sensitive to outside factors beyond the immediate influence of Government. One of the most evident obstacles was the operation of automatic stabilisers – i.e. those parts of the fiscal system which are sensitive to the condition of the economy. For example, sluggish economic growth slows down the growth of revenue, and on the expenditure side, social security schemes trigger increased spending. Automatic compensation thus follows when unemployment rises.

In addition to automatic stabilisers there are various expenditure programmes which provide for automatic compensation when specified criteria are met, including certain demographic features (such as age limits), disability, family size, income level, etc. In some cases, expenditure commitments are determined by specific legislation and contracts with long-term implications. Such expenditures, are frequently termed demand-led expenditures, thus highlighting the reduction in the flexibility of Governments in managing public expenditure²

2. In addition to some expenditure being demand determined some are also, if not supply determined, at least supply influenced. A particular example of this is in the health area, giving rise to the concept of 'physician induced demand'.

In some countries a commitment to indexation of benefits is enshrined in legislation. In others, it simply became the norm or established practice to increase benefit or payment levels in line with inflation.

Another source of fiscal rigidity derives from the accumulated debt resulting from the continuous running of fiscal deficits. Governments have limited control over the resulting debt service obligations. In addition, such obligations are influenced to a significant extent by interest rate and exchange rate movements which are largely outside the direct control of Government.

It is the case of course that the factors itemised above can also result in downward pressure on expenditure. Examples of this are where reductions in unemployment have a dampening influence on social welfare transfers or where demographic changes take pressure off some programmes. However, one of the striking features of the 1980s was that almost all the variables to which public expenditure is particularly sensitive combined to exert upward pressure on expenditure. This imparted a 'flexible upwards – rigid downwards' appearance to the public expenditure system. Another question which arises in this context is whether there are institutional/political features of the public expenditure management system which exacerbate this 'flexible upwards-rigid downwards' syndrome. There is little doubt but that there are many features of the political system which make expenditure reduction an extremely difficult process. It is not proposed to deal with these here. Some of the institutional issues are examined later in this Chapter. It is worthwhile anticipating one of the conclusions of that discussion.

The institutional arrangements bias the budgetary process against limiting spending item by item or programme by programme. Each agency and spending department is concerned with its own development, which is generally synonymous with additional resources. Budgeting by addition rather than subtraction becomes common practice. In this type of environment, resource reallocation is generally achieved through enlarging the overall pool of resources rather than reallocation within the existing pool.

(ii) The Need For Limits

The existence of many expenditure programmes with a bias towards increase, together with an institutional system which encourages expenditure growth, yield a spending process operating without limits. Under this arrangement, what is to prevent the aggregate level of public expenditure from becoming the sum of its parts? The nature of the rigidities are such that, in the absence of some overall spending constraint, public expenditure would continue to grow at a pace inconsistent with budgetary requirements and overall fiscal balance. In the absence of an overall limit, budgeting comes to be characterised as a 'bottom-up' process wherein the demands of all programmes are aggregated together.

The introduction of limits, with a view to correcting this pro-spending bias in the fiscal system, has the effect of introducing a 'top-down' element into the budgetary

process. A 'top-down' element is one wherein an overall spending total is derived from some norm or rule related to macroeconomic requirements. Virtually all OECD countries now formulate and publicise a high level target which sets a limit on total spending. In virtually all countries current budgetary goals are expressed as specific quantitative targets. This has the effect of communicating the Governments' intentions to participants in the budgetary process and also restricts the ability of the Government to subsequently adjust its aggregate revenue and expenditure levels. This restriction is increased if targets are specified for each of several years rather than as a level to be achieved at the end of a specified future period.

The form in which targets are expressed is of crucial importance. Expressing top level budgetary targets in terms of desired deficit positions is a poor and inadequate proxy for expenditure control. A desired deficit position implies that any level of spending is permitted as long as it is matched by revenue.

As discussed in Chapter 4, the budgetary environment which has characterised the period since 1987 will not radically change in the medium-term. The Council has recommended that current public expenditure remain constant in real terms up to the end of 1993. This budgetary environment will necessitate the continuation of a strong top-down element in the budgetary process. The current broad public finance targets as articulated in the 1990 Budget are consistent with a number of directions for the individual components. As indicated in Chapter 4, if the Government's objectives for fiscal policy are linked with the Governments' taxation objectives, it implies further real reductions in public expenditure unless the tax base is significantly broadened. This should not be taken as an argument in favour of detailed annual targets or as a wish for spurious accuracy. It is recognised that a certain degree of flexibility is required. However, the broad strategic direction of the various components of the budget (debt, expenditure and taxation) for a number of years out should be indicated.

(iii) Top-Down Limits and Resource Allocation

While the rigidities identified in the previous section pose difficulties for expenditure control, in the sense of bringing expenditure into line with macroeconomic requirements, they also give rise to management difficulties, in the sense of re-allocating resources in line with changing priorities.

The actual expenditure plans for any year are the result of a process of reconciliation between the top-down limits derived from macroeconomic requirements and the competing claims for resources to meet existing programme needs, and further policy developments in various fields. This reconciliation is an extremely difficult process, involving the articulation of priorities and the identification and agreement on cutback options, if required, to contain total spending within the agreed aggregate target.

How does one inject flexibility back into the budgetary system? How does one ensure that certain expenditure items and programmes which are flexible in an upward direction but inflexible downwards, do not crowd out more malleable but sometimes higher priority expenditure. Some of the rigidities considered earlier are not directly moveable, for example, debt service obligations. However, once an overall limit has been set, one would expect that individual expenditure programmes would begin to compete directly for resources. Even within individual programmes, limits should ensure that certain questions are asked, for example, the trade-offs between indexation and coverage in many social programmes.

That leads immediately to an institutional issue. In Ireland, as in most other countries, public expenditure management revolves around spending departments, agencies and their expenditure programmes. Each of these participants in the budgetary process endeavours to protect their own programmes. There is, therefore, an incentive for all programme and agency managers to push against the overall limit or resource constraint. There is no incentive or mechanism within the institutional structure for one programme to compete with another. Before attempting to ascertain how to ensure greater flexibility in the institutional side of budgeting, it is worth delving a little into how this inflexibility comes to exist.

Traditional Budgeting

This is a general discussion of budgetary systems – it does not purport to describe the Irish system, although parts of it undoubtedly reflect the Irish situation, particularly before the fuller reviews, which takes place through the Expenditure Review Committee, were introduced. The dominant pattern of decision-making on public expenditure (before recent attempts at retrenchment) has been characterised as incremental budgeting. In theory, in the course of the annual budgetary exercise, a full review of revenues and expenditures takes place. In practice, however, the review is far more limited and cursory. In effect it is a marginalist approach with most of the time being spent in scrutinising the positive margin i.e. increments in Government spending proposed from inside the bureaucracy by spending departments or by external agencies dependent on public expenditure. Incrementalism is just one feature of what has become known as classical or traditional budgeting. Other features are: it is annual (repeated yearly); it is conducted on a cash basis (as distinct from a volume basis); it is a budget based on inputs (as distinct from outputs).

Traditional budgeting has been designed to achieve the lower forms of control which we classified earlier in Section 3 – narrow financial control. This gives rise to another characteristic feature of traditional budgeting – the proliferation of detailed rules about the use of resources at lower levels of the bureaucracy. This form of budgeting has shown great staying power and remains the dominant form of budgeting in virtually all political systems. But its limitations are well known. Many of the detailed budgetary rules entail irrationality, waste and inactivity. Accepting nearly all previous decisions as given and examining merely the

positive margin leaves large tracts of expenditure not scrutinised. Concentration on inputs frequently means that the policy objectives of the expenditure are lost sight of. Its annual nature can also lead to spending frenzies at the end of the budgetary year. The automatic expansion of expenditure through incrementalism also severely reduces the manoeuvrability of the whole system.³

Traditional Budgeting and Retrenchment

When this traditional budgeting system is confronted with the need for budgetary retrenchment based on macroeconomic requirements or with the need to alter expenditure patterns in line with changing priorities, how is it likely to react? The traditional system is really not suited to achieving successful economies. Incrementalism is based on an information system with a strong bias towards expansion – virtually the entire flow of information is concerned with demonstrating what could be done with a little more money. The difficulties, therefore, with combining this traditional budgetary system with top-down limits, is that enormous pressure falls on the central department to identify reductions, assign priorities etc. Central decision makers do not generally receive suggestions for cuts and economies, so when such measures are required they will frequently have to be improvised at central level. Is the central department in a position to handle this task? Because of the central department's lack of detailed information about programmes and organisations, there is concern that the cutbacks achieved may not be in line with priorities, that the most visible parts of a programme may be targeted for retrenchment or that a line of least resistance will be followed.

Against the background of these difficulties it is not surprising that a range of techniques have been employed to restrain public expenditure growth. Some of these techniques may be blunt, in terms of reflecting priorities, but effective, in terms of achieving savings. One such technique is that of 'spreading the sacrifice' whereby all programmes face a certain percentage reduction (the decremental equivalent of incrementalism); others are input controls – such as recruitment embargoes, cash limits on different types of expenditure, incentives to early retirement.⁴

Changes to the Irish System

In Ireland, the necessity for financial stringency that existed in 1987 was such that the normal process of assessing competing demands for expenditure, i.e. the annual estimates process, would not of itself procure the degree of adjustment required. Following the completion of the 1987 Budget, the Taoiseach initiated a system of expenditure reviews. The process required all Departments to carry out a policy based review of their expenditure programmes.

3. Many of these features of the traditional budgetary system were identified in the publication at the beginning of the 1980s entitled *A Better Way to Plan the Nation's Finances*.

4. Many of these techniques are also designed to achieve greater efficiency. For example, cash budgets are squeezed on the assumption that there is some inefficiency in the system and that savings can be achieved without a deterioration in service.

Programmes were examined by an Expenditure Review Committee to see if they were justified on their merits and in relation to the Government's objectives for the economy. The Expenditure Review Committee comprised the Secretary and other senior officers of the Department of Finance, the Accounting Officer of the Department concerned and an independent consultant economist. The Committee reported to the Government on the outcome of its meetings with the spending Departments and made recommendations for expenditure cuts to Cabinet for consideration and decision. The exercise was co-ordinated by the Department of Finance. The process has been repeated each year to date.

The change in the system was very successful in achieving its objective of expenditure reductions. Among the reasons for its success were that it transferred the initiative from those seeking to spend more to those seeking to reduce spending. It had the full backing of the Taoiseach and the Minister for Finance. Ministers and senior officials of line Departments were brought into the process from the very start and the onus was placed on them to identify their spending priorities. Departments were forced to propose expenditure reductions or, in most cases, defend their major spending programmes against the Finance proposals for reductions. As part of the process, proposals are submitted to Government in the summer, as well as in the estimates campaign in the autumn.

International Experience

The general conclusion emerging from this discussion is that the articulation of policy priorities and the allocation of resources to reflect these priorities is a difficult task. It is, therefore, worth examining the international experience on the issue. In a recent OECD publication on *The Control and Management of Government Expenditure* it was noted that:

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

One example of increased emphasis on Ministerial block budgets is Denmark, where the overall expenditure target is broken down into specific spending targets for each Ministry almost one year before the start of a fiscal year. The Canadian system, known as the Policy and Expenditure Management System (PEMS) is another example of the trend referred to by the OECD. The PEMS seeks to ensure greater Ministerial control over the management of policies and expenditure through the integration of the processes of policy making and fiscal and

expenditure planning and through the establishment of specific expenditure limits (Resource envelopes) for policy sectors. An outline of PEMS is contained in the Appendix to this chapter.

