
A Strategy for the Nineties: Economic Stability and Structural Change

NATIONAL ECONOMIC AND SOCIAL COUNCIL

Constitution and Terms of Reference

1. The main task of the National Economic and Social Council shall be to provide a forum for discussion of the principles relating to the efficient development of the national economy and the achievement of social justice, and to advise the Government through the Taoiseach, on their application. The Council shall have regard, inter alia, to:

- (i) the realisation of the highest possible levels of employment at adequate reward,
- (ii) the attainment of the highest sustainable rate of economic growth,
- (iii) the fair and equitable distribution of the income and wealth of the nation,
- (iv) reasonable price stability and long-term equilibrium in the balance of payments,
- (v) the balanced development of all regions in the country, and
- (vi) the social implications of economic growth, including the need to protect the environment.

2. The Council may consider such matters either on its own initiative or at the request of the Government.

3. Members of the Government will meet regularly with NESC on their initiative or on the initiative of NESC to discuss any matters arising from the terms of reference and in particular to discuss specific economic and social policy measures and plans and to explore together proposals and actions to improve economic and social conditions. Any reports which the Council may produce shall be submitted to the Government, and shall be laid before each House of the Oireachtas and published.

4. The membership of the Council shall comprise a Chairman appointed by the Government in consultation with the interests represented on the Council, and

- Five persons nominated by agricultural organisations,
- Five persons nominated by the Confederation of Irish Industry and the Irish Employers' Confederation,
- Five persons nominated by the Irish Congress of Trade Unions,
- Five other persons appointed by the Government, including two from the National Youth Council of Ireland,
- The Secretary of the Department of Finance, and Secretary (Public Service Management and Development) Department of Finance.

Any other Government Department shall have the right of audience at Council meetings if warranted by the Council's agenda, subject to the right of the Chairman to regulate the numbers attending.

5. The term of office of members shall be for five years. Casual vacancies shall be filled by the Government or by the nominating body as appropriate. Members filling casual vacancies may hold office until the expiry of the other members' current term of office.

6. The numbers, remuneration and conditions of service of staff are subject to the approval of the Taoiseach.

7. The Council shall regulate its own procedure.

NATIONAL ECONOMIC AND SOCIAL COUNCIL

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

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OVERVIEW, CONCLUSIONS AND RECOMMENDATIONS

1. THE PERIOD SINCE 1986

The Irish economic performance over the period 1986-89 has been very impressive, particularly when viewed against the background of the disappointing performance of the first half of the decade. Both inflation and the balance of payments continued on the improving trend which had been established in the early 1980s. Inflation decelerated to below the international average and the balance of payments moved into surplus. The growth performance altered markedly with GNP growth averaging 3.6 per cent per annum over the 1987-89 period by contrast with 0.2 per cent per annum over the 1980-86 period.

The public finances exhibited a dramatic improvement. The national debt/GNP ratio was stabilised early in the programme period at a little over 131 per cent and then began to fall steadily. It is estimated that the ratio will be around 115 per cent in 1990. The cost of servicing the debt has fallen from almost 12 per cent of GNP in 1986 to 10.4 per cent in 1989. These changes were made possible by significant budgetary retrenchment. The EBR fell by 10.5 percentage points of GNP between 1986 and 1989. The current budget deficit accounted for 7 percentage points of this, with current expenditure falling by 9.6 percentage points of GNP.

Living standards also showed significant improvement, whether measured on the basis of real disposable income, real take home pay or real personal consumption. These increases in real earnings and improvements in living standards went hand-in-hand with significant improvements in cost competitiveness against our main trading partners.

One area which has generally been acknowledged as less impressive is the employment/unemployment performance. However, the employment performance is creditable, particularly looking at the growth of non-agricultural employment against the background of the significant reductions in public sector numbers. The 1986-89 period showed a distinct shift from the earlier eighties with employment growth once again becoming associated with economic growth. However, despite the reduction in the numbers on the live register, the unemployment performance must be considered a disappointment and still a grave problem, particularly when set against the trends in net migration.

The improvement in economic performance was due to a combination of internal and external factors. The main external factor was a very favourable world monetary and trading environment. The internal factors were appropriate

budgetary, monetary and exchange rate policy and agreement on income developments, all of which were incorporated in the Programme for National Recovery (PNR). The great strength of the PNR was that it provided economic and social policy with the necessary underpinning of consistency, continuity and credibility, thus providing a particularly favourable domestic environment.

2. THE ECONOMIC OUTLOOK

(i) The Projections

The economy is generally expected to perform strongly in 1990 with expected GNP growth in the range 3.5 to 4 per cent, a deceleration of inflation by comparison with 1989 and the balance of payments to continue in surplus to the extent of 1 to 2 per cent of GNP. Total employment is expected to grow by from 11,000 to 13,000 in 1990 with the average live register unemployment forecast to fall in the range 221,000 to 223,000 down from 232,000 in 1989.

The medium-term outlook covering the period 1991-94 in Chapter 3 is built up from a set of assumptions about economic trends and assumptions concerning Government policies and EC policies affecting Ireland. The fundamental economic assumptions are a continued increase in Ireland's export markets, though falling back from the rapid increases of the 1986-89 period, and continued pay moderation similar to that which characterised the Programme for National Recovery. On the domestic policy front the assumptions are broadly of a no policy change basis and indexation of various programmes and payments. The projections do not take into account any prospective structural changes in the taxation system or any macroeconomic implications which may arise from the general developments in Europe or recent developments in the oil market.

Based on these assumptions, the projections envisage GNP growth averaging 3 per cent per annum over the 1991-94 period with GDP growing by 3.75 per cent on average. While this is less than the growth rate of the 1986-90 period it is still a good performance in the context of the 1980s as a whole. Based on these economic growth projections, employment is expected to grow by about 9,000 annually over the period, emigration is assumed to decline gradually towards 16,000 in 1994 and unemployment is projected to fall by 2,000 – 3,000 per annum.

On the public finance front, the main features of the outlook are a change in the current budget position, moving from a deficit of 1.25 per cent in 1990 to a deficit of 0.75 per cent in 1993 and 0.25 per cent in 1994. The EBR is projected to rise initially, reflecting carry-overs from the 1990 Budget, to fall back to its 1990 level of about 2 per cent of GNP in 1993 and to fall to about 1 per cent of GNP in 1994. Based on the projected borrowing requirement and specific assumptions about interest and exchange rates, the National debt/GNP ratio would be around 102 per cent in 1993 and of the order of 98 per cent in 1994.

(ii) The Uncertainties

The assumptions underpinning these projections are critical. The exposure of the Irish economy to world developments is such that international impulses are transmitted to Ireland very rapidly through the monetary variables of inflation and interest rates, and through the real variables of world economic growth, which affects both demand for Irish production and the supply of foreign investment. The medium-term projection is therefore crucially dependent on a benign external environment.

A more than usual degree of uncertainty now surrounds the international economic situation. This arises, in particular, from concerns about the outlook for the price of oil and the security of supplies. Without major upheavals in the world oil market, the impact on world economic activity of recent oil market developments is unlikely to be as serious as the adverse effects of the two previous oil shocks if the policy responses are appropriate. Nevertheless the degree of uncertainty caused by developments in the Middle East is itself now a matter for concern.

A number of other factors were giving rise to concern even before the oil price developments. These were: developments in central and Eastern Europe; the widespread increases in long-term interest rates; and the fragility in certain sectors of financial markets. In addition to those general international uncertainties, the Irish economy is particularly sensitive to developments in two other areas: (a) the outlook for the UK; and (b) the effects of a number of developments in agricultural markets. The assumption underpinning our forecast, that the UK would overcome its present difficulties without recession is now uncertain. Our assumptions had already anticipated a tight policy regime for agriculture, and while the impact of additional developments (Middle East and BSE) may be more significant in the short-term than the medium-term, they nevertheless add further to the general uncertainty.

There are also risks to the projection in the domestic environment. They derive from two principal sources: wage cost competitiveness and budgetary expectations. The projections assume continued pay moderation, a tight fiscal stance and do not include any structural alterations to the tax system.

The uncertainties surrounding the medium-term outlook are of particular concern to the Council. This derives from the conclusion in Chapter 1 that the impressive performance of the 1986-89 period was due in no small way to a particularly benign external environment. This period demonstrated that as soon as the economy breaks out of a vicious circle, improvements can flow very rapidly and can be mutually reinforcing. The converse, of course, is equally true and the pre 1986 period demonstrates how difficult it can be to break out of a vicious circle. It is this experience, together with an appreciation of the speed with which international impulses are transmitted to the Irish economy, which explains the Council's concern about the medium-term outlook. All the policy recommendations are framed against this background.

3. A STRATEGY FOR THE NINETIES

(i) . . . The Need for Structural Change

The objectives of economic and social policy do not change very much from period to period, but the relative priorities which attach to individual objectives are almost certainly likely to change. The Council in 1986 did not accept the scenario which was projected on the basis of a continuation of the policies then in place. Revised policies were put forward, many of which were accepted, and the outcome was quite different from the no-policy-change projection. Equally, the Council now considers that the evolution of the economy to 1994 which is likely if there is no policy change is entirely unacceptable. Growth of employment of 9,000 per year implies continued involuntary emigration and only a modest fall in the level of unemployment. If the medium-term scenario set out above is unacceptable, then the only alternative is to reject the idea of no policy change which underlies that projection. The need to increase employment by much more than 9,000 a year and to reduce unemployment well below 200,000 by 1994 is now a central objective of the Council.

Rejecting the idea of no policy change implies altering the basic structural parameters which characterise the economy. This calls for a major programme of structural and adjustment policies covering industrial policy, agricultural policy and manpower policy designed to overcome barriers to long-run development and facilitate structural change. In the Council's view, even sustaining the current performance will be difficult unless major structural reforms are undertaken.

The Council's objectives have to be achieved in the context of very radical changes now taking place in the international economic environment. The GATT talks covering agriculture and services; developments within the EC, in particular the completion of the internal market by 1992, and drives toward economic and monetary union, mean that the Irish economy will become even more integrated into the world economy. The intensification of competition arising from this increased integration means that the effect of internal inefficiencies in impeding growth will be magnified. Changes which increase the exposure of the economy to external forces must be complemented by measures which enhance the internal efficiency of the economy. What is required therefore, is a coherent programme of measures covering taxation and social welfare, reform of public enterprises, and regulatory change which contribute to the internal efficiency of the economy and its adaptability.

(ii) . . . Allied With Economic Stability

While microeconomic reforms did not feature prominently during the period of the PNR, very considerable efforts went into the restoration of internal and external stability. What can we learn from the Programme and indeed from the history of Irish economic policy over the last twenty years? The outstanding lesson is that macroeconomic stability is vital to support economic progress in a small open

economy. The central objective of macroeconomic policy has to be the encouragement of the long-term growth potential of the economy, not maximisation of its short-term performance. Fiscal activism can play a very limited role in enhancing the performance of the economy. The essential theme which must run through the conduct of macroeconomic policy is that of consistency viz. fiscal and monetary policy must be consistent with the EMS exchange rate anchor.

If, in addition to this, high employment growth and low unemployment are desired, the evolution of incomes must also be consistent with the exchange rate anchor. Related to this is the need for a system for the determination of incomes, which facilitates improvements in competitiveness and which handles distributional conflicts without disruption to the functioning of the economy. One of the lessons of the PNR is that a negotiated consensus on incomes at national level can achieve these objectives. In the Council's view, a negotiated consensus at national level is the mechanism of income determination which is most likely to make macroeconomic policy consistent with employment growth and the reduction of unemployment.

(iii) . . . And A Social Dimension

The results of the PNR on the social dimension are not as unequivocal as they are on the economic dimension. In the case of social welfare, policies have been pursued which have in some respects improved the system of social security and recognised to some degree the needs of the most disadvantaged. In the case of health it is far from clear that the principle of protecting the disadvantaged was generally achieved in the period 1986-90. There are some clear instances where the results of policy were to widen and intensify disadvantage and inequality. In regard to housing policy, widening social divisions resulting from the interplay of public policy and private markets were also increasingly evident in the system.

In the Council's view, any future programme must include reforms of policies in areas such as health, housing and education which generate social inequalities. Fundamental reform in this context implies a restructuring of policies, services and subsidies rather than increased public expenditure.

(iv) . . . Leading To An Overall Strategy

Integrating all these strands, the Council envisages an effective overall strategy for economic and social policy for the nineties having three broad mutually supportive components:

- (i) a consistent economic strategy for budgetary, monetary and exchange rate policy designed to achieve the continuation of economic stability;
- (ii) a continuation of the consensus on income developments of the last three years which provides improvements in competitiveness and resolves distributional conflicts without disruption to the functioning of the economy;
- (iii) a radical policy programme covering industrial and agricultural policy,

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

4. THE CENTRAL THRUST: POLICIES FOR EMPLOYMENT AND UNEMPLOYMENT

In the discussion of strategic issues for the nineties the creation of employment and the consequent reduction of unemployment and involuntary emigration were identified as the primary objectives. However, it may not be clear how the three strands of strategy which we recommend relate to this primary policy objective. Before proceeding to the individual strands, it is therefore important to clarify the Council's position.

As argued in the previous section, the major lesson of the evolution of the Irish economy over the past two decades is that economic stability is essential to support economic progress in a small open economy. A key conclusion is that fiscal activism can play a very limited role in enhancing the performance of the economy. The role of policy therefore is to provide economic stability which ensures that the economy realises its full potential for increased output and employment.

The manner in which the second strand of our strategy relates to our principal objective is more clearcut. A major issue to be addressed following the expiry of the current PNR is to find the appropriate balance between growing living standards and increasing employment. Approached from the strategic perspective of the Council's key objective, priority should be accorded to the task of increasing employment. A major component of the efforts to increase employment, therefore, is a continuation of the consensus on income developments of the last three years, which provides improvements in competitiveness and manages distributional conflicts.

The final strand of the Council's strategy is a coherent programme of structural and adjustment policies. The Council has argued in the previous section why it is now vital to develop this aspect of its strategy. The programme of structural reforms which are proposed has the ultimate objective of enhancing the wealth producing potential of the economy and improving its international competitiveness. This will necessarily involve increased employment and reductions in unemployment and involuntary emigration. In the case of housing, for example, the introduction of a property tax would remove distortions in the housing system and would redress the excessive incentives which channel savings into property rather than other productive activities. It would also allow reductions

in the tax burden on earned income and thus reduce the tax wedge between what employers pay and workers receive. The changes recommended in the tax/benefit system are designed to ameliorate poverty and unemployment traps thus reducing any labour market disincentives which may exist.

Structural reforms also refer to changes introduced to overcome barriers to long-run development. These arise particularly in the industrial and agricultural areas. Finally, policies which are more directly related to employment and unemployment are training, education and special employment measures coming under the broad umbrella of manpower policy.

The purpose of this section has been to show how the entire strategy fits together and how each policy is designed to address either directly or indirectly the major policy issue of employment and unemployment. The main policies are now examined separately.

5. ECONOMIC STABILITY

(i) The Budgetary Stance

While the conventional measures of the current budget deficit and the EBR have been reduced considerably, there is still a significant public finance problem in the form of outstanding debt. In the Council's view, therefore, the debt/GNP ratio is still an appropriate target of fiscal policy. Focussing only on the borrowing flows such as the current budget deficit and the EBR does not allow an appreciation of the conditions necessary for a sound fiscal strategy. The Council believes that continued reductions in the debt/GNP ratio and the associated interest costs must be a central feature of medium-term fiscal policy. A reduced debt/GNP ratio will enhance the flexibility of the budgetary system, reduce its vulnerability to external shocks (such as interest rate changes) and protect the medium-term growth potential of the economy. These considerations suggest that the target of a debt/GNP ratio of around 100 per cent by 1993 is the minimum target consistent with achieving these objectives.

In addition to considerations of sustainability, flexibility and impact on growth potential, fiscal policy will have to be formulated in future in the context of capital mobility within the European Community. The abolition of exchange controls means that financial flows will be much more sensitive to actual or even perceived changes in the fiscal regime. In the PNR the commitment to maintenance of the exchange rate within the EMS, and the adoption of domestic policy measures consistent with this commitment, minimised the exchange rate risk inherent in investing in Irish securities and increased the confidence of potential investors. Evidence for this can be seen in the foreign take-up of Irish gilts. Against that background of foreign confidence, fiscal policy has very few degrees of freedom in this new environment.

Based on these considerations, therefore, the Council is strongly of the view that the current budget deficit and the EBR should be maintained on a sustained downward path each year, notwithstanding any constraints which might exist in particular years – such as 1991 when the carryover costs of the 1990 Budget will fall to be absorbed.

In working out the implications of this target for expenditure and taxation, it is necessary to consider a number of objectives in the taxation area which the Council has, and which have budgetary implications. These are:

- (i) in the personal income tax system, the Council believes that it is desirable to reduce the high average and marginal rates of tax on earned income;
- (ii) in the case of indirect taxes, the Council is strongly of the opinion that the removal of frontiers must be part of the completion of the internal market. It therefore supports the changes in indirect taxation which this entails;
- (iii) the Council believes that it will be necessary to adjust DIRT to avoid capital movements based on tax differences and to ensure that indigenous financial institutions can compete in a unified financial market.

The Council believes that the task of bringing the debt/GNP ratio to around 100 per cent should be attained principally through restraint on current public expenditure. More specifically, the Council recommends that current public expenditure should not increase in real terms in the period up to 1993, effectively implying no real increase in overall public sector activity.

Where increases in public expenditure are necessary, or are considered desirable in particular programme areas, they should be offset by real reductions in other areas. For example, the Council's objectives of some real increase in social welfare payments and a greater allocation of resources to the long-term unemployed must be accommodated within this overall objective. The overall target for current public expenditure is demanding and will give rise to difficult policy decisions.

In regard to taxation, we know that significant improvements can be obtained from changes in the structure of taxation. Thus, in the Council's view, the medium-term growth potential of the economy can be enhanced through reductions in the debt/GNP ratio while simultaneously reaping efficiency gains through a thorough restructuring of the tax system. The Council emphasises that the scope for a significant fall in the overall tax burden is limited in the context of its overall objectives. This means that the changes considered desirable will have to be accommodated through a widening of the tax base.

Another factor which needs to be considered in the context of future fiscal policy is the treatment of budgetary receipts from the sale of state assets. There is a danger (see the UK for example) that such receipts could be used to finance budgetary deficits, thus ensuring a looser budgetary strategy than would otherwise prevail. The Council wishes to emphasise that receipts from privatisation do not alter the

fundamental budgetary position. Consequently, it recommends that such receipts should not form part of the budgetary arithmetic, i.e. they should be kept off-budget.

(ii) The Relaxation of Exchange Controls

The relaxation of Irish exchange controls in the context of economic and monetary union narrows even further the degree of manoeuvre which exists on Irish fiscal policy. It is also likely to give rise to an increase in the volatility of capital flows and hence in the volatility of interest rates. However, the broad principles which should govern the conduct of macroeconomic policy are not changed by this abolition. The Council wishes to strongly reiterate its commitment to the policy of maintaining the nominal value of the punt in the EMS. In the Council's view, an explicit non-accommodating exchange rate policy, and the adoption of domestic policies consistent with the maintenance of the exchange rate within the EMS, was a major contributor to the decoupling of Irish and UK inflation and interest rates and the convergence of Irish and German rates.

The exclusion of sterling from the ERM greatly complicated the execution of Ireland's exchange rate policy. At a number of points in the 1980s a sudden weakness of sterling against the ERM currencies brought to light an ambiguity within Ireland's overall exchange rate policy. As indicated above, commitment to the EMS since 1987 has secured our impressive inflation and interest rate performance. While sterling entry to the ERM is welcome, the wider band adopted still allows considerable scope for fluctuation.

Developments in 1989 and indeed the experience of the last decade lend some support to the view that capital outflows may be a continuous feature of Ireland's experience. This could reflect structural differences between the Irish economy and financial system and more advanced EC economies. There are limits to the ability of domestic macroeconomic policy to address this problem. This highlights once again the importance of developmental measures.

The ultimate abolition of exchange controls will also generate difficulties in the taxation area. The Council believes it will be necessary to adjust DIRT to avoid capital movements based on tax differences.