Implications for Ireland

Some tentative observations are now offered on the Irish system in the light of the above observations on budgetary systems and on recent international developments. *Firstly*, a system of public expenditure management involving the formulation of a total financial frame, or resource envelope, within which freedom is given to identify priorities and allocate resources, appears superior to a system where decisions are taken centrally on individual programmes and inputs. A number of other advantages could be claimed for the system but a more detailed evaluation of alternative systems would be necessary before confident conclusions could be drawn. The suggested advantages are, *secondly*, it could institute a system of competitive dialogue between programmes. This is in contrast to the situation described earlier where programmes tend to compete against the resource constraint rather than with one another for additional resources. This competitive dialogue might also be much more effective at eliciting information on programme objectives, costs and achievements than the existing system. *Thirdly*, the system could possibly spread the burden of fiscal restraint across the public sector, reducing the need for one central department to act as guardian of the resource constraint, sole provider of retrenchment options and priority setter, and resource allocator in specific areas. *Fourthly*, such a system would be very comprehensive, incorporating all the means at the disposal of the policy maker and ensuring that all the resources deployed for the achievement of particular policy objectives are considered. The issue of tax expenditures is very important in this regard. Their management will be considered in a later section.

If we consider a number of practical examples from the Irish public sector, the possible advantages of such a system can be seen in practical terms. *Firstly*, within the overall objective of economic development, there are a number of elements of public policy – industrial development, tourism development, tax expenditures in the form of the business expansion scheme and a whole host of other policies and programmes. An envelope incorporating these programmes would enable a calculation of the total amount allocated to an objective and permit re-allocations within the envelope. Another example is the allocation of support for the unemployed across various headings – income maintenance, special schemes, training and education, spanning at least three Government departments. Desirable reallocations would again be facilitated if all of these comprised one envelope or part of an envelope. In general, the grouping of programmes into policy sectors or envelopes should be organised and based on the similarity of programme objectives.

In the early 1980s the Department of Finance initiated a system involving a new, comprehensive presentation of public expenditure by programme to complement

the traditional estimates and other budget publications.⁵ The presentation was designed to identify major areas of policy by activity rather than by departmental responsibility, showing the costs associated with each area and indicating the activities and policies being pursued. This is effectively the basic framework through which an 'envelope' or some similar system might operate. It would involve, in particular, the aggregation of programmes with similar objectives and the construction of a decision-making framework around this grouping.

In summary, budgetary decision-making is quite a complex area. Considerable progress has been made in bringing the *level* of public expenditure into line with macroeconomic requirements. Success in reforming the *pattern* of public expenditure has been somewhat less. The above observations on possible alternative systems are offered as a basis for discussion – it is acknowledged that there is no right or wrong decision-making system. The Canadian and Danish systems are simply put forward as examples – not as potential blueprints for Ireland. Such systems could be used as analytical devices to complement the existing decision-making system. The danger with this, however, is that the analytic device and the actual decision-making system proceed in parallel and no benefit in terms of decision-making is derived from the analytic device.⁶ Since what is ultimately required is better quality decisions, it might be more appropriate to integrate some variant of the systems put forward into the public expenditure decision-making system, if only on a limited, pilot project, basis. Consideration of such alternative systems also raises questions about the ability of individual departments to think and act strategically. The Council has some concern in this regard.

(iv) The Need for a Strategic Perspective

The suggestion that central planning departments should concentrate on the allocation of resources to reflect broad priorities with decision-making on specific programme choice delegated down raises a fundamental question about the ability of individual departments to take a strategic perspective and allocate resources to reflect this perspective. Unfortunately the evidence is not very encouraging.

The following extracts from reports on the various policy areas are the basis for this conclusion.

Beginning with Ireland's industrial policy:

Currently, the Government bodies who should be responsible for policy-making are often spending time 'fire-fighting' and responding to IDA initiatives. They have neither the staff nor the information to formulate strategy, or to oversee the development agencies on an ongoing basis (NESC, 1982).

5. Comprehensive Public Expenditure Programmes

6. Among the reasons for the failure of Planning, Programming Budgetary System was that it was introduced in parallel to the then existing public expenditure management system with the idea that it would ultimately replace that system. However, while its information requirements were very demanding it never got to the stage of contributing to an improvement in the decision making process.

The situation is similar with regard to manpower policy where it was found:

The Department of Labour did not evolve into a central force with the authority and drive to co-ordinate, further develop and review manpower policies according as economic and social conditions change (NESC, 1986A).

The NESC's report on Community Care Services found a similar situation prevailing in regard to the health services:

At present the system of resource re-allocation between programmes and between regions appears to be ad-hoc; the Department of Health has acknowledged for instance that the "current system for allocating resources on a geographic basis owes more to history than to any scientific methodology" (NESC, 1987).

While there has been some change in the industrial development area, through the publication of a White Paper by the Department of Industry, it is uncertain that the Department has taken control of resource allocation to the extent necessary.⁷ In the case of Labour there has also been a White Paper and a restructuring of the agencies in the area. However, a strategic policy direction is not evident in the White Paper. It is understood that another White Paper on Industrial Policy is imminent.

It is not clear what the reasons are for the disappointing performance of Government departments in strategic management. Unfortunately, the White Paper on the Reform of the Public Service did not address these issues. While it did address *some* of the issues such as aims, objectives and outputs in the context of advocating a total management system for Government departments, the issue needs to be more specifically addressed. One of the reasons which has been adduced is that agencies, in some cases at least, have staff whose qualifications and expertise outstrip that of the parent department. Also, the fact that the autonomy of the agencies is long established and extremely strong (Health, for example) renders strategic management extremely difficult.

5. ENHANCING EFFICIENCY AND EFFECTIVENESS

While concerns about value for money have always been a feature of the budgetary landscape, the necessity for fiscal retrenchment has focussed greater attention on the issue. Value for money budgeting is concerned with promoting economy, efficiency and effectiveness in Government spending programmes, assessing the continued relevance of programmes in the light of changed circumstances and, in some cases, involving a reassessment and realignment of the role of the public sector, and examining whether some public services should continue to be provided and produced by the state or be transferred to the private sector.⁸

7. For comment on the White Paper on Industrial Policy see NESC 1986B.

8. The efforts in this area are designed to improve both allocative and productive (input/output) efficiency, see discussion in Chapter 12.

The measures taken in a variety of countries range from campaigns to improve financial management, including management reforms and improved incentive structures, to strengthened external monitoring and tighter controls of expenditure and inputs, to increased competition in the provision of Government services. We now examine each of these in turn.

(i) Direct Input Controls

Constraints on the principal input – manpower – have featured prominently in Government attempts to restrain public expenditure in the 1980s. In the first half of the 1980s a system was in operation whereby only one in three staff vacancies could be filled. In 1987, the Minister for Finance introduced a complete embargo on recruitment to the Public Service, except for certain key posts which could be filled with the consent of the Minister for Finance and the Minister for the area concerned. In July 1987, in the course of a review of public expenditure, it was decided that it was necessary to reduce the numbers of public servants and the pay bill more rapidly than could be achieved by relying on natural wastage. Initially, a scheme of voluntary redundancy was offered to public servants in areas where staff numbers were surplus to requirements – it was subsequently offered on a more general basis to employees aged 50 or over. The early retirement scheme was terminated in 1989 and the voluntary redundancy scheme was restricted to particular areas. There was an easing of the recruitment embargo in 1990 with limited scope existing for the filling of some of the vacancies arising.

Such measures are a crude but effective means of public expenditure retrenchment. They are effective because pay represents such a high proportion of public expenditure and they ensure blanket coverage of the measure. Despite their bluntness their use is probably due to the difficulties outlined in the previous section. It is estimated that the measures resulted in a fall in the numbers employed in the public service – including the local authorities – by about 20,000 from 1987 levels to its present level of approximately 196,000.

While such measures are effective in terms of restraining public expenditure, a number of problems can arise. By definition, such measures fall most heavily on the manpower intensive parts of the public service. In addition, recruitment embargos impact most severely on high turnover segments of the public service. As a result of these features, the budgetary retrenchment achievement may not be in line with priorities. Another criticism frequently levelled at such measures is that the brunt of adjustment is borne by the front-line staff with the support services escaping retrenchment. All this implies that measures such as these need to be accompanied by determined managerial efforts to redeploy overall resources in line with priorities.⁹

9. In the Irish case, redeployment occurred from within the civil service to the Department of Social Welfare and from other parts of the public service into the civil service (notably Revenue). Such redeployment took place on a voluntary basis, in accordance with the Programme for National Recovery.

The easing of these measures is now being replaced by more fundamental changes in the financial procedures governing administrative and running costs. The Minister for Finance indicated in the 1989 Budget that he was examining ways of fixing administrative budgets on a three year cycle at a level which would involve a real reduction in funding each year because of greater efficiency but which would allow greater managerial flexibility within those budgets. This is a welcome development in that it recognises the totality of running costs (not just manpower costs) and devolves responsibility to where it can be exercised best.

(ii) Cash Limits

Another form of input control has been the more general cash limit approach. This received its fullest development in the UK. A cash limit is defined as an administrative limit on the amount of cash that the Government proposes to spend on certain services or blocks of services for a year ahead. If, in the course of a year, the cost of a particular service rises by more than the amount provided for, then, in most cases, unless the increased costs could be financed by savings elsewhere in the block, the service would have to be cut-back to keep cash expenditure within the prescribed limit. The main areas which could not be covered by cash limits were those where expenditure was largely demand determined, in the sense that Government was obliged to meet claims from qualified applicants.

In the UK, cash limits were used to achieve a variety of policy objectives, from being a proxy for a public sector incomes policy to an instrument for reducing the volume of public expenditure. The latter could be achieved through setting limits by reference to lower than expected inflation rates through which the volume of public expenditure could be squeezed without ever making explicit that volume falls were intended. Cash limits were also expected to place constraints on public sector pay increases as follows – a pay norm was incorporated in the cash allocation such that any increase above the norm would have to be compensated for through reductions in other parts of the allocation. This, however, would only be feasible where responsibility for pay negotiations rested at the level where such trade-offs are being made. However, pay and employment conditions are determined in bargaining between civil service unions and central departments. In effect the discretionary power of line managers is frequently considerably restrained.

Another form of input control is pay restraint. The 1987 Public Service Pay Agreement was designed to ensure that the evolution of public sector pay did not put at risk the budgetary and financial targets underpinning the Programme for National Recovery. It is not intended to discuss general public sector pay issues here save to make one remark. It is sometimes argued that public sector pay forms such a large proportion of public expenditure that pay *rates* rather than *numbers* should bear the brunt of adjusting the public sector pay bill. This, however, needs to be qualified in one important respect. Pay is much more than the result of dividing the public sector pay bill by numbers employed. Pay is one of the mechanisms through which staff are

attracted, retained and motivated. While acknowledging the need for pay restraint in order to ensure adherence to tight fiscal targets, containing pay rates below private sector norms can result in recruitment and retention problems. Where the Government is competing with the private sector for similar kinds of labour, it will have to generally keep in line in the long run or find itself with lower quality manpower or a serious vacancies problem.