(iii) The Oil Crisis and Macroeconomic Policy

The Council referred earlier to the uncertainties generated by developments in the Middle East for the oil markets. An important question is how economic policies should respond to these developments, since the more serious consequences can arise from the reactions to these events and the resultant second round consequences. The following remarks are designed to minimise adverse consequences for the economy of oil market developments.

Firstly, it is not desirable to try insulating the economy from the impact of higher oil prices, through limiting the knock-on effect of oil price increases to domestic

energy prices. Subsidising domestic oil consumption would have undesirable effects on the Government's fiscal position (unless offset by other changes) and would hinder efforts to conserve energy.

Any attempts to mitigate the adverse short run economic effects of higher oil prices are also misplaced. The Council believes that the medium-term strategy it has put forward in this report is the correct one even if the medium-term outlook becomes more unfavourable. The experience with previous rounds of sharp increases in oil prices of trying to offset the negative growth impact by expansionary fiscal policy, or of trying to avoid the reduction in living standards consequent upon the change in the terms of trade, indicates that such policies are inappropriate.

A somewhat lower level of economic activity and the possibility of higher interest rates arising from higher oil prices would tend to have adverse effects on the Government's fiscal position and thus render more difficult the task of fiscal correction. However, in the Council's view, the essential justification for fiscal correction is relevant regardless of the evolution of the international economy. The Council is therefore of the view that the budgetary targets recommended should remain unchanged in the event of unfavourable international developments.

While some adjustments may be required in a number of areas to reflect the changed outlook, the Council considers that the fundamental lesson of the past twenty years is that Ireland cannot insulate itself from adverse international trends. To do so would be to jeopardise the progress which has been achieved in the last four years.

6. STRUCTURAL REFORMS

The third strand of an overall economic and social strategy for the nineties recommended by the Council is a coherent programme of structural and adjustment policies designed to improve the economy's internal efficiency, enhance international competitiveness and overcome barriers to long run development. The rationale for the programme of reforms derives in a negative sense from the conclusion that the absence of macroeconomic levers puts a premium on the correct use of the remaining policy instruments at the disposal of policy makers. It also follows from the conclusion that the Irish economy will become more integrated into the international economy. However, it follows in an even more fundamental sense from the Council's unwillingness to accept the employment and unemployment projections which would arise if there were no changes in policy. The Council's programme of structural reform is designed to increase the employment creation capacity of the economy.

The Council's definition of structural reform is very wide-ranging, covering not only public financial interventions but implying changes which ensure competition

in all markets. In the Council's view, many policy measures, particularly regulatory interventions, which were previously considered of mainly domestic relevance, will become of much greater consequence now that Ireland is integrating more fully into the international economy and may, consequently, need adjustment to ensure international competitiveness. It is not been possible to specify each and every reform which might be desirable. What is essential is that policy makers in the individual areas are aware of the fundamental changes in the external environment and recast any policies which impede growth.

While the Council has distinguished between a programme of reforms designed to enhance economic efficiency and a set of reforms designed to ameliorate social inequities, a common thread runs through both. Governments intervene in the economy both to enhance its operation and to achieve certain distributive objectives. However, interventions to enhance its operation will have distributive implications while the pursuit of distributive objectives can impact on economic performance. As a consequence, assessments of policy intervention will have both economic and social dimensions.

In all the areas which the Council examines it attempts to strike an appropriate balance between narrowing social inequalities and enhancing the efficiency of the economy, with all the decisions being informed by the Council's over-riding objective of increasing employment. Thus, while the areas examined are grouped into economic and social there are no differences in analytic approach. We will now look at each area in turn.

(i) Tax Reform

Assessment of the PNR on Tax Reform

Many of the changes introduced in the income tax area over the past four years are consistent with the programme of reform advocated by the Council. These are, in particular, the reductions in average and marginal tax rates, the movement to a current year assessment for the self-employed, the reduction in the numbers on higher rates and improvements in tax administration

However, the Council has reservations about two related aspects of the changes since 1986. First, it is concerned that the changes may have reduced to an undue extent the overall progressivity of the system. Second, it considers that the base has not been significantly broadened. What has occurred since 1986 has been tax rate reductions, financed, not only by base widening, but also by the buoyancy of tax revenues. This gives rise to the two reservations.

The changes in indirect tax since 1986 have been desirable measures of tax reform, in particular, the broadening of the base to include electricity and telecommunications and the reduction of the standard VAT rate from 25 to 23 per cent. In the corporation tax area, the reduction in tax rates and the widening of the base through the reduction of accelerated depreciation allowances constitute

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genuine reform along the lines advocated by the Council. However, alongside this there has been an extension of measures which narrow the corporation tax base, and measures which are either ad hoc or intended to achieve specific allocative objectives.

A Future Tax Reform Strategy

Tax reform in any new programme for economic and social development must give priority to the Council's overall objective of increasing employment and reducing inequities. In addition, given the Council's strong support for the process of European integration, it also believes that tax policy must accommodate indirect tax approximation in the Community and the likely necessity to make some adjustment in DIRT. Based on these considerations, the Council recommends the following specific reforms.

- 1) The Council recommends reductions in effective marginal and average rates of tax on earned income.
- 2) The Council is concerned at the undue reduction in progressivity which could result from reductions in tax rates, especially those which flatten the schedule.
- 3) The Council believes that the progressivity of the income tax system can be retained to the extent desired, even with a flattening of rates, if the base is broadened sufficiently.
- 4) Given the other objectives of the Council in the fiscal area, the Council considers that further reductions in taxes on earned income are only possible with measures that broaden the tax base including the introduction of a comprehensive property tax.^{1,2}
- 5) Concern with disincentives in the labour market arising from the interaction of tax, social security and low pay leads the Council to recommend the application of employees' PRSI at a lower single rate with no exemption and no ceiling. This recommended change should be considered in the context of overall tax reform.
- 6) In regard to VAT approximation, the Council recommends that a tax reform strategy should aim for a top VAT rate of 18 per cent and the application of a 3 per cent rate on presently zero rated items.
- 7) Measures to compensate the less well off for the overall effects of indirect tax reform must accompany the imposition of VAT on items currently zero rated. A generalised small increase in social welfare would not be the appropriate response. A thorough investigation of the low income losers and a targeted set of compensation measures is necessary.
- 8) Some adjustment of excise duties and DIRT will also be necessary for European Integration.

1. The IFA, ICMSA and ICOS oppose the imposition of a property tax on agricultural land, farm buildings and structures on the grounds that it would:

- amount to double taxation – be inequitable between taxpayers – be regressive – be detrimental to the future development of Irish agriculture

See Chapter 6 for full text of reservation.

2. The CIF does not agree with the introduction of a property tax. See Chapter 8.

(ii) Industrial Policy

The basic perspective which has informed all the Council's work on industrial policy is that policy should be aimed at removing the constraints on the development of the economy. There are a number of structural characteristics in the economy, the overcoming of which requires active developmental policies.

These structural characteristics include the small size of the domestic market, the distance from large and concentrated centres of population, and Ireland's technological backwardness relative to the more advanced economies of North America, Europe and Japan. To these underlying impediments must now be added the challenge of a much increased rate of technological change, greater internationalisation of economic activity and the completion of the internal European market.

The Council's core position on the development of the industrial sector in Ireland is that sustained industrial development requires the development of a strong indigenous sector. While the attraction of foreign firms should also be an integral part of industrial policy, a realistic appreciation of their contribution to the long-term industrialisation of the economy is necessary. In the Council's view, this fundamental policy position should be seen in a substantial shift in the allocation of resources within an overall industry policy budget away from the attraction of mobile investment projects from abroad and towards the development of indigenous industry.

The policy instruments utilised to develop a strong indigenous sector need to be carefully chosen. The first key requirement is selectivity. The Council believes that the instruments should be addressed to alleviating the specific competitive disadvantages which indigenous businesses face in competing internationally and should aim to assist the creation of structurally strong Irish firms. These principles imply a reallocation of resources from tax-based incentives to direct aid, and within direct aid from capital grants to grants for non-fixed asset investment.

In regard to foreign industry, the Council believes that the type of foreign firms which should be attracted to Ireland are those which will locate functions in Ireland which are the key to the competitive success of the company, those which form a significant market for potential sub-supply linkages, and projects with a high skill requirement in its workforce.

The Council's more recent work has reaffirmed the correctness of these policy positions. However, completion of the internal market does require some changes in Ireland's industrial policy:

- (i) the scale of firms must become a more important concern of industrial policy;
- (ii) policy should aim to increase the ability of firms to innovate.

The scale of firms is significant because, in the Council's view, 1992 will bring about further concentration in many industries. In some cases, Irish firms will be unable to overcome the advantages which their rivals derive from scale of operation; in such cases these disadvantages must be circumvented or avoided. In other cases, it will be necessary to overcome the difference in scale, and industrial policy should assist this development.

In the Council's view innovation must receive greater priorities in Irish industrial policy. This is necessary because:

- innovation is central to competitive success in many sectors;
- firms in peripheral countries and regions tend to undertake less innovation;
- the EC is now actively promoting technological development.

Emphasis on good management emerged consistently from our consideration of responses to the threats and opportunities of 1992. Given the existing low level of commitment to management development in Ireland, investment in managerial resources should command priority across all sectors.

The Council is of the view that government industrial policy should be clearly stated in such a way as to obviate undue discretion in the interpretation of that policy by state agencies. To achieve this the Council recommended, inter alia, the concept of an industrial policy budget and the application of specific performance criteria to state agencies. The Council looks forward to the forthcoming review of industrial policy to assess the extent to which the intentions declared in policy statements covering all the above issues have been translated into action.

(iii) Agricultural Policy

In discussing strategic issues for the nineties, the environmental changes facing the agricultural sector, in particular the pressure for fundamental changes in agricultural policies, were stressed. Whatever the precise outcome of the GATT negotiations, it is almost certain that it will provide a significantly more difficult environment for Irish agriculture. In addition to reform of the CAP, the Council is also concerned with the persistence of low and volatile farm incomes for a sizeable segment of Irish farmers and with problems surrounding the development of the food industry.

Since the impact of further reform of the CAP will be in direct proportion to the importance of agriculture in individual member states and since Ireland is also significantly more dependent on export subsidies, the proposed changes are very significant for Ireland. The NESG shares the Community's rejection of the free trade solution advocated by the US. It favours a solution which recognises the social dimension of markets and the social costs and benefits which are generated by adjustment to the exigencies of market forces. However, this rejection of a free trade solution is only tenable on the basis of a new balance between prices and

market policies, and socio-structural policies. This has important implications for Ireland since the structural policies area of the CAP is dependent on national input both financially and from a policy formulation perspective.

The Council recommends that Ireland should immediately seek a full comprehensive analysis of the effects of further CAP reform, arising in particular from GATT commitments, on the various Regions and Member States. The results of this analysis should form the objective basis for consequential adjustments to EC policies, including the CAP. Ireland should also seize the opportunity of change to ensure that future CAP policies and schemes are more appropriate to the problems and characteristics of Irish farming. Any adjustments must be evaluated in the context of the Community's commitment to economic and social cohesion.

Solution to the problem of low farm incomes, and of other problems in the agriculture and food industries generally, requires that greater progress be made in solving the structural weaknesses of the sector. The formulation of an effective structural policy requires a thorough re-evaluation and clarification of the objectives of the policy. This can only be done at national level.

In the Council's view, future Irish structural policy should give priority to achieving effective land use rather than to maintaining the maximum number of holdings at inadequate income levels. But it recommends this structural priority only within the context of complementary productivity policies and non-agricultural programmes.

Two broad types of non-agricultural programmes are available: the creation of off-farm employment and direct income aids. The increase in part-time farming in recent years constitutes a major structural change. The continuation of this trend depends on the success of general rural development programmes. But off-farm employment cannot solve the income problems of some farmers, and cannot completely solve the income problems of others. It is in this situation that there is a strong case for direct income aids.

The discussions of both industrial and agricultural policy are very relevant to the future evolution of the food industry. The industrial constraints are those which face all indigenous firms and which require industrial policies of the type advocated earlier. The issue of scale is particularly germane here. There are also constraints emanating from the agricultural side which affect the development of the food industry. While the incentives created by the CAP have not been conducive to the development of a food industry in Ireland, solution to the other constraints emanating from the supply side requires a strengthening of the structure of Ireland's farm businesses. Given the nature of the market for land, this can only occur under the guiding hand of a clear and much more vigorous national structural policy. This must be complemented by productivity policies – especially those which focus on the development of human resources – and non-agricultural programmes aimed at employment creation and income support.

The problems of adjustment which the agricultural industry will face as a result of the general changes affecting the industry but particularly arising from the need to secure agreement in the present GATT round are enormous. However, the linkages between the agricultural sector and the rest of the economy are such that the problems facing the agricultural sector have implications for the economy as a whole. The Council believes that these impending difficulties should be used as an opportunity to develop the kind of fundamental thinking about structural reform which it advocates. The potential contribution of domestic policy to the desired changes of a structural nature should not be underestimated.

(iv) Manpower Policy

Education and Training

Under this heading the Council considered training and education and special employment measures. In considering the role of these policies in creating employment and tackling unemployment, it is most important to distinguish between long-run structural improvements and measures which create employment immediately or bring about an early reduction in unemployment.

There is an important long-run role for training and education in creating employment. This derives from the fact that education, skills and technology can now be important sources of national competitive advantage. Education and training policy must, therefore, be part of Ireland's development policies. The challenge for public policies is to upgrade the skill level of the labour force through both the education and training systems.

While education and training policies have a central role in long-run economic development, the means through which they can offer more immediate options for increasing employment and reducing unemployment is not that simple. Where there is a specific and identifiable skills mismatch between the unemployed and available jobs, then training is the solution to unemployment. In other cases, training will need to be accompanied by some policy measures which increase the demand for the labour of those undergoing training.

Where a specific skills mismatch cannot be identified, it is possible that a general mismatch can exist between a whole category of citizens and the requirements for many jobs. For example, the long-term unemployed have, in many cases, lost even the most basic work related skills. The aim of education and training in this case is not to fill an identified skills shortage but to get these groups onto the first rungs of the occupational ladder. If there is an existing shortage of unskilled labour, this policy will reduce unemployment. If there is not, then training, which is targeted on young people or the long-term unemployed, will be a policy for redistribution of job chances, rather than for reducing aggregate unemployment.

The ability of training to fight unemployment can be enhanced if training is part of an active labour market policy which includes intervention at the moment of job

loss. Well chosen training at that point, when combined with policies which maintain labour demand, can avoid some of the most damaging and self-perpetuating aspects of unemployment. Swedish labour market policy, for example, consists of more than just training and retraining. It combines very early retraining with policies on the demand side and a less liberal system of unemployment benefit.

The formal education system also has a central role in tackling unemployment and other labour market disadvantages. It is crucial, in particular, that the content and orientation of senior cycle second level and third level is geared to the employment needs of the economy. An increase in participation at these levels of education could have some impact on unemployment if the increased participation is selective and directed at fulfilling specific skill requirements. Further, if the problem of early school leaving and associated social problems can be effectively addressed, it will contribute both to an overall improvement in the education and skill levels in the labour market and to enhanced equality of attainment in education.

Special Employment Measures

The three main types of special employment measures are labour subsidies, direct job creation schemes and enterprise schemes. Each of these schemes has drawbacks which limit their ability to create permanent employment. However, these drawbacks can be minimised if such special employment measures are strongly targeted on the long-term unemployed and on local communities in which unemployment is extremely high. The Council recommends that the other policies in this report need to be complemented by a radical approach to the problem of long-term unemployment using targeted special employment measures.

Two propositions underpin the economic case for this position. There is a strong element of hysteresis in unemployment, i.e. if unemployment becomes high it will tend to stay high and if it becomes low it will tend to stay low. Anything which reduces long-term unemployment will therefore tend to remove some of the underlying causes of long-term unemployment. The second proposition is that a growth in the demand for labour which is targeted on the long-term unemployed will provide very little upward pressure on wage bargaining. By contrast, a general stimulus to demand will do little to reduce long-term unemployment, but still tighten the labour market.

The entire package of proposals in this report are designed to enhance the employment creating potential of the economy. These policies cannot channel labour demand towards the long-term unemployed and all the evidence suggests that slowly rising general demand for labour will not reach into that particularly disadvantaged group. It is possible that strong demand for labour, even with very high long-term unemployment, can generate wage pressure. What is needed now is policies which target labour demand on areas of high long-term unemployment.

Special employment measures – particularly subsidised job creation and temporary direct hiring – are the policies which can achieve this. However, their effectiveness in achieving a permanent improvement in job prospects and life chances can be greatly enhanced if they are part of a comprehensive area-based package of economic and social interventions.

The Council is not simply recommending more of the same in regard to these special measures. The Council wishes to see these schemes operated in an integrated fashion in the context of its local area-based strategies. The concentrated incidence of unemployment, low incomes and deprivation in certain communities and regions provides a strong case for developing area-based programmes. The special measures should be integrated with local employment and economic development initiatives giving a comprehensive decentralised approach. These initiatives are likely to be more effective if they follow an assessment of local potential and build on the capacity of local communities.

Evidence suggests that concerted, intensive, programmes in small areas, containing elements of housing and environmental improvement, as well as retraining and employment schemes and 'outreach' health and educational projects, can have an impact over and above the separate effects of individual programmes. Furthermore, the more closely involved are local communities in the planning and delivery of area-based projects, the more they will reflect local needs and priorities.

The Council also wishes to emphasise that it sees this radical approach to long-term unemployment being accommodated within its overall expenditure framework. A reallocation of resources will therefore be necessary to give effect to the policy. In the Council's view, the very high priority which it attaches to tackling the problems of long-term unemployment must be operationalised by devoting resources to it.

(v) Structural Reforms in the Public Sector

Public Enterprises

The principal conclusion in regard to public enterprise performance is that, in the absence of market failure, all enterprises, public or private, perform more effectively where product markets are competitive than where competition is absent. The policy priority should therefore be to increase competition and improve regulation. The scope for introducing competition in areas traditionally regarded as being natural monopolies could be considerably wider than has hitherto been thought possible. This is because natural monopoly characterises only a part of the industry's activities in some cases.

Where competition is being introduced to an area which was previously a monopoly, it is necessary not only to change the regulatory regime but to take action to prevent the previously dominant incumbent from abusing its position.

In cases where the product market is not competitive, 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 narrow efficiency terms but at cost of much broader economic inefficiencies. Such a policy is likely to be actually harmful.

In cases where the product market is competitive and where there are no market failures, there may be a case for privatisation. This case may be given further support by the need for private equity finance. If these companies are not to face a limit on their development when Government as the major shareholder is unwilling to commit equity finance, then access to private finance will become essential.

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. This may involve allowing state-sponsored companies access to particular markets, with clear ground rules specified. They frequently have the technical expertise, management resources and critical mass necessary to be internationally competitive.

In cases where the introduction of competition is not feasible or where competition is introduced and the public and private sectors are in direct 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. Ensuring fair competition between public and private enterprises requires, as a first step, transparency of the financial flows between the state and state owned companies, and flows between the subsidiaries of state-sponsored companies. Unfair competition can arise through (i) the provision of soft loans and guarantees to state-sponsored companies (ii) through the forgoing of dividends and a commercial rate of return on capital employed (iii) through a requirement on state companies to pursue social objectives without financial compensation. Fair competition requires individual subsidiaries of companies to stand alone commercially in their individual markets.

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. The Council wishes to emphasise that a general presumption in favour of private ownership is not justified. Each case must be examined individually and conclusions reached on the particular circumstances of each case.

Management of Public Expenditure

A number of important lessons can be drawn from the evolution of public expenditure over the last two decades. Bringing expenditure into line with macroeconomic requirements and reallocating total expenditure across the various programme areas in line with changing priorities is complicated by rigidities inherent in the fiscal system. The Council is of the view that a strong top-down element is necessary in the budgetary process to ensure overall expenditure is in line with fiscal requirements. Consideration should also be given to increasing the flexibility of the system to ensure that it reflects changing priorities.