(iii) Improving Financial Management

Efficient resource management in the public sector had traditionally been rendered difficult by the nature of management objectives, rigidities in the budget system and lack of information about resource use.¹⁰ Public sector management objectives have been couched in terms of staying within detailed cash allocations rather than in terms of employing resources in the most cost-effective way in the pursuit of well specified objectives. Rigidity in the budget system limited the ability of top management to transfer funds between blocks and years and the ability of middle and lower management to vary the input mix in order to operate at lower cost. Neither was there flexibility in transferring spending between financial years, inviting irrational end-year spending. Lack of management information about economic costs compounded these difficulties. Cash authorisation budgets did not give line managers much information about the resource use and costs involved in carrying out their activities.

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

Ireland has been no exception in the introduction of such initiatives in the 1980s. Some of these have been mentioned already:

- (i) the introduction of a formal system of reporting to Government on the financial performance of the Commercial state bodies based on corporate plans
- (ii) publication of the "Comprehensive Public Expenditure Programmes".
- (iii) the fixing of administrative budgets on a three-year cycle with delegated managerial flexibility.

10. See OECD Economic Surveys, United Kingdom 1988/89

Other changes are:

- (a) the issue to departments of "Guidelines for Financial Management"
- (b) publication in September 1985 of a Government White Paper on the *Reform of the Public Service*
- (c) prescription of systematic procedures for the appraisal of capital projects.

Many of the weaknesses of the management system cited earlier were identified in the White Paper and some of the solutions proposed earlier were put forward. While events, particularly since 1987, have cast something of a shadow over general reform of the public service, the improvement of management systems as recommended in that paper would, if applied, greatly assist the overall control of public expenditure.

(iv) External Monitoring

External monitoring of the efficiency and effectiveness of government expenditure has been increased during the 1980s. In many countries use is made of direct private sector input to efficiency and effectiveness reviews. In the US a private Commission known as the President's Private Sector Survey on Cost Control was established to recommend ways of reducing the cost of Government and making it more efficient. In the UK the Rayner Scrutinies, as they became known, involved an examination of selected areas by individual Departments. The Irish Government has followed this route with the appointment in 1988 of an Efficiency Audit Group with a brief to examine, in conjunction with Departmental managements, the workings and practices of each Government Department with a view to recommending improved or alternative practices and methods which would reduce costs and improve efficiency.

In addition to these arrangements, most countries have external monitoring through the Government's auditor. There has been a distinct shift in the functions of this auditor in many countries over the 1980s. Recall that in Section 3 we distinguished three levels at which control operates: (i) financial regularity (ii) efficiency and effectiveness and (iii) strategic control. Government auditors have traditionally operated at level 1, i.e. financial probity. However, many countries have entrusted the Government auditor with a 'comprehensive' auditing function. In Australia, for example, the comprehensive auditing approach involves the planning, programming and conduct of a cycle of audits that examine and assess the legal compliance, administrative compliance, financial regularity, economy and efficiency of the auditees. The efficiency audit element of comprehensive auditing involves an evaluation of the effectiveness of the administrative actions and decisions taken by management in achieving programme objectives within the policy guidelines provided by the Government. In Canada, Netherlands, UK, US and Germany the external auditor also conducts reviews of how resources are managed, controlled and accounted for, how economically programmes are carried out, and whether they are meeting intended objectives. In Ireland the Comptroller

and Auditor General has a non-statutory function in relation to administrative efficiency.

(v) Exposure to Competitive Forces

Testing the cost-efficiency of government activity has increased over the last decade by making in-house production units compete with external producers in a competitive tender for specified tasks. As discussed in Chapter 12 many of the changes of this nature come under the privatisation umbrella. In considering this issue it is important to note that governments are involved in the production and provision of goods and services in a variety of ways. A useful distinction in this regard is that between 'who is the producer?' and 'who pays?' There are publicly produced private goods, like electricity and railways; there are publicly produced goods that are publicly provided, free of charge, like education; and there are privately produced goods that are publicly provided such as parts of the health services. The variety of arrangements possible is well illustrated by the case of health in Chapter 9 (Figure 9.1).

Since there is a range of avenues through which state intervention occurs, there are a whole host of policy changes under the broad umbrella of privatisation and deregulation ranging from charging to contracting out.

For some, privatisation has come to denote the process by which goods and services, currently financed and provided by the State sector, shift (*either* how they are paid for, or how they are provided, or both) to the private sector. Privatisation is also used to cover a change from 'inside' to 'outside' contracting of Government purchases and services.

A less well known form of contracting-out/privatisation has to do with welfare services, in particular, health, but sometimes education also. It is effectively a way of allowing the market to penetrate these services and it amounts to an extension of outside contracting beyond what it was originally conceived as. In the UK attempts have been made to create internal markets in both the health and education sectors. In the UK health services, competitive pressure is being stimulated by increasing the proportion of GPs income which depends directly on the length of their patient lists and by making it easier for patients to switch from one GP to another. Similarly, efforts are being made to ensure that hospitals are funded for the work they do and compete with each other to provide services to districts acting on behalf of their resident populations and the GPs.

How do these changes work?

It is important to ask why differences in performance might be expected between services that are tendered and those that are provided in-house.¹¹ One argument is that in-house provision removes, to a significant extent, the incentives and

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

constraints that apply to firms operating under competitive market conditions, such that there is not a strong incentive to maximise productive efficiency. It is sometimes argued that the answer to this is to regulate performance directly. However, those attempting to do so face information difficulties such that they cannot easily determine whether the service is being provided at a higher cost than necessary because the relevant information about efficiency is not readily available to them.

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

A number of problems arise with this scenario. Firstly, effective competition in the tendering process may not emerge. There are a number of reasons why this might happen, for example, sunk costs incurred in bidding, or differences in information between incumbents and potential entrants. Secondly, once a contract is awarded, the operator may try to increase profits by failing to fulfil his obligations or, by trying to reduce costs through reducing service levels. It is possible to guard against this by having tightly specified contracts and close monitoring and enforcement.

Empirical Evidence

Because experiments with contracting out really began in the 1980s the empirical evidence is very recent. In two case studies McDavie (1985) found cost savings and productivity improvements, where refuse collection had switched from public to private contracts. A cross-section analysis of 128 Canadian municipalities showed public collection was 50 per cent more expensive than private collection. The UK Audit Commission, looking at refuse collection in England and Wales, concluded that, although privatised services produce better results on average, privatisation was not necessary to secure efficient performance; one quarter of the internal public service units had costs as low or lower than the average privatised service. Hartley and Huby (1985) looked at a range of cases where local authority or health authority services had been privately contracted in the UK and concluded that private contracting had generally been associated with substantial reductions in costs.

Some detailed work has been undertaken in the UK on competitive tendering in refuse collection. Domberger et al (1986) found that where services had been tendered, costs are significantly lower (by broadly 20 per cent) than where they had not been. There was no evidence to suggest that these cost savings were achieved at the expense of a deterioration in the quality of service provided to householders. Neither does the evidence suggest that the lower costs of tendered

services result from 'loss-leading' behaviour (by either private contractors or in-house units) to establish (or reinforce) incumbency in a particular market. They, therefore, conclude that where tendering has been introduced, it has resulted in a significant improvement in the efficiency with which refuse services are provided. The results also show that the cost savings achieved where tendering results in the contract being awarded to the in-house unit are similar to those achieved where the contract is awarded to a private company. This finding is of course consistent with the growing literature that points to the importance of competition in inducing enterprises to act efficiently (see discussion in Chapter 12).

In a follow-up piece of work, Cubbin et al (1987) examined the likely sources of the efficiency gains associated with competitive tendering. This is important from a policy perspective since many critics of competitive tendering policy allege that the main sources of savings are lower wages and reduced fringe benefits rather than better management of resources and higher physical productivity of inputs. The results of the follow-up do not support the view that the bulk of the recorded cost savings arise from lower wages and fringe benefits. Greater productivity of labour and vehicles appears to lie at the heart of the efficiency gains. There was subsequent debate in the literature about the extent of the cost savings associated with competitive tendering and the interpretation of the causes of the observed savings (see Ganley and Gahl, 1988 and Domberger et al, 1988).

Domberger et al (1987) also investigated the case of hospital domestic services with the objective of comparing the costs of domestic services for hospitals that have been subject to the tendering process with those that have not. They also examined whether the cost reductions achieved by the use of outside contractors are greater than those achieved where the contract is awarded in-house. They concluded that the introduction of competition resulted in substantial savings – of the order of 20 per cent. However, the cost savings offered on some contracts in the first years of tendering were implausibly large.

A Policy Position

The issue surrounding the contracting-out of services is not confined to the public sector. Many private sector organisations have been engaged in a similar exercise. This very fact should serve to underline the point that the ownership issue (i.e. the public/private distinction), is not central to this discussion. It derives rather from the fact that organisations are made up of disparate units which are linked together for the purpose of providing goods or services. Individual departments within these organisations, public or private, can be categorised as facing the kind of incentives discussed earlier while the managers of the organisation are frequently short of the information necessary to evaluate the performance of these divisions. As with the case of public enterprises it is competition which is the key dimension to ensuring efficiency. The core policy position is, therefore, one of ensuring effective competition where feasible.

6. CONTROLLING TAX EXPENDITURES

It was noted earlier that in order to comprehensively assess the role of the public sector, it is necessary to take into account off-budget activities. The most notable of these are tax expenditures, loan guarantees and regulation. The generic title applied to these activities (i.e. off-budget) gives a clue as to why they deserve special attention from a control perspective. Two main issues arise in regard to tax expenditures. The first relates to their general desirability as a form of Government intervention as against other forms, in particular, direct Government expenditure. The criterion for choosing between different forms of intervention are efficiency (of which controllability is an aspect) and equity.¹² The second issue relates to the management of tax expenditures in a budgetary context. The first issue is dealt with in the tax reform chapter and the chapters on individual policy areas. It is the second issue we address here.

We begin with a definition of a tax expenditure. Tax expenditures refer to the revenue foregone as a result of specific departures from the tax code to achieve a certain objective. The name 'tax expenditure' reflects the fact that a concession in the tax law designed to induce or subsidise private action towards a certain end is virtually identical to a direct Government expenditure with the same outlay. Direct Government expenditure appears in the budget as an outlay whereas a tax expenditure has the effect of reducing receipts as distinct from adding to expenditure.¹³

Tax expenditures give rise to particular difficulties from a budgetary control perspective. There is a tendency for tax expenditures to be subject to less control than direct expenditure by virtue of their relative invisibility or lack of transparency, the fact that they do not pass through the normal appropriations channels, and the fact that there is rarely provision for a regular and systematic review of the various expenditures. Changes in the level of tax expenditures is sometimes due more to changes in the tax rates than explicit Government decisions. On the general issue of whether to use tax expenditures, or direct aids, the latter tend to be controllable and more targetable with eligibility criteria attached. Tax expenditures on the other hand tend to be more open ended with the total amount of expenditure often dependent upon the behaviour of the beneficiary. Tax expenditures also tend to assume the status of entitlement and tend not to be viewed in terms of an alternative to Government expenditure.