The Council welcomes the fundamental changes that have been introduced into the management process in Ireland since 1987 to overcome the incrementalism inherent in the traditional budgetary system. The underpinning of this change with strong political will has resulted in significant public expenditure retrenchment.

The type of changes which the Council believes merit some consideration are the use of a total financial frame or block budget within which there is greater freedom to reallocate funds and adjust programme priorities. This would have to be accompanied by appropriate mechanisms to monitor results and outputs. Such a system would allow central departments to concentrate on the allocation of resources to reflect broad priorities with decision making on specific programme choices delegated to individual policy areas.

In considering the desirability of any changes of this nature the ability of individual departments to take a strategic perspective and allocate resources to reflect that perspective must be addressed. The Council has some concern in this regard.

In terms of ensuring value for money in the public sector, the Council believes that input controls are blunt but effective means of curbing public expenditure. 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. 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.

In terms of exposing the public sector to greater market forces the Council's position is 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 regard to tax expenditures, the Council believes that their management 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.

7. STRUCTURAL REFORMS IN THE SOCIAL AREA

Four key themes comprise the Council's social policy perspective for an economic and social strategy. First, the social benefits of reduced unemployment cannot be overstated: the growth of unemployment is strongly related to the rise in the 1980s in income poverty – especially among families. The single most effective contribution to the mitigation of family poverty would be the elimination of unemployment.

Second, social policies and the welfare state must continue to operate in a very constrained fiscal context. This context heightens the need to restructure social programmes to ensure that they accord with both equity and efficiency objectives. In the Council's view, structural reforms (by which is meant restructuring within existing resources) are necessary to enhance efficiency and to ameliorate social inequalities.

Third, the Council's analysis of social policies and services is one which links across functionally separate areas of policy in order to achieve co-ordinated interventions and avoid distortions and inefficiencies.

Fourth, social policies deal not only with directly state-funded and state-provided services but also with market based provisions – in health and in housing for instance. A challenge to social policy will be to find the appropriate 'mix' of public and private and to prevent inequality while ensuring the choice and freedom which the market can confer.

In the tax/benefit system, for instance, the need to design policies jointly for the administratively separate systems is emphasised. The proposed restructuring of PRSI should be considered in a wider tax reform context. It is also one instance of the Council's suggested co-ordination strategy. The restructuring, entailing a wider employee contribution base, is geared also to mitigating the 'poverty trap' and enhancing the return-to-work disposable income of employees who are offered low paid employment.

In the health and housing systems, the Council has called for policies which embody the four themes noted above. To adequately manage the health services, for example, the Council has proposed the adoption of reforms, based broadly on the Commission on Health Funding's report, to restructure public – private interactions. Thus, private care, it is suggested, has a complementary role in a publicly funded system. Public hospitals should offer private care but the public

subsidisation of private care should end, and access to hospital services should be administered on the basis of need. The constrained fiscal context is relevant to health care: the Council points out that the resources in the health care system can be used more efficiently and equitably and that no real increase in public expenditure is, therefore, justified.

The housing system is largely a private one but one marked by many subsidies and other interventions. On the whole, housing conditions for the population are good: the task now is to focus on the more acute and more complex housing needs. To obviate the need for extensive public building programmes, more active, equitable policies for private rented, and voluntary/social housing need to be considered. Further, more efficient management of the public housing stock will conserve both the quality and quantity of non market, local authority housing. The tax system and the income maintenance system also affect the housing system. A prime example of the coincidence of equity and efficiency considerations is the Council's call for the taxation of property and the reduction in income tax – a reform which would enhance both the tax regime and the housing system.

The pre-eminence of unemployment in the Council's pre-occupations highlights the importance of social welfare and of the tax/benefit nexus. The Council has therefore drawn attention to the 'unemployment trap' which may affect a limited segment of the labour force. This complex issue cannot be resolved by any one short-term measure. A set of measures affecting the tax/benefit system are proposed for consideration in the wider context of overall tax reform:

- (i) a restructuring of employees' PRSI to reduce the burden on low paid employees;
- (ii) a reform of child income support measures to enhance the work incentive of employees with families by increasing, and then taxing, Child Benefit, and by ameliorating over time the role of Child Dependant Additions for the unemployed in the total package of Child Income Support measures.

Finally, the Council has pointed to the potential role of area based policies in addressing unemployment and in increasing the effectiveness of existing social provisions. Unemployment and associated problems are to some extent concentrated in particular areas or communities. There is scope therefore to direct unemployment initiatives at particular areas and to combine such initiatives with area based co-ordination of educational, health, housing and community development policies.

(i) Health Policy

This aspect of public policy is particularly susceptible to reform. The Council has considered in full the detailed proposals of the Commission on Health Funding and has examined the relevant research on health policy. Accordingly, the Council has adopted a number of principles for the future development of health care.

First, health care should be largely publicly financed, for both equity and efficiency reasons.

Second, lower income groups should be entitled free of charge to all necessary health services and certain other additional services including GP services: other income groups should be entitled only to necessary services.

Third, there is considerable scope to improve the management and organisation of the health services. Notably, a more appropriate organisational structure, a budgetary system for hospitals based on actual costs of specific hospital case mixes, internal reforms in the management of hospitals and, in particular, in admissions routines, and much greater emphasis on modern planning and management systems, would cumulatively make a significant impact on the functioning of the hospitals system.

Fourth, the structural alteration of the health care system towards non-institutional care can reduce the growth in demand for hospital care and provide more appropriate care.

Public health expenditure has been subject to significant retrenchment and this has translated into real reductions in health service inputs such as hospital beds, nurses and so on. The Council considers that the number and distribution of hospitals and hospital beds is now approaching the more rationalised and co-ordinated structure long recommended for the hospital system.

On balance, the Council does not consider that real public expenditure on health care should increase in the period ahead: the efficient management and use of resources, the Council believes, is more important than marginal changes in the level of expenditure.

The emphasis on the efficiency of the health care system must be matched by a concern for equity. In particular, it is unacceptable that access to necessary health care should be determined by the income of patients or by their status as public or private patients. Therefore, it is essential that in the hospitals system, as long as private and public care co-exist, that private care should not be subsidised, that admissions and access to services be based on need, and that public and private care should be equitably co-ordinated.

(ii) Housing

The system of housing is generally adequate. The main strands of future policy should be:

- the equitable subsidisation of various tenures;
- an emphasis on managing and conserving the local authority housing stock;
- a greater role for the subsidiary tenures – private rental and voluntary/social housing;

a co-ordinated resettlement strategy for homelessness and acute housing need.

In relation to the subsidisation of private housing, the Council has recommended that housing be subject to property tax and in that context, that mortgage tax relief at the standard rate should be retained. (In the absence of a property tax the Council recommended that a very restrictive stance towards mortgage interest relief should be adopted). These changes would contribute, not only to a more efficient housing system but also to a more efficient and equitable system of taxation: the extension of the taxation system to housing would represent a structural alteration to the tax base. A further improvement in the tax base, which would also improve the housing system, is the inclusion of capital gains on house sales in the tax base.³ Tax reform and housing policy converge on a policy of reforming the tax treatment of housing in this manner.

This central element of a more efficient tax system for owner occupied housing must be complemented by policies for the other tenures. In the case of local authority housing, for example, the capacity of local authorities to meet housing need would be improved in the long-run if much less of the stock were sold to tenants, and if such sales were on less generous discounts. Further, the emerging emphasis on maintenance and refurbishment, if continued, will enhance the efficiency of the local authority housing system.

The role of the other tenures – private rented and voluntary/social – must be seen in the light of the housing system as a whole. If these tenures are supported they can, in particular, provide a flexible, accessible stock of housing for those unable to purchase owner occupied dwellings or those for whom standard local authority housing is inappropriate. The costs of support to these tenures must be evaluated in the light of the alternative cost of directly meeting such housing need through State construction and provision of local authority dwellings. Further policy towards these tenures should therefore:

underpin both the demand for and supply of private rented accommodation through improved housing income supports, through supply incentives geared at the lower cost end of the rental market, and through limited regulation and;

continue and improve the subsidies to the voluntary/social tenure and in general encourage the growth of this sector.

The Irish housing system is good by international standards. What the system needs in the future is a more balanced mix of subsidies for the various tenures and an approach to housing which is targeted. The Council, for instance, favours improvement grants only to improve specific, poor quality accommodation or to improve the housing conditions of specifically identified groups or areas.

3. 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.

The remaining problem of homelessness should be viewed, in the Council's framework, in the context of the housing system and in a targeting framework. If the tenures which are, in principle, open to the homeless – private rented and voluntary/social – are appropriately subsidised and regulated, then the question of local authorities' direct provision of public housing is less important. What is important in the local authorities' response to homelessness is the need to provide specific types of accommodation in specific locations: this must be done in a broad social services framework geared at resettlement.

(iii) Education – The Need for Review

The Council itself has not undertaken an in-depth study of education policy. However, it has noted that the OECD is carrying out a fundamental review of Irish education policy. The Council awaits the outcome of this review. To achieve both equity objectives, in terms of equality of opportunity, and efficiency and developmental objectives, in terms of the supply of relevant skills, it will be necessary to consider fundamental aspects of education policy.

The following central questions must be addressed in the future. First, what is the appropriate management and decision making structure for the education system at central and local levels? Second, what reforms are required in the financing and provision of education to obtain equality of opportunity? Third, what should the curriculum at second level comprise, and what structures and initiatives are required to ensure that the desired curriculum (a comprehensive curriculum, for example) is in fact pursued universally throughout the school system?

The education system is clearly relevant to training and it will be necessary to assess the training and education systems jointly. Policy changes may be necessary in both these areas to maximise the contribution education and training can make to the reduction of unemployment.

In the future, the Council will address these and other aspects of education policy. An overall review of education policy is now an imperative in the light of demographic changes, constraints on public expenditure, and general changes in the environment in which the education system must function.

(iv) Social Welfare

An adequate and comprehensive system of social welfare is vital to the attainment of the Council's social objectives. The first central recommendation here is that the policy of narrowing the disparities in the payments received by different categories of recipient should continue. Second, the Council suggests that real payment rates in social welfare, can at least be maintained. The combination of declining numbers of beneficiaries in some areas and continuing real growth in GNP will allow some scope for social welfare recipients to share in the growth in national income. This can take place without the share of social welfare spending in GNP rising.