With the greater efforts being focussed on controlling public expenditure in the last two decades, tax expenditures have increasingly come under the spotlight. However, the solutions adopted tend to vary. The OECD (1984) has identified

12. For a good discussion of these arguments applied to Ireland's industrial policy instruments see NESC, 1986B.

13. Tax expenditures can take a number of different forms such as tax exemptions, tax allowances and special rate reliefs. They present considerable difficulties both conceptually and with regard to measurement.

three approaches. *First*, the ad-hoc basis whereby information on tax expenditures is provided in the context of reviewing specific policy issues or in the context of proposing new tax expenditures. *Second* the provision of periodic listings of the most important tax reliefs without any attempt to separately identify tax expenditures from the integral reliefs of the tax structure. *Third* the provision of tax expenditure accounts. They are usually annual listings accompanied by estimates and are generally attached to the annual budget statement. This approach is followed in Australia, Austria, Canada, France, Germany, Spain and the US.

The publication of tax reliefs and tax expenditure, as is now done in Ireland in the Annual Report of the Revenue Commissioners, results in better information being provided but does not automatically result in better management. Effective management of tax expenditures requires that they be considered as alternatives to direct Government expenditure. This involves allocating the tax expenditures to individual spending programmes, thus integrating them into the normal budgetary process. In this regard it was noteworthy that the Department of Finance publication Comprehensive Public Expenditure Programmes, which was designed to show the total costs associated with particular policies, did *not* include tax expenditures in the totality of resources devoted to particular programmes. Of the countries mentioned above with tax expenditure accounts, only in Canada and to a lesser extent, the US are they integrated into the budgetary review process. We have already seen the way the Canadian system operates, actually promoting consideration of trade-offs between tax expenditures and direct aid.

Some might argue that the recent experience with public expenditure retrenchment in Ireland has resulted in greater control of tax expenditures. Before adopting a position on this argument it is necessary to refer back to the planning and control concepts and also to integrate budgeting issues with the broader tax reform issues. The Council's policy on tax expenditures, derived from a tax reform perspective, is as follows: the priority of taxation policy must be the widening of the tax base and the simultaneous reduction of tax rates. Widening the base covers, inter alia, the removal of tax expenditures. One of the reasons for this policy position is that the tax system had, over a period of time, come to be seen as an instrument for the achievement of a whole variety of objectives. While this might suggest the wholesale removal of tax expenditures, it must be tempered by the broader policy context – as argued above, the relative suitability of different interventions, in particular the respective merits of tax-based and direct incentives.

It is possible that in the context of tight financial control, restriction on tax expenditures is seen as a means of narrowing budget deficits. While it does do this and also helps to widen the tax base and reduce tax rates (within an unchanged tax burden), this has to be linked to the broader policy issues. Such an approach is neither systematic nor comprehensive. Approaching it in this way results in tax expenditures being considered in isolation from the main objectives to which they relate. Control would be much more effective if they were integrated into the main

public expenditure decision-making framework and considered in the context of the totality of resources devoted to a particular activity and what policy in that area is trying to achieve.¹⁴ The Council has attempted to do this for mortgage interest relief and health insurance deductibility (see Chapters 8 and 9).

7. OVERVIEW

In this Chapter we began with a broad look at the evolution of public expenditure since the mid sixties and proceed to examine in greater detail the evolution of current public expenditure since 1987. We noted that management covers both the planning and control of public expenditure – that they are effectively opposite sides of the same coin; control is not possible without planning and planning is likely to be ineffective in the absence of appropriate controls.

In Section 4 we identified a number of rigidities in the fiscal system, relating both to the nature of the expenditures and the institutional arrangements for budgeting. These features have resulted in public expenditure being flexible upwards and rigid downwards while the institutional arrangements bias the budgetary process against limiting spending programme by programme. To counteract these rigidities it was recommended that a strong top-down element be introduced into the budgetary process. This top-down element is an overall spending total derived from macroeconomic requirements.

While acknowledging that strong political will is the major requirement for effecting expenditure adjustments, the Council is of the view that explicit medium-term targets for the public finance aggregates is also an essential underpinning for public expenditure control. The current broad public finance targets as articulated in the 1990 Budget are consistent with a number of directions for the individual components. As indicated in Chapter 4, if the Government's objectives for fiscal policy are linked with the Governments' taxation objectives, it implies further real reductions in public expenditure unless the tax base is significantly broadened.

In Section 4 the reallocation of expenditure within the total in line with changing priorities is discussed and it is concluded that the rigidities in the fiscal system pose difficulties in this regard also. The traditional budgeting process and how it might operate in the context of the need for retrenchment is examined. It is concluded that it is not really suited to achieving successful economies and that enormous pressure falls on the central department, which it is generally not equipped to deal with. There is a danger in this scenario that retrenchment techniques might not be in line with overall priorities. Prima facie evidence for this conclusion might be derived from the use of generalised cut-back techniques. Considerable changes have been made to the expenditure management process in Ireland since 1987 to overcome the incrementalism inherent in the traditional budgetary system.

14. Some technical problems are likely in implementing such a recommendation, although they are not insurmountable.

The problems identified with the expenditure management process are not unique to the Irish situation. It was noted that a number of countries are shifting emphasis to formulation of a total financial frame or block budget within which there is greater freedom to reallocate funds and adjust programme priorities. This allows central departments to concentrate on the allocation of resources to reflect broad priorities, with decision-making on specific programme choices delegated to where the information is available to do so effectively. A comprehensive monitoring mechanism would have to accompany any such delegation with the expected results and outputs of policies carefully specified.

The benefits of such a system lie principally in the provision of a framework within which priorities are clearly identified and resources allocated and can be made comprehensive by incorporating all the instruments at the disposal of the policy-maker. It was also argued that it could theoretically institute a system of competitive dialogue between expenditure programmes and perhaps spread the burden of fiscal restraint across the public sector.

Before any changes of this nature are considered, a fundamental question has to be raised, viz. the ability of individual departments to take a strategic perspective and allocate resources to reflect that perspective. Some doubts were expressed about this ability in the chapter. If the type of structural changes which we have identified as being necessary right through this report are to be achieved this issue will have to be addressed. Equally, the issue is central to achieving a policy of continued public expenditure restraint without damaging the growth potential of the economy.

In Section 5 we considered value for money budgeting and evaluated some of the techniques which have been pursued in Ireland. We also considered some new developments on the international front and examined their applicability to Ireland. Direct input controls, particularly manpower controls, were found to be blunt but effective means of curbing public expenditure. It was argued that such measures need to be accompanied by determined managerial efforts to redeploy resources in line with priorities.

The Council welcomes the concept of administrative budgets on a three-year cycle with greater managerial flexibility. It will overcome some of the shortcomings of the present system such as the spending frenzies at the end of the year.

To counteract some of the weaknesses in the budgeting system, many countries, Ireland included, have launched specific campaigns to promote better financial management. It is not clear what degree of progress has been made in Ireland on this front. There should be an annual review of developments in this area following up on the initiatives in the White Paper on Public Service Reform.

In external monitoring, there is a strong case for charging the Comptroller and Auditor General with a comprehensive auditing function, covering efficiency and

effectiveness as well as financial regularity. It is understood that this issue is presently under consideration.

There is an extended discussion of the idea of exposing the public expenditure system to greater market forces. The various forms which this can take are itemised. The manner through which these changes are expected to generate enhanced efficiency are discussed and the empirical evidence considered. The Council's policy position is broadly as follows:

- (i) ownership (i.e. public or private) is not central to the issue;
- (ii) competition is the key dimension to ensuring efficiency, which is highlighted when it is noted that both public and private sector organisations try to expose their in-house units to greater competition;
- (iii) in-house units can win in a competitive tendering situation;
- (iv) the core policy position, therefore, is one of ensuring competition where feasible.

In Section 5 the control of tax expenditures was considered. Tax expenditures give rise to particular difficulties from a budgetary control perspective. It is argued that the management of tax expenditures can only be effective when they are integrated into the main public expenditure decision-making framework and considered in the context of the totality of resources devoted to particular areas.

APPENDIX TO CHAPTER 11

THE CANADIAN PUBLIC EXPENDITURE MANAGEMENT SYSTEM (PEMS)

THE CANADIAN PUBLIC EXPENDITURE MANAGEMENT SYSTEM (PEMS)

The system attempts to take into account criticisms directed at the management of expenditures, including the lack of incentives to review ongoing programmes, the consideration of new proposals in isolation from clearly articulated objectives and expenditure limits, uncertainty created by seeking to contain spending growth through the continued use of expenditure reductions to keep within expenditure limits and the effect of this on long-term planning.

The objective of the system is to ensure that policy and programme decisions are taken in the context of, and with responsibility for, costs and expenditure limits and that, in turn, expenditure decisions are taken with an understanding of, and responsibility for the government's policies and priorities. The system involves two significant features:

1. The preparation of a long-term fiscal plan encompassing government revenues and expenditures over a five-year period, i.e. setting out the overall financial constraints within which policy choices must be considered.
2. The establishment of specific expenditure limits (resource envelopes) for policy sectors, related to the government's priorities, and the assignment of the responsibility for managing a particular policy sector's resources to the appropriate Policy Committee of Cabinet.

A Cabinet Committee on Priorities and Planning is central to the policy and expenditure management system. It has responsibility for setting the overall direction of government policy including the establishment of the fiscal plan and the determination of resource envelopes for each Policy Committee. It is not proposed to discuss the more precise elements of the long-term expenditure planning process. Of much more relevance to the issues/problems discussed earlier is the system of resource envelopes and the Committee on priorities and planning.

The creation of resource envelopes and their integration into the decision-making process of the Cabinet Committee structure are central to the new system. The envelope basically defines the resources that are available over time to a Policy Committee for a particular policy sector. Based on the budgetary requirements of departments and agencies within the sector, the Policy Committee of Cabinet responsible for that particular sector provides direction on the use of the resources.

Total government expenditures have been divided into ten envelopes. Most of these envelopes provide opportunities for the reduction or elimination of expenditures on programs within the envelope in order to yield resources for the expansion of other programs or the development of new ones. While the envelope is defined in terms of an expenditure budget, decisions on the envelope are arrived at with reference to all the means available to achieve a particular objective over

time: tax expenditures, loan guarantees, and the use of regulatory and legislative devices, as well as direct funding. This inhibits, for example, escaping the discipline of the envelope limit by expanding tax incentives.

These resource envelopes, together with information on the major policy areas, are intended to serve two basic purposes:

- (i) To display for Ministers quickly and conveniently the relationship of particular programs with a particular policy sector not only to other programs within the sector, but to the objectives and expenditure goals of the government as a whole. As such, envelopes are expected to facilitate the identification of expenditure pressure areas, and the comparison of expenditure trends to the government's objectives;
- (ii) To provide Policy Committees with both the opportunity and the incentive to develop systems for reviewing programs within their policy sectors and for reallocating resources from less effective to more effective programs. This is imperative given the requirement that the funding for new initiatives and activities be generated from savings on existing programs.

The program content of the envelopes has been designed to maximise policy trade-offs within each envelope while ensuring that Ministers' responsibilities for their respective departments and agencies are not dispersed across several envelopes and Committees.