The policy in relation to increases in social welfare must also take labour market considerations into account. It is important that the gap between the incomes of social welfare beneficiaries and of employees should not narrow: policy in relation to social welfare payments must therefore be co-ordinated with income developments generally and with other matters which affect the disposable income of employees (income tax, PRSI, etc).

The general structure of the social security system, one based on social insurance contributions complemented by social assistance should continue: the coverage for social insurance contributions and entitlements should be as wide as possible.

Reform in social welfare must be viewed in the light of the tax/benefit system overall, as taxation and social welfare overlap and have joint effects on individuals and families. The system of PRSI contributions should be assessed as a tax, while still retaining an earmarked contribution. In the context of overall tax reform the employee's PRSI contribution rate should be restructured: exemptions and ceilings should be abolished and there should be one rate lower than at present. This reform would ameliorate the poverty trap, as PRSI deductions are significant for many low paid employees. In the same context, the PRSI tax allowance should be abolished and the revenue raised should be deployed to reduce income tax and PRSI rates.

Tax and social welfare converge at the point where the tax treatment of social welfare is determined. Short-term social welfare payments fall unambiguously within the Council's comprehensive definition of the income tax base: these payments should therefore be subject to income taxation.

The system of Child Income Support should be developed and rendered more targeted. Specifically, Child Benefit should be increased and taxed. This proposal reflects the Council's objectives in regard to improving income support for families, making the tax/benefit system more targeted, and improving labour market incentives.

The 'poverty trap' must be addressed. In the long-term the scale and nature of this problem, and solutions to it must be thoroughly researched. In the short-term the combination of restructured PRSI rates and a reformed Child Benefit will make some impact on the poverty trap.

Social welfare policies run in parallel with the Council's general tax reform proposals. The strategy of base broadening and rate reduction, for example, is being applied also to social insurance contributions. Finally, the Council's overall concerns with social policy, are reflected in its specific proposals which are geared towards:

- maintaining and improving the incomes of the lowest income groups;
- redistributing resources towards families, and targeting towards lower income families; and
- improving labour market incentives.

8. INSTITUTIONAL ISSUES

Institutional arrangements in the economy must be adapted and developed to facilitate the formulation and implementation of appropriate policies. The Council, having considered the preliminary research work underway on Ireland and other small open economies, suggests that three institutional developments are necessary.

First, Ireland must systematically learn policy lessons from the small, open, more successful European economies. In terms of macroeconomic policy, industrial development, labour markets and social policy, economies such as Sweden, Austria, Denmark and Finland are a source of policy learning. That these economies share structural similarities to Ireland and still rank in the top five or ten countries in the world in terms of economic performance, is a strong basis for shifting the focus of policy learning and development towards them, and away from more traditional points of comparison.

Second, an outstanding institutional feature of the small European economies noted above is their strong emphasis on achieving consensus and on finding mechanisms to resolve distributional conflicts. The recent experience in Ireland of the PNR is evidence that Ireland may have scope to broaden and strengthen the role of consensus and of consensus-forming arrangements.

In the context of this report, the Council has already indicated that a negotiated national consensus is the approach most likely to ensure achievement of its overall objectives. The Council believes that to be really effective in promoting employment and resolving conflicts a negotiated consensus must include, at least, the evolution of pay, taxation, the public finances, exchange rate and monetary policy, the various publicly provided services and social welfare.

Third, the system of policy formation in Ireland may require change, specifically in the direction of the key characteristics of policy making systems in these countries. Ireland now requires policies of structural adjustment as well as macroeconomic and development policies. The formulation and development of these policies will in turn depend on a stronger and more analytical approach to public policy and the development of more open, accessible and communicative styles of policy debate and policy change.

9. CONCLUSION

The Council wishes to make a number of remarks in conclusion. Ireland has developed a set of policies and an institutional mechanism over the last four years which has succeeded in providing an impressive economic and social performance. However, fundamental problems, particularly in regard to very high levels of unemployment and an overhang of national debt persist. The Council has in this

report put forward a strategy for the nineties, designed to build on the success of the last four years. A change of direction is now required in one important respect – fundamental structural changes are now required to complement the overall economic stability which has been achieved. The Council believes that continued negotiated consensus is the key to the successful implementation of the strategy outlined in this report.

PART I

THE MACRO-ECONOMY – ANALYSIS AND STRATEGY

THE IRISH ECONOMY SINCE 1986^{1,2}

1. INTRODUCTION

In November 1986 the NESC published *A Strategy for Development 1986-90*. The Council was very concerned at that time at the evolution of the economic and social situation over the first half of the 1980s and was very apprehensive at the implications of a continuation of the policies then in place. The Council was also of the view that the major imbalances which had built up in the economy could not be redressed in a short space of time. Hence, the recommendations of the Council were set in a medium-term context.

It is worthwhile examining very briefly the situation faced by the economy at that time in order to highlight the major improvements which have taken place in many of the economic aggregates. It is also appropriate to recount the significant changes in policy which occurred over the period in order to derive any appropriate lessons with a view to incorporating these lessons into the future conduct of economic and social policy.

2. THE ECONOMY AT END 1986

At the end of 1986 the Council assessed the prospects for growth in the Irish economy over the period 1986 to 1990, against the background of the likely evolution of the international economic environment over the following five years and assuming that the broad thrust of government policies then in place would remain essentially unchanged. Two scenarios were sketched: an optimistic scenario in which an average growth rate of GDP of just over 3 per cent was envisaged for the 1986-90 period. Under the pessimistic scenario, a growth rate of under 2 per cent per annum was in prospect for the 1986-90 period.

The principle purpose of these medium-term projections was to assess the extent to which the two most pressing problems facing the Irish economy, namely, the scale of unemployment and the serious imbalances in the public finances, might be expected to be ameliorated over the following five years, assuming that the broad thrust of existing Government policies, both macroeconomic and sectoral,

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1. Following discussions in the Council, the successive drafts of this report were prepared by Gerry Danaher, Tony McCashin and Rory O'Donnell of the Council's Secretariat.
 2. The Secretary of the Department of Finance did not consider it appropriate to comment on matters of budgetary policy.

remained unchanged. The principle conclusion of the exercise was that, even in the face of a modest upturn in the world economy, the evolution of national output would be insufficient to reduce unemployment or to generate a significant improvement in the public finances. Indeed, under the more pessimistic scenario for output growth, both unemployment and fiscal imbalances could deteriorate appreciably.

It was against this background that the Council put forward an overall strategy for economic and social development. The strategy had four major components:

- (i) an integrated macroeconomic policy addressed to correcting the imbalances in the public finances while at the same time promoting the development of the traded sectors through the provision of an appropriate environment;
- (ii) fundamental reform of the tax structure designed to enhance the efficiency and equity of the system;
- (iii) the promotion of the traded sectors, through the provision of an appropriate environment together with a set of improved sectoral policies;
- (iv) the progressive removal of the major inequities in society.

3. PERFORMANCE SINCE 1986

(i) Programme for National Recovery

The Government, in October 1987, agreed a Programme for National Recovery with the social partners. This Programme was governed by the principles set out by NESc in *Strategy for Development 1986-90*. The Programme covers the period to end – 1990 and envisages progress being made in four broad areas, in line with the four dimensions of the NESc strategy. Under the heading of macroeconomic policy, the major objectives of the Programme were:

- (i) to stabilise the National Debt/GNP ratio in the course of the programme, involving a reduction in the EBR to between 5 per cent and 7 per cent of GNP;
- (ii) moderation of pay increases to a level not exceeding 2.5 per cent in each of the years 1988, 1989 and 1990 to be underpinned by lower income taxation and a low level of inflation;
- (iii) linking firmly the exchange rate to the European Monetary System;
- (iv) achieving lower inflation and interest rates.

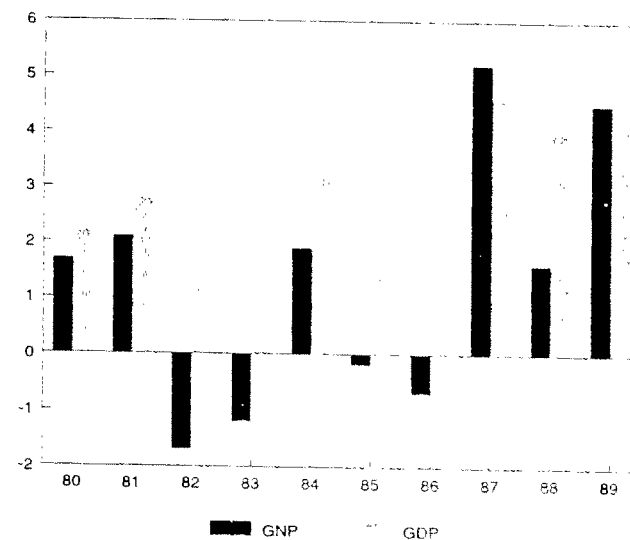
(ii) Economic Growth.

The macroeconomic performance since 1986 will be addressed under the following headings: growth, inflation, employment/unemployment/migration, balance of payments, public finances, interest rates/monetary developments. In order to provide some benchmark the 1986-89 performance is generally compared with the performance of the 1980-86 period.

In terms of growth, the turnaround has been quite dramatic since 1986. The average annual growth rate over the period 1980-86 was barely above zero with

the result that GNP in 1986 was virtually unchanged from its 1980 level. In fact, growth was significantly negative in 1982 and 1983 (Figure 1.1). By contrast, GNP has grown at an average annual rate of 3.6 per cent since 1986. The volume of GDP growth has experienced a similar turnaround, increasing from an average of 1.7 per cent over the 1980-86 period to 4.4 per cent in the 1986-89 period.

Figure 1.1
Volume Changes in GDP and GNP 1980-89



Source: Table A1.1

The difference between the movement of GNP and GDP is due to net factor income from the rest of the world. This is largely comprised of profit repatriation by the foreign industrial sector operating in Ireland and by interest payments on the foreign debt. The extent of such outflows is shown in Figure 1.2. Net outflows grew rapidly in the early 1980s, reaching 12.5 per cent of GNP in 1985. As a result, while the volume of GDP was over 12 per cent greater in 1986 than in 1980, the corresponding figure for GNP was only 2 per cent. After falling marginally in 1986 and 1987, net outflows increased in 1988 to 13.4 per cent of GNP and to 14.7 per cent in 1989.