THE MANAGEMENT OF PUBLIC ENTERPRISES

1. INTRODUCTION

A number of arguments can be marshalled in support of direct state involvement in the provision of goods and services and in the development of an industrial infrastructure. Amongst these arguments are ones based on the existence of market failure and risk aversion on the part of private entrepreneurs. In the case of a small and developing economy there are additional factors: the existence of economies of scale and the necessity for large initial capital outlays which would typically render private sector participation prohibitive. Public enterprises were also frequently created to promote social objectives that would be consistent with social profitability criteria but which would not generate private profits.

Many Irish public enterprise faced serious difficulties in the 1970s and 1980s. In many cases these were similar to those experienced by firms in the private sector and frequently for the same reasons: market conditions, adverse cost developments and inappropriate financial structures. However, there are also likely to have been some structural factors contributing to their disappointing performance. There has been a significant improvement in the financial health of these companies in the last number of years which is documented in Section 2. This was partly due to an improved trading environment and to significant labour shedding.

Given the contribution of the public enterprise sector to the economy, as a sector in and of itself, and as a provider of goods, services and infrastructure to the remainder of the economy, its efficiency and effectiveness is of paramount importance. Continued improvements in this respect are now likely to require attention to the structural factors which inhibit performance.

One of the structural changes which is now under active consideration in many countries and has been implemented in some is privatisation. Some sections of this chapter deal with various aspects of privatisation. The reason for this is not because privatisation is considered to be the central issue in regard to public enterprises (in fact the conclusion is that it is not the central issue), but rather because it raises fundamental issues which need to be addressed if that sector is to contribute to Ireland's long-run development.

Section 2 presents the results of some recent analysis of the performance of state-sponsored bodies. Section 3 examines the relationship between state bodies and Government and traces attempts by the latter to achieve greater control over the former. Section 4 examines the meaning and objectives of privatisation. Section 5 considers the incentives to efficiency which exist in the public and private sector

and uses the concepts of market failure and government failure to elucidate the issues. Section 6 examines the empirical evidence on the comparative performance of public and private enterprises. Sections 7, 8 and 9 consider the financial aspects of privatisation, privatisation and wider share ownership, and privatisation and industrial policy respectively. Conclusions are presented in Section 10.

2. RECENT PERFORMANCE OF THE COMMERCIAL STATE-SPONSORED BODIES

There has been little systematic analysis of the commercial state-sponsored sector in Ireland. However, there have been some recent attempts to remedy the situation. Sweeney (1990) conducted an aggregate and individual statistical analysis of seventeen non-financial commercial public enterprises over the period 1980 to 1987 inclusive. Official figures are now published also on the performance of public enterprises (Budget, 1990, Table 6, p.208).

Sweeney shows that the sector's contribution to GNP amounted to 10.2% in 1987. It accounted for 6.3% of employment and over 18% of gross capital formation. In 1987 commercial public enterprises accounted for the first four of the five largest employers in the country. He also shows that the size of Ireland's public enterprise sector is in the middle range of the developed countries, judged both by contribution to GDP and to gross capital formation.

According to Sweeney, in the eight years 1980 to 1987 the aggregate profits before interest and tax (PBIT) of the non-financial commercial state companies was positive. However, aggregate net profit (profit after depreciation and interest payments) was negative in the first four of the eight years (when Telecom and An Post are excluded) and, when included, there was also an aggregate loss in 1984. The negative or low net profit reflects the high gearing of the sector. The ratio of PBIT to net assets, reflecting the trading performance of the sector, increased from 3.1% in 1980 to 11.2% in 1984, falling back to 8.4% in 1987.

These broad trends are confirmed by the official figures in Table 12.1. Between 1984-85 and 1988-89 turnover increased by 14 per cent and profitability was turned around from an aggregate loss of £54m in 1984/85 to an aggregate profit of £183m in 1988-89. Over the same period, total employment fell by 9.3 per cent.

3. SOME CONTROL ISSUES¹

Public enterprises or commercial state-sponsored bodies are organisations which sell their products, be they goods or services, and which derive the major part of their revenues from the sales of these products. The relationship between these enterprises and their sole shareholder – the Government – occurs at a number of levels and has evolved in a number of directions over the past decade as Governments have sought to achieve greater control.

1. This section draws heavily on Ferris (1987)

Table 12.1
Aggregate Results and Financial Position of
Commercial State-Sponsored Bodies

Profit/(Loss) Account	Total				
	1984-85 £(000)	1985-86 £(000)	1986-87 £(000)	1987-88 £(000)	1988-89 £(000)
Turnover	3,734,409	3,921,339	3,833,966	4,151,529	4,264,593
Profit after tax and Minorities	(23,921)	78,685	58,426	63,233	163,894
Extraordinary Item	(30,298)	(27,526)	(806)	(52,440)	18,752
Net Profit	(54,219)	51,159	57,620	10,793	182,646
Balance Sheet					
Fixed Assets	3,502,856	3,721,201	3,851,938	4,033,696	4,180,295
Investments	2,397,692	3,037,450	3,482,038	3,802,546	4,508,223
Net Current Assets	335,165	347,911	278,030	405,195	354,070
Long Term Funding and Provisions	5,335,362	6,048,398	6,485,030	6,968,686	7,521,354
Net Worth	900,351	1,058,164	1,126,976	1,272,751	1,521,234
Smallholder's Funds and Reserves					
Minority Interests	895,679	1,051,345	1,118,492	1,262,962	1,511,119
	4,672	6,819	8,484	9,789	10,115
	900,351	1,058,164	1,126,976	1,272,751	1,521,234
Employment					
State Equity Investment	81,084	77,866	75,291	74,667	75,532
State Subsidies	81,000	36,245	29,000	11,000	11,648
Dividends/ Distributions Paid	120,000	116,000	117,099	118,898	112,005
Corporation Tax Charge	81,145	94,818	55,666	16,075	16,774
	(2,560)	(2,927)	(22,173)	(32,946)	(18,257)

Sources: Budget 1990.

Notes:

- The bodies whose accounts are aggregated in this table are as follows:
 - Energy-Related Companies: – INPC, ESB, BGE and BNM
 - Industrial Bodies: – Irish Steel, and Siuicre Eireann
 - Transport Bodies: – Aer Lingus/Aer Linte, B & I, CIE and Aer Rianta
 - Banking and Insurance: – ICC, ACC and Irish Life
 - Communications Bodies: – BTE, An Post and RTE
 - Other Companies: – Irish National Stud, Great Southern Hotels and Arramara Teo, Racing Board and Bord na gCon.

In Ireland there are two modes of control of public enterprises: Ministerial Control and Parliamentary Control. Parliamentary control is exercised through legislation and through the opportunity to consider periodic injections of state capital. Ministerial control has three different strands: (a) the appointment of Board members to carry out the policies laid down in legislation or by directive; (b) power to govern the presentation and form of reports and accounts and to provide for audit; (c) exercise of influence by formal and informal contact. Parliamentary control is exercised principally through the Oireachtas Joint Committee on State Sponsored Bodies which take their membership from both Houses of the Oireachtas. The Committee is required to examine the reports and accounts and overall operational results of state-sponsored bodies engaged in trading or commercial activities.

More recently, successive Governments have sought to exercise more control over the state-sponsored bodies, emphasising the need for improvements in their commercial performance. This was prompted by significant deterioration in the commercial performance of these enterprises and also by the realisation that the charges for their services were impairing the competitiveness of the internationally trading sectors of the economy. The need for greater control arose also from an observation that market pressures were likely to be either absent, inadequate or ignored in these enterprises. However, many of the solutions were 'administrative' in nature and were seen as proxies for market forces. Ferris (1987) itemised a number of areas where new measures were introduced, covering, inter-alia, corporate planning, investment appraisal and accounts and reports.

Each state-sponsored enterprise is now required to prepare a corporate plan covering a five year period on a 'rolling' basis, containing an outline of corporate objectives, the strategies which are being adopted and the detailed programmes to achieve the objectives. There has also been considerable emphasis on improving the appraisal of capital expenditure, incorporating the recommendations of the Report of the Working Group on Cost Over-runs on Public Construction Contracts. A number of measures have also been introduced to increase the clarity and comprehensiveness of the reports and accounts and improve financial control of the state-sponsored companies. There were a number of other areas mentioned by Ferris – borrowing limits, performance indicators and pricing policy. While there are limits set down by statute to the guaranteed borrowings of state companies, there is no publicly articulated general policy in regard to many of these issues.²

Ireland is not unique in the issues arising in the relationship between commercial state companies and Government. In the UK, for example, dissatisfaction with the performance of nationalised industries resulted in repeated attempts to prescribe more specific objectives. In spite of this, detailed scrutiny by the Government of

2. It is noteworthy, for example, that in the 1990 Budget the Minister for Finance raised the VAT rate on electricity from 5 to 10 per cent and removed the VAT exemption for the telephone service (imposing VAT at 10 per cent on telephone and related services) while indicating in both cases an expectation that the additional costs would be absorbed by the two companies.

day-to-day activities of nationalised industries tended to increase rather than diminish, and their autonomy was steadily eroded. Failure of these administrative solutions is the background against which a market based solution, i.e. privatisation, was introduced.

In Ireland a further step in the policy towards state-sponsored enterprises is contained in the 1990 Budget:

There has been significant growth in recent years in the proceeds of the sale of State assets. These sales have been carried out in pursuance of the Government's view that it is not in the best interests of the State – any more than it would be for a business – to continue to hold assets which are not providing an adequate return, in particular when the national debt and debt-service costs are so large. I have, therefore, made a prudent provision in the White Paper on Receipts and Expenditure for a further increase in such sales in the current year. This is the first phase of a new five-year programme of such sales so as to help to reduce the national debt.

4. PRIVATISATION: DEFINITION AND RATIONALE

(i) Meaning of Privatisation

The term privatisation, although popularly associated with the sale of commercial public sector companies to the private sector, has been used as an umbrella to cover a variety of Government policies. A wider definition than the sale of public sector companies would be a transfer of assets to the private sector, implying that the predominant share in ownership of assets on transfer lies with private shareholders.³ The latter definition does not, of course, enable us to identify precisely what forms of assets transfer fall within the definition. Obviously, the sale of public corporations operating in the market sector is covered by the definition. However, this definition would also cover sales of local authority dwellings. Even where the purpose of such sales is to increase the incidence of owner-occupation, the new private owners are simply performing the service of providing accommodation for themselves. There is a genuine transfer of assets to the private sector and substitution of private for public (local authority) ownership.

Privatisation is also used as an umbrella for deregulation and liberalisation policies. These policies may or may not accompany the sale of assets to the private sector. Deregulation is the removal of statutory restrictions on competition and liberalisation consists of the introduction of measures to increase competition.

These policies can take the form of encouraging or requiring public or private sector companies to compete with each other, or of allowing new entrants to the market of established state companies and regulated monopolies. Interestingly Yarrow (1986) argues that the identification of privatisation policy with asset sales

3. Transfer of state assets can occur other than through sale of state companies through the stock market – an example is a management buy-out.

is misleading for two reasons. First, asset sales need not be involved, as in the case of franchises awarded for the running of public facilities or publicly maintained legal monopolies. Second, even where asset sales occur, much of the impact of policy may arise from decisions taken about regulation. Yarrow uses a definition as follows: "the transfer from the public to the private sector of entitlements to residual profits from operating an enterprise, coupled with any accompanying changes in regulatory policy".