Table 1.1 shows Ireland's growth rate compared to some other OECD economies. Despite inter-year variations – largely the product of an uneven pattern of profit repatriations – Ireland's growth over the period 1987-1989 was ahead of the EC average, and was broadly comparable with the average OECD performance. This is in marked contrast to the first half of the 1980s.

Table 1.1
Real GNP Growth in Selected OECD Countries

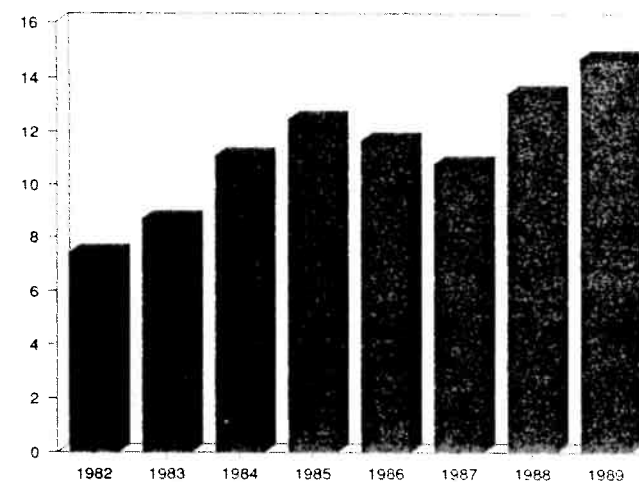
	1986	1987	1988	1989
Germany	2.3	1.7	3.6	4.0
France	2.3	2.4	3.8	3.7
Italy	2.5	3.0	4.2	3.2
United Kingdom	3.6	4.7	4.5	2.3
TOTAL EEC	2.6	2.8	3.9	3.5
United States	2.7	3.7	4.4	3.0
Smaller European Countries	2.9	3.0	3.4	3.7
TOTAL OECD	2.7	3.5	4.4	3.6
Ireland	-0.7	5.2	1.6	4.5

Table 1.2
Percentage Increases in Real Take-Home Pay, 1980-1990

	Average Industrial Earnings % Change		Average Male Industrial Earnings % Change	
	Single	Married	Single	Married
1980-87 Cumulative	-7.0	-8.2	-10.8	-7.5
1988-90 Cumulative	+8.2	+5.0	+9.4	+6.0

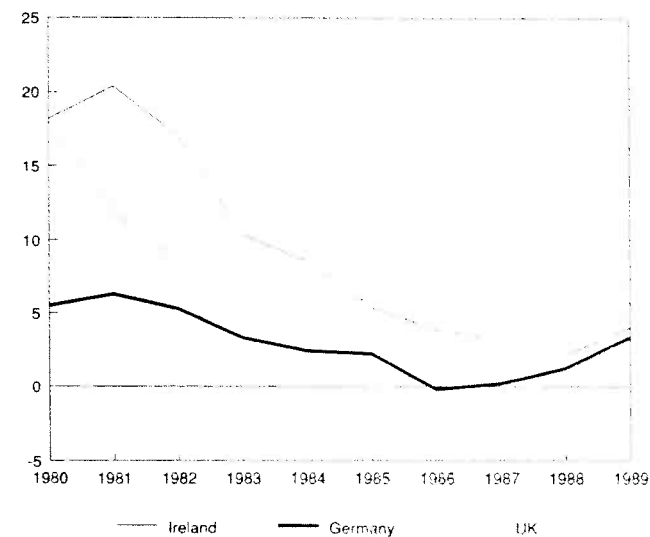
Source: 'Programme for National Recovery'. Progress Report by the Central Review Committee.

Figure 1.2
Net Factor Income to Rest of World



Source: Table A1.2

Figure 1.3
Irish & Selected Inflation Rates



Source: Table A1.3

(iii) Inflation

The period since 1986 has been characterised by a further deceleration of Irish inflation, falling from 3.9 per cent in 1986 to 3.2 per cent in 1987 and 2.1 per cent in 1988. This represented a continuation of the experience since 1981 when inflation peaked at 20.4 per cent. However, inflation has turned up again in 1989 to give an annual average rate of 4 per cent. International inflationary pressures – higher commodity prices, increased interest rates and a strengthening of the US dollar – were mainly responsible. Irish inflation resumed its downward trend in 1990 and now stands significantly below EC and OECD averages.

(iv) Employment/Unemployment/Migration

In terms of the change in total employment, the period 1986-90 stands in marked contrast to the early 1980s. Between 1986 and 1989 total non-agricultural employment increased by 14,000, while between 1980 and 1986 total non-agricultural employment fell by 34,000. When the agricultural sector, which is experiencing a secular downturn in employment, is included, the respective figures are a fall of 75,000 in the 1980-86 period and a growth of 9,000 in the 1986-89 period.

The numbers on the live register show a reduction of approximately 2 per cent between 1986 and 1989, from 236.4 thousand in 1986 to 231.6 thousand in 1989. However, using 1987 as a base, the fall is much more dramatic – from 247.3 thousand to 231.6 thousand, a fall of 6 per cent. As a per cent of the labour force, unemployment fell from 18.1 per cent in 1986 to 17.9 per cent in 1989.

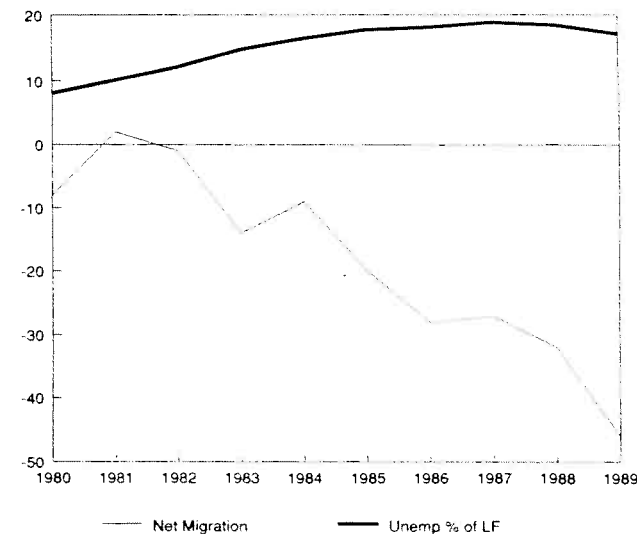
These employment and unemployment figures must be seen in the context of the changes in migration flows. Net migration increased from 28,000 in 1986 to 46,000 in 1989. It has fallen back to 31,000 in the year to April 1990 and there is strong evidence of a continued decline since then. Figure 1.4 shows the migration and unemployment trends.

(v) Living Standards and Competitiveness

While the national accounts data on personal disposable income are not yet available on an up-to-date basis, it is possible to make some estimates of how personal disposable income has evolved. We will complement these estimates with average earnings calculations and with the evolution of personal consumer expenditure to gain insights into how living standards have evolved since 1986. It is estimated that real disposable income increased by approximately 4.5 per cent in 1987 and by a further 3.5 per cent in 1989. 1988 saw only a marginal increase.

Turning to earnings it has been estimated that the combination of pay increases, tax changes and the low levels of inflation over the three years of the Programme will result in the real take-home pay of workers with average industrial earnings increasing by some 5 per cent to 9.4 per cent. This compares to a fall of 7 per cent to 11 per cent over the period 1980 to 1987 (see Table 1.2).

Figure 1.4
Migration and Unemployment 1980-89



Source: Table A1.4

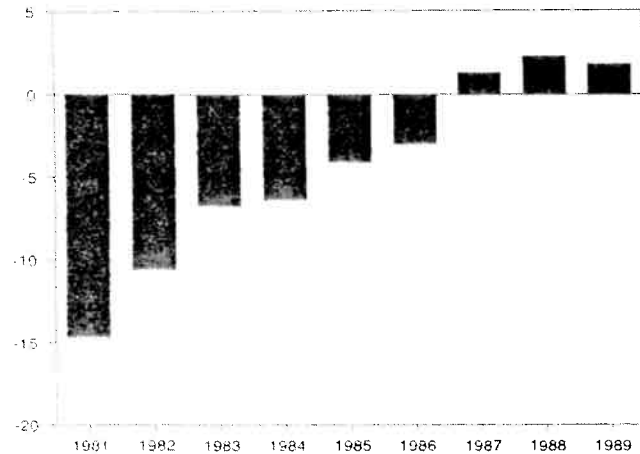
The real earnings and real disposable income increases together with falls in the savings ratio have fuelled significant growth in real personal consumption. Total real consumer spending increased by 2.5, 3.1 and 5.0 per cent in the three years 1987, 1988 and 1989.

One of the features of the 1986-89 period which sets it in marked contrast with the early 1980s is that these increases in real earnings and improvements in living standards were compatible with significant improvements in cost competitiveness. These improvements are considered in detail in the chapters dealing with employment and unemployment. It is sufficient to note here that hourly earnings in Ireland increased by 7.6 per cent between 1986 and 1989 while the average increase in our main trading partners was 13.9 per cent (in common currency terms). Looking at wage costs per unit of output the differences are more dramatic; however, considerable problems are associated with the measurement of wage costs per unit of output in Ireland because of differential performance within the industrial sector.

(vi) Balance of Payments

The balance of payments moved into surplus in 1987 to the tune of 1.3 per cent of GNP (Figure 1.5). The surplus increased in 1988 to 2.3 per cent and fell back to 1.8 per cent in 1989. This outcome is the result of divergent movements in the merchandise trade account and in the invisibles account (i.e. services, international

Figure 1.5
Current Account as % of GNP 1980-89



Source: Table A1.5

transfers and net factor income). The trade account moved very sharply into surplus in 1986, 1987 and 1988, while the deficit on the invisibles account increased rapidly in 1987 and 1988 (Figure 1.6). The trend in the invisibles account is strongly influenced by the net factor income item which is composed of Government debt interest and profit repatriation.³ The national debt interest element rose to 4.8 per cent of GNP in 1988 and to around 5 per cent in 1989. Profit repatriations reached 10.1 per cent of GNP in 1988.