There are many other aspects to privatisation which are more germane to the management of public expenditure more generally than to the management of the public enterprise sector (see Chapter 11).

(ii) Objectives of Privatisation

Privatisation programmes have been developed in pursuit of various objectives with different objectives having higher priority at particular times. Bishop and Kay (1988) argue that while the origins of privatisation in the UK lie in a concern to diminish the power of public sector trade unions, this was not a factor of much significance in the development of the programme. At other times financial arguments have been central. In the early years of the privatisation programme, when borrowing targets proved particularly difficult to meet, privatisation was seen as an important revenue source. Wider share ownership has also been an objective of privatisation. In fact, it is clear that in pricing share issues, the UK Government has been willing to sacrifice revenue in order to secure wider share ownership.

It is, however, concern for efficiency that drives much of the privatisation debate. In the case of the sale of the nationalised industries in the UK, concern for efficiency has been an important issue, although, as pointed out by Bishop and Kay (1988), this has often been based on a loosely argued ideological faith in the superiority of private ownership. There is, however, considerable ambiguity about the relative role of competition and ownership in promoting superior performance. In this chapter, what we are concerned with is the issue of efficiency and with the concept of privatisation as strictly an economic instrument. We turn now, therefore, to examine the concept of efficiency before examining how it is argued to be enhanced through privatisation.

5. INCENTIVES TO EFFICIENCY

It is important to make a distinction between different types of efficiency – productive efficiency and allocative efficiency. Productive efficiency requires that whatever is done should be achieved at minimum cost. Allocative efficiency implies that what is done meets consumer needs at prices which reflect the costs of provision.

What incentives exist to achieving both productive and allocative efficiency in the public and private sectors? What is the relationship between ownership and efficiency? This is the central question surrounding the issue of privatisation since many of the proponents of privatisation point, inter-alia, to its beneficial impact on efficiency. We answer the question about the relationship between ownership and efficiency by firstly examining how efficiency is ensured in private competitive markets and, secondly, by examining the evidence on efficiency differences between the public and private sectors.

Competitive forces operate in four main ways. *First*, there is competition in the product market which encourages firms to supply the goods desired by consumers at a price which reflects the cost of production. The firm, therefore, has an incentive to achieve allocative efficiency, provided that the market price reflects the value of its output (implying that external effects and distributional consequences are unimportant). *Second*, there is competition in the market for corporate control such that management is impelled towards maximising the value of the company. If the incumbent management does not do so, then the firm will be taken over. *Third*, private shareholders may be better informed and be more demanding than Government as a shareholder because they share more directly the benefits and costs of the way a firm is managed. Shareholders may also set up incentive systems – featuring bonus payments or profit sharing, for example – that put pressure on managers to be more efficient. *Finally*, there is the threat of bankruptcy.

Table 12.2
Ownership, Competition and Efficiency Incentives

Types of Firm/ Competitive Forces	Publicly owned monopoly	Publicly owned competitor	Private monopoly	Competitive private firm
Can the firm go bankrupt?	No	No	Yes	Yes
Can it be taken over?	No	No	Yes	Yes
Is the product market competitive?	No	Yes	No	Yes
Incentives to – allocative efficiency?	No	Yes	No	Yes
– productive efficiency?	No	No	Yes	Yes

Source: Adopted From Kay, Mayer and Thompson (1986)

Using the criteria of: (a) whether the product market is competitive; (b) whether the firm can be taken over; and (c) whether the firm can go bankrupt. Table 12.2 examines whether, for different types of firms, there are incentives to productive and allocative efficiency.

In the absence of the competitive pressures in the form of bankruptcy, take-over or product market competition, the table suggests that the incentives to achieve productive and allocative efficiency are diminished. The table also suggests that there is a clear correlation between competitive product markets and allocative efficiency and between ownership and productive efficiency. Allocative efficiency is therefore a function of market structure rather than ownership and can therefore only change as a result of changes in market structure.

Productive efficiency is a function both of ownership and of market structure. In the case of the relationship between productive efficiency and market structure, the argument runs that, where the market is competitive, firms will be forced to carry out their activities at minimum cost. In the case of ownership and productive efficiency the argument has a number of strands. *Firstly*, if public enterprise managers cannot make decisions independently of the need to meet the demands of political expediency, changes of ownership should improve the quality of managerial decision making – in effect, reduced political interference. *Secondly*, improved productive efficiency should result from the setting up of incentive systems by shareholders to reward managers for efficiency. *Thirdly*, more effective financial management results as an enterprise relinquishes access to direct financial support from the Government and becomes subject to the discipline imposed by the private capital market and the market for corporate control. While none of these arguments unequivocally implies that privatisation will significantly increase productive efficiency, some improvement is likely to result.

The table suggests that: (i) even where the product market is competitive, there may not be incentives to productive efficiency (i.e. publicly owned competitor); and (ii) that where the product market is not competitive, but where the firm can either be taken over or go bankrupt, that there are incentives to productive efficiency (i.e. private monopoly).

Some qualifications

This conclusion that privatisation tends to promote productive efficiency and that competition promotes allocative efficiency is too much of a simplification however. This is so for two reasons. *Firstly*, there is a strong presumption that markets do and will operate efficiently. Markets sometimes do not operate in this way because of market failures.

It was held that private ownership would not achieve allocative efficiency and consequently many activities were provided by the public sector. There may, of course, have been productive efficiency losses by having these activities provided

by the public sector; productive efficiency may, therefore, have been sacrificed for allocative efficiency. In this case, simply changing the ownership of the enterprise could achieve some gains in productive efficiency but at the expense of a deterioration in allocative efficiency.

The *second* qualification is covered in the answer to the question: do private firms, which do not face competitive product markets, have greater incentives to productive efficiency than their public counterparts? The enterprises that are frequently subject to privatisation are generally well established firms which, when transferred to private ownership, can build upon the advantages arising from their position as a dominant incumbent, to reduce the threat of competitive market entry and to utilise the financial strength which enables it to outlast competitors when price competition is intense. These financial and technical advantages are frequently reinforced by the political skills and influence which incumbents have normally acquired. They thus hold substantial competitive advantages reflecting their expertise, regulation and physical assets. They are, in effect, dominant firms and would therefore be expected to exert substantial control of their product market. While the scope for political interference may be less in a private sector business, it may also be the case that private sector managers face fewer constraints in exploiting a dominant market position.

These two qualifications, i.e. (i) the failure of markets, and (ii) that private firms which do not face competitive product markets face broadly the same kind of incentives to productive efficiency as their public counterparts, indicate that the structure of incentives towards the promotion of efficiency is substantially more complex than encompassed by a simple distinction between public and private. Any policy position on privatisation will have to reflect this complexity. This complexity is also reflected in the findings of empirical studies which have sought to compare the performance of public and private enterprises.

Government Failure

In the discussion up to now the arguments have been couched very carefully in economic terms, distinguishing between productive and allocative efficiency, examining the incentives to both and emphasising that the issue is far more complex than simply one of ownership. Such concepts frequently appear to be very far removed from the practical world of day-to-day decision makers. In this subsection it is proposed to try and bridge the gap between these two worlds. In order to do that two papers prepared by people familiar with the practical world of state-sponsored companies – Dempsey (1986) and Dargan (1986) are examined.

In the strategic issues chapter we argued that while markets nearly always fail in some degree so do Governments. With regard to any intervention by government, the question should be: how much information do administrators have and how likely are they and the politicians to be captured by vested interests? In the case of interventions through state-sponsored bodies, how likely are they to act in a

commercial manner? It is to this question that Dargan (1986) and Dempsey (1986) addressed themselves.

Their comments confirm the existence of Government failure. However, the comments were made in the mid-eighties thus preceding some of the changes recently brought about by Government and described in Section 3 above. Dempsey (1986) concluded that the state is not a satisfactory shareholder in a commercial business, arguing that its procedures are, of necessity, ponderous and political, and unsuited to the direction of the more immediate and often opportunistic nature of business. He points out that the responsibility of ownership is to ensure that the business is run efficiently and effectively, yet the mechanisms of state ownership are almost, by definition, quite unsuited to that role. Not only is the decision taking line far too long and unwieldy to enable shareholder consent to be obtained in good time, but the system is actually counter-productive. Dargan (1986), in making a similar point, instances situations where changes in capitalisation involving an equity investment may take two years from the time of a board recommendation.

Both papers are very critical of the method of board selection, arguing that the present system of appointment is not done by the shareholder wholly and exclusively in the interest of the business. Dargan, in discussing the objectives of state companies, argued that in many cases recompense is not provided for non-commercial activities carried out by these bodies on specific direction by the Government. He also sees a danger that some bodies come to be viewed as instruments of national taxation or price control.

The net result is that there is a significant degree of Government failure in the use of state-sponsored bodies to achieve particular objectives. This has the effect of lowering the productive efficiency of these bodies, frequently resulting in situations where such bodies fail to remunerate the capital employed in the business.

6. PERFORMANCE OF PUBLIC AND PRIVATE ENTERPRISES

Unfortunately, there have been few systematic studies of the relative performance of the public and private sectors and those that have been done have to be interpreted with some caution. One of the reasons for the paucity of research is the difficulty in making meaningful comparisons. These difficulties arise from:

- (i) the problem of finding suitable test-beds, i.e. sectors where both public and private enterprises operate: even when they are found, they are almost invariably unrepresentative;
- (ii) public corporations may have some non-commercial objectives including social obligations to deliver essential services, sell at below cost, which may involve cross-subsidisation, and provide employment, all of which may bias comparisons of efficiency;
- (iii) appropriate measures of output may be difficult to devise where outputs are not sold on a competitive market;

- (iv) public corporations may sometimes face different input prices as a consequence of being in the public sector (access to cheap capital through State guarantees or requirements to purchase more expensive inputs).

We will now briefly summarise the findings of the comparisons which have been undertaken and present some conclusions based on the findings.

Pryke (1982) compared three activities in the UK where services were provided by both public and private sectors – airlines, ferries and Hovercraft, and sale of electricity and gas appliances. In each of these activities, Pryke's analysis shows a picture of a more profitable private enterprise, increasing its market share at the expense of the public sector. Where comparisons of cost levels and efficiency were feasible, the analysis shows the private enterprises in a favourable light. Pryke concluded that these public enterprises have been badly managed and that the main explanation for this poor performance is a weakening of incentives resulting from public ownership.

Two major international surveys of public/private ownership studies have been carried out. Millward (1982) reviewed a whole range of studies, the results of which we will briefly summarise. Studies of the costs and efficiency of electricity generation and distribution in the US found that public sector utilities typically have lower unit costs of supply than their private sector counterparts. In contrast, a comparative study of water utilities in the US showed substantially higher costs in the public sector. From Canada, a study of the costs and efficiency of two competing railroads – one privately and the other publicly owned – concluded that the publicly owned one did not have higher unit costs than the privately owned one. A similar study of air services within Australia showed very little difference between the performance of the public and the private. Millward's general conclusion from all of these studies is that overall there is "no broad support for private enterprise superiority".

The other major international survey of public/private ownership was conducted by Borcharding et al (1982) - it cites more than fifty studies from five countries. They conclude that the empirical findings are 'consistent with the notion that public firms have higher unit cost structures'.

Can these findings be reconciled? Are there some general findings which are common to all studies? Some writers in the area have attempted to do so and they generally appeal to the market structure and the structure of incentives in each case to reconcile the different findings. The first major conclusion on which there is general agreement is that it is the varying interaction between ownership and competition, and the effects of regulation in markets where competition is absent, that explains differential public and private sector performance. Deriving from this is a second main conclusion which commands agreement in the literature – in the absence of market failures, all enterprises, public or private, perform more

effectively where product markets are competitive than where competition is absent. Where competition has been introduced between public and private firms, the differences in costs between the sectors is largely removed. A third conclusion, also finds consensus that *where product and factor market inefficiencies are significant* there is no general support for the view that private companies are more efficient than public companies. Indeed in some cases, it tends to point in the other direction, towards better performance by public firms. However, this may derive from the fact that regulation of private sector firms where competition is absent can give rise to distortions which can induce poorer performance. Another conclusion on which there is broad agreement is that where the activity in question forms a small part of the operation of a far larger enterprise, it tends to underperform its private sector counterpart.⁴

An area where dispute emerges is where product markets are generally competitive. Bishop and Kay (1988), for example, conclude that "where product markets are competitive some studies also suggest that the efficiency of public enterprises may match that of private companies". Yarrow (1986), on the other hand, concludes that "where product markets are less monopolised, the comparative performance studies suggest a more favourable verdict on private enterprise". However, he goes on to state that "even here, however, the evidence is far from overwhelming".

7. FINANCIAL ASPECTS OF PRIVATISATION

An objective of privatisation has also been to ease the borrowing position of Governments. In the UK, for example, in the early years of the privatisation programme, when borrowing targets proved particularly difficult to meet, privatisation was seen as an important revenue source. In the UK, the extent of the sales of public assets has had important effects on public finances and indeed has had important implications for fiscal policy as a whole.

These effects are partly due to statistical conventions. Historically, in the UK, Government purchases of shares and assets were treated in national accounts as public expenditure rather than as investment. The converse of this provided the rationale for treating all sales of Government shares and assets as negative public expenditure. The two immediate consequences of this are: (i) privatisation is treated as reducing public sector borrowing, rather than as a means of financing the difference between public sector revenues and expenditure figures; (ii) privatisation revenues reduce the reported level of public expenditure.

4. The same is, of course, often true within the private sector. However, poor performance in a competitive market by privately owned companies leads to remedial action in a manner which is not necessarily assured under public ownership.

In order to understand the implications of this convention, we will explore how the sale of a public enterprise affects the public finances. Consider first the case of a sale of a profitable publicly owned firm. The value of any enterprise now is the value in present day terms (technically known as the present value) of the future stream of income which the enterprise would generate. The sale price would therefore be equivalent to the present value. In effect, the Government is trading that future stream of income for an immediate cash benefit and the net worth of the public sector will be unchanged by the act of ownership transfer. We have assumed that the future stream of income would be the same under the new owners as under public sector ownership. However, where privatisation induces an improvement in the internal efficiency of the enterprise, and there are no offsetting market failures, the future income stream and, consequently, the present value, will be higher than had the assets remained under public ownership.⁵

We turn now to the question of whether the privatisation of enterprises that are incurring losses improves the Government's budgetary position – this is a situation where privatisation is widely advocated. The concepts to be used are similar to those for a profitable enterprise. When an enterprise is expected to carry on making losses even after a change of ownership, then the present value is negative. In such cases, if the enterprise is sold at a competitive price, this price will be negative. This means that the buyer will have to be paid an up-front lump-sum subsidy equal to the negative present value of the enterprise's future losses, or a stream of marginal subsidies will have to be guaranteed. The subsidy need not be explicit. It could, for example, be used to assume part or all of the liabilities of the firm. Where changes in the performance of the enterprise are expected, a positive price is conceivable. The position regarding loss making subsidiaries is well summarised by Mansoor (1987).

The notion that privatisation, regardless of changes in performance – as opposed to liquidation – offers permanent financial dividends to the budget where enterprises are heavily subsidised is therefore misleading. Such dividends will emerge only if enterprises can be run more efficiently in the private sector... (p.6).

In general, therefore, while the sale of a public asset can temporarily reduce the Government's taxing or borrowing requirements, it does not represent a fundamental change in the budget balance. This happens because asset sales tend to reduce the conventional deficit in the year of sale, while the impact on Government's 'permanent income' or wealth is neglected. Thus, although asset sales improve cash flow and appear to provide a margin for cutting taxes or increasing expenditure (by providing extra revenue), this may occur at the cost of tightening these constraints in future years. To quote the OECD (1986) on this point:

5. The overall economy will be better off as a result of these greater efficiencies unless they are the result of greater exploitation of market power. Who captures these benefits depends upon the relative bargaining power of the buyer and the seller.

... each sale of a public asset only provides the government with a once-and-for-all source of revenue. The treatment of the proceeds of such sales as deficit reducing, or even as negative outlays, may lead to the incorrect impression that the government's budget position has improved when all that has happened is that its financing has been made easier. If these sales were considered in a balance sheet framework, which took account of effects on both government assets and liabilities, their long-run effects on the public finances would be more evident. Moreover, continual disposal of the government's assets leads inevitably to the depletion of its wealth. Once the stock of assets is depleted, alternative financing must be found. While the sale of assets has merit on economic efficiency grounds in many instances, the fundamental determinants of governments' medium-term budget balances are unaltered by such transactions. The danger of bringing revenues from asset sales on-budget rather than keeping them off-budget is that, by running down their stock of assets, governments will eventually find themselves even more constrained either to raise taxes, accept further increases in net debt, or monetise future deficits in order to finance the *flow* of expenditures.

The privatisation of public enterprises also raises another financial issues, viz. the price which the Government realises on the sale. The general evidence from the UK is of assets being sold at substantial discounts (Mayer and Meadowcroft, 1986). Two methods are available for selling public assets: offers for sale and tender offers. In an offer for sale, shares are offered to the public at a fixed price which is determined in advance of the sale. In a tender offer, the offer price is not fixed in advance of the sale. Instead, bids are invited at or above a stated minimum price. The price is then determined once all the bids have been received. In the UK a large proportion of the biggest asset sales have been by offers for sale. The crucial issue here is the price at which the offer is made. Comparing the offer price with the price at which shares are subsequently traded in the market indicates that discounts on public offers averaged 28 per cent, well in excess of the average for private issues (Mayer and Meadowcroft).

It is argued that the Government would tend to underprice assets since it is difficult to evaluate the price which the private sector would be willing to pay (the reservation price) (see Mansoor (1987)). While acknowledging the difficulties which Governments face in placing values on the assets the Council strongly recommends that no major discounting should be attempted.⁶

8. PRIVATISATION AND WIDER SHARE OWNERSHIP

Although the systematic underpricing of issues may have stemmed initially from a desire to ensure a successful sale, it has, according to Bishop and Kay, developed

6. The experience with local authority house sales is not very encouraging in this respect (See Chapter 8).

into the main instrument of Government's policy of creating wider share ownership. By giving preferential treatment to small investors, sales of public enterprises can be structured so as to encourage wider share ownership. Judged by its share ownership objectives, however, the UK privatisation programme has been relatively unsuccessful. In many cases most of those subscribing to the share issues quickly sold their holdings – placing greater emphasis on short-term profits than on long-term investment. Bishop and Kay describe very well the dilemma with which the Government has been confronted:

to increase share ownership among a risk-averse public unused to share dealing, it is necessary to offer tempting discounts; but a large discount means that substantial gains can be made by early scale, in which case wider share ownership has little endurance (p.34).

The general conclusion about privatisation and wider share ownership is that it is a poor policy instrument for widening share ownership; this objective can be better achieved by other policy instruments.

9. PRIVATISATION AND INDUSTRIAL POLICY

As indicated earlier, the state-sponsored commercial bodies have a very significant role in the national economy. They have individually and collectively made an enormous contribution to the economy over several decades. Their importance to the economy is accentuated against the background of the evolution of the Irish manufacturing sector since the 1960s. As a consequence of this evolution, Ireland's state-sponsored enterprises loom very large in the indigenous base of the economy. This position rendered them very susceptible to becoming one of the main job creation vehicles of Government in the late 1970s and early 1980s. In fact, their deteriorating financial performance in the late 1970s and the first half of the 1980s can be partly attributed to the role ascribed to the State sector in creating jobs.

Against that background is there a role for the commercial state sector in Ireland's development efforts and, if so, how is it to be harnessed? In addition, how does the concept of privatisation fit in with the State companies' role in development?⁷

Commercial State-sponsored bodies (CSSBs) have two roles to play in Ireland's development efforts. The first is to provide the products and services which their consumers desire at minimum cost to ensure the competitiveness of their customers in foreign markets. This is the conventional economic perspective of productive and allocative efficiency discussed at length in this chapter. The second role is that of seizing opportunities and engaging in product and market development to ensure that their business grows and remunerates the capital invested in it. If the company remains entirely or even partly in State ownership

7. For some commentators in the area, privatisation itself is seen as an industrial policy.

then very clear criteria are necessary to ensure that it does not use its ownership structure/access to Government or its market position in other areas in an uncompetitive manner. The reason for looking upon commercial State enterprises as development vehicles is that they frequently have the technical expertise, management resources and scale necessary to be competitive internationally.⁸

One functional area, however, in which CSSBs are weak is the financial area – they generally have an inappropriate financial structure, in particular, a weak balance sheet. This is one of the reasons why the downturn in the Irish economy in the 1980s had such a severe impact on the performance of CSSBs. It can be seen from Table 12.1 that injections of state equity into CSSBs has declined very rapidly, from £81m in 1984-85 to £12m in 1988-89 and even this was principally rescue finance to companies such as Irish Steel and B&I.

There would appear to be little likelihood of change in this situation. The Minister for Finance in a recent speech indicated that non-programme outlays in the Budget, relating largely to the capital restructuring of semi-state bodies, had fallen from £140m in 1984 to £30m in 1989. Against this background it is instructive to quote the Minister for Finance on policy towards access to capital by CSSBs:

The general aim is to minimise recourse to the Exchequer as a source of capital for the commercial State bodies, and as the figures show this objective is gradually being attained. This policy makes sense not only in budgetary terms, but also in a situation in which the EC Commission reportedly intends to police more actively any steps that it would regard as State aid to publicly owned industry. It is also desirable on budgetary grounds, and indeed in accordance with normal commercial practice, that Exchequer capital should be remunerated. This too is happening on an increasing scale and it is essential that the momentum should be maintained (Minister for Finance, 1989).

The basic thrust of this policy position is of the sole shareholder unwilling to commit equity finance to a portfolio of companies.⁹ All companies, regardless of ownership structure, require a judicious balance of equity and debt if they are to grow and develop in a sustainable basis. If the principal shareholder is unwilling to commit equity, then the alternative option is likely to be a change of ownership to ensure access to the capital markets for equity financing. This effectively means privatisation. The Government position on equity finance is usually justified on the grounds of scarce resources. In this regard, it may be worthwhile thinking of the option of equity investment in CSSBs in industrial policy terms and considering

the relative return on what have conventionally been regarded as industrial policy instruments and the return from equity investment in CSSBs at the margin. This, of course, takes us back to the much more fundamental question of whether the Government can ever act as a truly commercial shareholder and thus simulate the incentives generated by the private capital market.

Still looking at the privatisation issue from an industrial policy perspective, it is useful to consider how competition within the State sector might impact on industrial policy objectives. In a recently published book entitled *The Competitive Advantage of Nations* (Porter, 1985) the researchers conducted in-country research in the ten leading nations, closely studying the patterns of industry success as well as the company strategies and national policies that achieved it. The research identifies the fundamental determinants of national competitive advantage in an industry and how these determinants work together as a system. The author then develops a concept of clustering, in which related groups of successful firms and industries emerge in one nation to gain leading positions in the world market. The finding regarding rivalry and competition is striking:

Among the strongest empirical findings from our research is the association between vigorous domestic rivalry and the creation and persistence of competitive advantage in an industry (Porter, 1985).

Interestingly, it is also argued that, when improvement and innovation rather than static efficiency are recognised as the essential ingredients for competitive advantage in an industry, domestic rivalry is superior to rivalry with foreign competitors.

Rivalry is seen as creating pressure on firms to improve and innovate. Local rivals push each other to lower costs, improve quality and service and create new products and processes. Domestic rivalry, according to the authors, need not be restricted to price; in fact rivalry in other forms such as technology may well lead to more sustainable national advantage.

10. REGULATION OF COMMERCIAL STATE-SPONSORED COMPANIES

In cases where the introduction of competition is not feasible, or where competition is introduced and the state-owned company is one of the competitors, clear regulatory rules are necessary to govern the operation of such businesses. We will deal with each case separately. Looking first at regulation where competition is not feasible, the two main types of regulatory control which have been tried are rate-of-return regulation and price regulation. The basic idea of rate-of-return regulation is that the level of profits which the regulated enterprise is allowed to make is limited to that required to provide a pre-specified 'fair' rate-of-return on the enterprise's capital assets. This system sets up incentives for many types of behaviour which are dysfunctional, eg. an incentive to choose techniques of

8. A very good example of this is the market development pioneered by Aer Rianta in duty free shopping.

9. It is important to distinguish between State aid and equity finance. State aid to publicly owned industry is effectively a subsidy to a business because it is not viable in a commercial sense or is required to pursue non-commercial objectives. Equity finance is a totally different concept. It can of course be analogous to aid if the State foregoes an adequate return on capital employed.

production which are too capital intensive, by comparison to what they would have chosen in the absence of this type of regulation. Rate-of-return regulation also has an effect on price-setting behaviour; it encourages the use of multi-part tariffs, price discrimination, and, in some circumstances, the setting of prices below marginal cost for those activities which are comparatively capital intensive.

A second basic problem identified from North American experience is technically known as regulatory capture. The argument here is that the authority established to regulate the industry and protect consumers or other industry participants from the abuse of a dominant position, may form a relationship with the businesses they are supposed to regulate, and effectively promote their interests rather than those whose interests they were established to protect. The main reason put forward to explain the development of such a relationship is that the regulatory body is heavily dependent on the regulated enterprise for the information and analysis it requires to regulate effectively.

Dissatisfaction with this form of regulation has led to a search for alternative systems. The main alternative which has been tried is the direct regulation of prices rather than profits. It is argued that this system would minimise the incentive to the choice of inefficient production techniques inherent in rate-of-return regulation. It is also argued that the relative simplicity of price regulation and the absence of significant scope for discretion by the regulatory authorities reduces the dangers of regulatory capture. A good example of this type of regulation is that adopted for British Telecom in the UK – the 'RPI minus X' formula. This permits BT to increase the prices of a bundle of its services by an amount which is X per cent below the increase in the retail price index. The verdict on this scheme must await the availability of evidence on its performance in practice. It is noteworthy that a system of price regulation of state monopolies was operated by the National Prices Commission before its abolition. At present it would also appear that a form of price regulation is operated by individual departments on the state bodies under their aegis. In this regard the Council is of the view that the objective of policy should be to ensure that the trading sectors are not placed at a competitive disadvantage relative to their international competitors by virtue of the prices of state services.

Turning now to situations where competition is feasible and where state-controlled companies compete with private firms, the Council believes that clear ground rules are necessary to ensure that competition is fair. This means ensuring that State companies do not abuse a dominant position through the subsidisation of products/services in markets where competition is effective by products/services in markets where the company has a dominant position. It also means ensuring that State companies do not suffer a competitive disadvantage through being forced, without compensation, to fulfill social functions and also by being prevented from competing in particular markets.

Ensuring fair competition requires, as a first step, transparency of the financial flows between the State and State-owned companies and flows within the separate divisions of State-owned companies. Without adequate transparency it will be impossible to put public and private enterprises on an equal footing. This is also the approach of the European Commission in its efforts to ensure free and fair competition across member States. The Commission does not take a position on State-ownership or privatisation but argues strongly that the right of member States to own companies and provide capital or other forms of finance must not be used to circumvent the state aid rules. Transparency would cover capital injections, loans and guarantees to public enterprises. Consideration would also have to be given to the forgoing of dividends and the forgoing of an adequate return on capital employed. Transparency also requires the separate identification of the commercial and social functions of public enterprises, with the financial cost of pursuing the relevant social objectives explicitly identified in the accounts. It is also important that the social objectives are explicitly costed at the outset of the accounting period rather than equated with the financial shortfall at the end. Finally, transparency requires the preparation of separate published accounts for each commercial subsidiary of State-owned enterprises with a view to preventing abuse of a dominant position.

11. CONCLUSIONS

A significant part of the discussion in the chapter was concerned with efficiency issues – the incentives to efficient performance (both productive and allocative) under public and private ownership and the empirical evidence on the issue. An analysis has been given of the theoretically expected influence of various incentives and of the empirical findings. The principal conclusion is that, in the absence of market failures, all enterprises, public or private, perform more effectively where product markets are competitive than where competition is absent. Hence, where there are deficiencies in these areas, the policy priority should normally be to increase competition and improve regulation.

This general conclusion is confined to situations where there is no market failure. However, market failures do occur. It was the belief that private ownership would not achieve allocative efficiency in the presence of market failures which frequently provided the rationale for state provision and the establishment of state enterprises. The natural monopolies which generally involve the use of networks – telecommunications, electricity, railways and gas – fall under this heading. Historically, it was felt the most appropriate way to deal with natural monopoly situations was to establish a state company and impose a regulatory regime. There is evidence that the scope for introducing competition in natural monopoly areas could be considerably wider than has hitherto been thought possible. This is because of a general conclusion emerging from studies of these industries that 'natural monopoly' characterises only a part of the industry's activities and for the remaining activities there is scope for the introduction of competition. For

example, in railways, the track system is the natural monopoly part while train operation is not; in electricity it is the transmission system which is the natural monopoly, not the generation system. No general presumption is possible; each case must be evaluated on its merits to examine whether it is feasible to introduce competition for at least some of the products or services provided by these businesses.

In enterprises which are not natural monopolies of the type specified in the previous paragraph, but where, nonetheless, competition is restricted and where the introduction of competition is considered desirable, it is not just a matter of changing the regulatory regime. This is because the dominant incumbents may be able to reduce the threat of competitive market entry. This can arise from financial and technical advantages reinforced by political skills and influence built up over many years. In such cases, it will be necessary to take action to prevent the previously dominant incumbent from abusing its position.

In cases where the product market is not competitive, either because of natural monopoly conditions or for other reasons, privatisation, in the absence of liberalisation, is a totally inappropriate policy. Privatising a public monopoly without any changes in competitive conditions may generate some improvements in productive efficiency but at the cost of allocative inefficiencies. Such a policy is likely to be actually harmful.

In situations where the product market is competitive and where there are no market failures, there may be a case for privatisation. In such cases, allocative efficiency is assured by virtue of a competitive product market, while increased productive efficiency would be generated by the presence of a bankruptcy incentive, through the market for corporate control, and through the absence of government interference. Privatisation in this case would be likely to yield positive savings to the exchequer, assuming that it could capture a portion of the projected efficiency improvements in the sale price. The efficiency improvements derive in the main from the demise of 'Government failure'.

In such conditions a case for privatisation may be given further support by the need for private equity finance. There is very strong evidence that the Government as the major shareholder in state companies is unwilling to commit equity finance to its portfolio of companies. If these companies are not to face a limit on their development, access to private finance will become essential. The Council believes that the role of state companies must also be viewed from an industrial policy perspective. In this regard trade-offs can be considered between funds allocated to conventional industrial policy instruments and equity investment in CSSBs.

Looking at the issues from an industrial policy perspective, the major conclusion is identical. The evidence suggests that the association between vigorous domestic rivalry and the creation and persistence of the competitive advantage of a business

or an industry is very strong. Consequently, the introduction of competition, where feasible, is supported both in terms of allowing the private sector access to previously protected sectors and permitting the public sector access to particular markets, with clear regulatory rules in each case. State enterprises have a role to play as development vehicles as well as providers of goods and services. As with their private sector counterparts, this involves product and market development to ensure that the business grows and remunerates the capital invested in it. They frequently have the expertise, and the human resources and other resources necessary to be internationally competitive.

In cases where the introduction of competition is not feasible or where competition is introduced and public and private enterprises are in competition, clear regulatory rules are necessary. Price regulation appears to offer many advantages over rate-of-return regulation where the introduction of competition is not feasible. To ensure that competition between public and private sectors is fair there must be transparency of the financial flows between the state and state-owned companies and flows between the subsidiaries of State-sponsored companies. An advantage can accrue to a public sector enterprise through capital injections, the forgoing of dividends and an adequate return on capital employed, and the provision of 'soft' loans and guarantees. Disadvantage can accrue to state-enterprises through a requirement to pursue social objectives, without compensation. Fair competition also requires individual subsidiaries of companies to stand alone commercially in their individual markets.

We now turn to some conclusions regarding other aspects of privatisation:

- (a) privatisation, per se, ignoring any efficiency effects for the moment, does not represent a fundamental change in the budget balance. This is the case regardless of whether the enterprise is profitable or loss making. This conclusion, of course, is qualified by the extent to which benefits flow from the improvements in efficiency which privatisation can generate.
- (b) where privatisation does take place, the full market value should be extracted using whatever mechanisms are available. No major discounting should be attempted.
- (c) privatisation is not an appropriate instrument for promoting wider share ownership.

To maximise the contribution of the state-sponsored sector to the economy, the Council recommends that an audit be undertaken of state companies to translate the broad principles of policy which the Council has outlined in this chapter into specific policy choices. This will involve: (i) ascertaining the rationale for State involvement in the various areas; (ii) examining whether the market failures still exist, in cases where that was the original justification for intervention; (iii) examining the nature of the product market – whether monopolistic or competitive and the scope for enhancing competition. It is very important to *resist* the conclusion that because the weaknesses arising from Government as shareholder

(i.e. government failure) are so serious and so pervasive that a general presumption in favour of private ownership is justified. Government failure must be set against market failures, and conclusions reached based on the particular circumstances of each case. Finally, steps should be taken to minimise Government failure. This would involve fundamental changes in the relationship between the Government and the state-sponsored body.