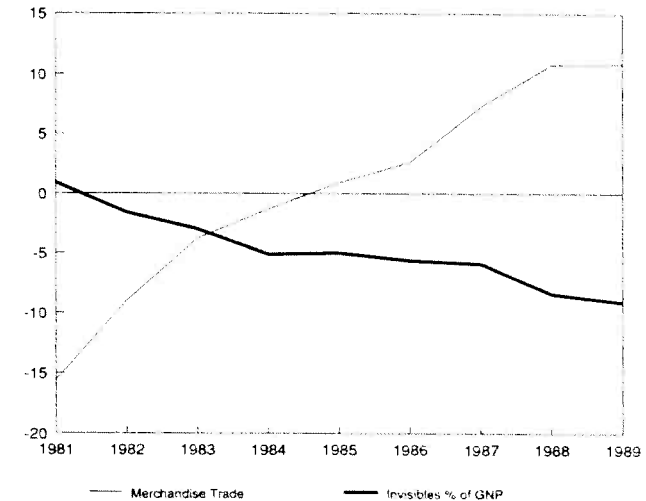
As will be discussed in the assessment section of this chapter, some of the changes experienced in the 1986-89 period are a continuation of a trend of the 1980-86 period. Nowhere is this more true than in the balance of payments. The current account balance improved consistently from an unsustainable deficit of 14.7 per cent in 1981 to a deficit of 3 per cent in 1986, moving into surplus in 1987. The evolution of the merchandise and invisible accounts are similarly a continuation of trends established in the early 1980s.

3. The merchandise and invisibles components of the current account are very much related of course with the rapid growth in exports from the foreign sector (which is a significant driver of the merchandise trade balance) having, as its counterpart, profit repatriation by the foreign sector which forms a significant proportion of the invisibles account.

(vii) Public Finances

Against the background of the deteriorating public finance position in 1986, one of the Council's major recommendations was that stabilisation of the debt/GNP ratio should be a minimum objective of fiscal policy. Stabilisation was seen by the Council as a first and necessary step towards the ultimate objective of reducing the ratio.

Figure 1.6
Balance of Payments
% of GNP



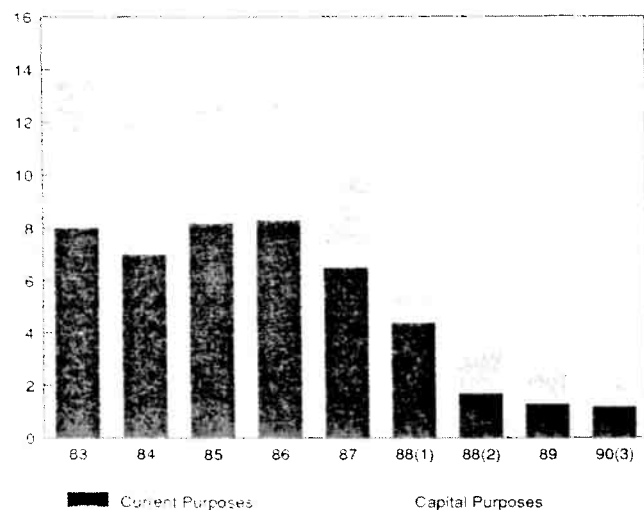
Source: Table A1.5

1987 witnessed a sharp shift in policy with fiscal retrenchment being the central theme of the 1987 budget. This initial shift was subsequently copperfastened in the Programme for National Recovery, the major public finance objective of which was to reduce the EBR to between 5 per cent and 7 per cent of GNP in order to stabilise the debt/GNP ratio by 1990.

The evolution of the public finance aggregates clearly reveal the commitment to this strategy (Figure 1.7). In the 1987 budget the EBR was budgeted to fall to 10.4 per cent of GNP compared with a 1986 outturn of about 13 per cent. The actual outturn was 9.9 per cent. In 1988 a reduction to 8.2 per cent was budgeted. Excluding once-off receipts under the Tax Incentive Scheme, the actual outturn was again less than budgeted at 6.0 per cent. With the EBR objective of the Programme for National Recovery achieved, the targetted EBR for 1989 was 5.3 per cent of GNP. In line with the pattern of the previous years, the outturn was

again less than budgeted at 2.3 per cent of GNP. A significant feature of the budgetary regime between 1986 and 1989 has been the extent to which budgetary targets have been more than achieved. The pace of budgetary retrenchment was eased considerably in 1990 with a targetted reduction in the EBR from 2.3 per cent of GNP to 2.1 per cent.

Figure 1.7
Exchequer Borrowing Requirement
% of GNP



Source: Table A1.6

National Debt and National Debt Interest

The reductions in the public sector deficit together with active debt management policy served to stabilise the debt/GNP ratio at a little over 13 per cent. 1988 witnessed a turnaround with the ratio declining marginally followed by a substantial reduction of over 10 percentage points in 1989 (Figure 1.8). It is estimated that the ratio will fall to around 1.5 per cent in 1990. Since National debt interest is a product of the level of the debt and the interest rate, the stabilisation of the debt and the easing of interest rates since 1986 have both contributed to a very significant reduction in the cost of servicing the debt from almost 12 per cent in 1986 to 10.4 per cent in 1989 (Figure 1.10).

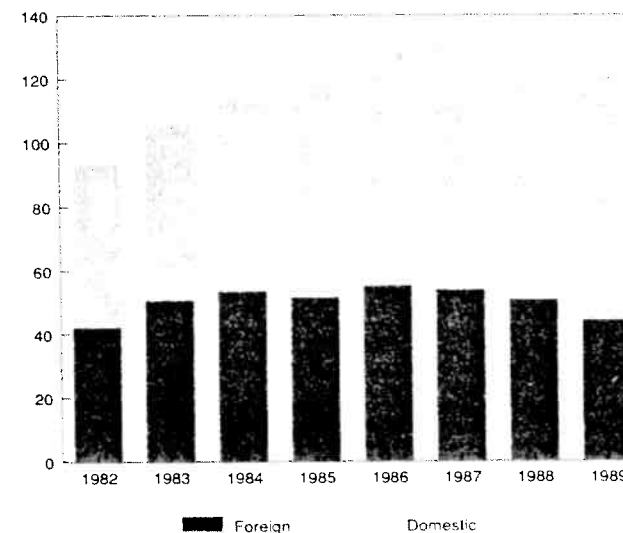
Method of Budgetary Adjustment

In Strategy for Development, the Council recommended that public spending reductions were the most appropriate means of restoring order to the public finances. The Council argued that it was neither feasible nor desirable to restore order to the public finances by means of higher taxation. Consequently, the Council recommended that the burden of adjustment should be borne by reductions

in current spending and in non-productive capital spending. The following charts explore the means through which these radical improvements were achieved.

Between 1986 and 1989, current expenditure fell from 48.5 per cent of GNP to 38.9 per cent of GNP. Exchequer borrowing for capital purposes fell from 4.5 per cent of GNP to 1.0 per cent in 1989. The level of current revenue also fell from 40 per cent of GNP in 1986 to 37.6 per cent in 1989 (Table A1.9).

Figure 1.8
Foreign and Domestic Debt/GNP Ratios



Source: Table A1.7

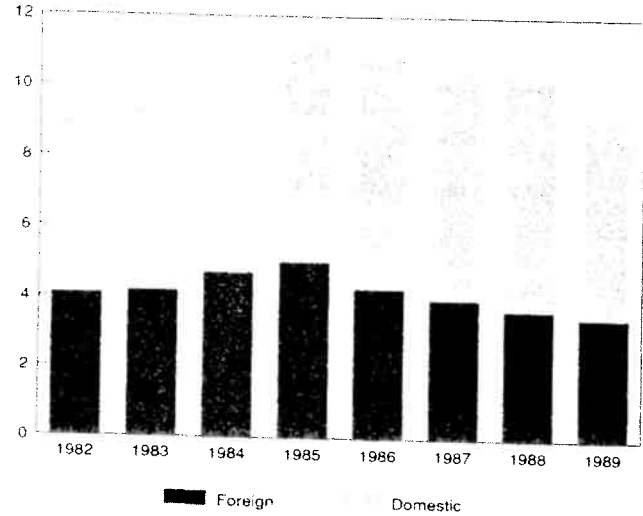
In summary, therefore, the EBR fell by 10.5 percentage points of GNP between 1986 and 1989. The current budget deficit accounted for 7.0 percentage points of the reduction with borrowing for capital purposes accounting for 3.4 percentage points. Current expenditure fell by 9.6 percentage points of GNP to accommodate the simultaneous fall in the current budget deficit and in current revenue.

Contribution to EBR Change

Current Spending ⁴	-9.6
Current Revenue	2.5
Exchequer Borrowing for Capital Purposes	-3.4
EBR	-10.5

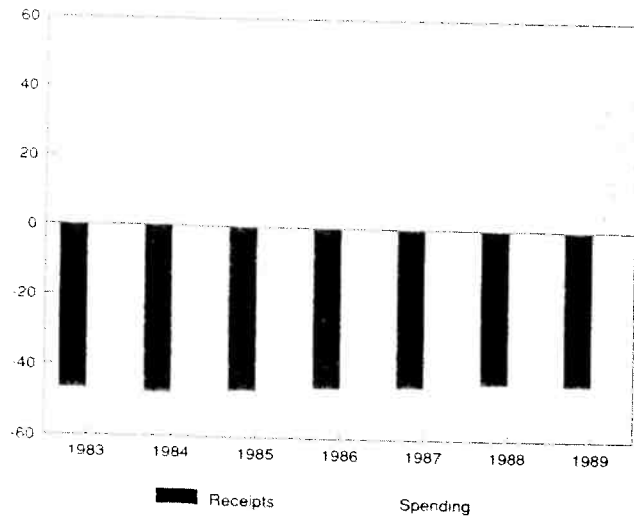
4. Some of this (of the order of 2 percentage points perhaps) is due to the ending of the Local Loans subsidy arrangements.

Figure 1.9
Foreign and Domestic Debt Interest Cost as % of GNP 1982-89



Source: Table A1.8

Figure 1.10
Total Public Spending and Receipts
% of GNP



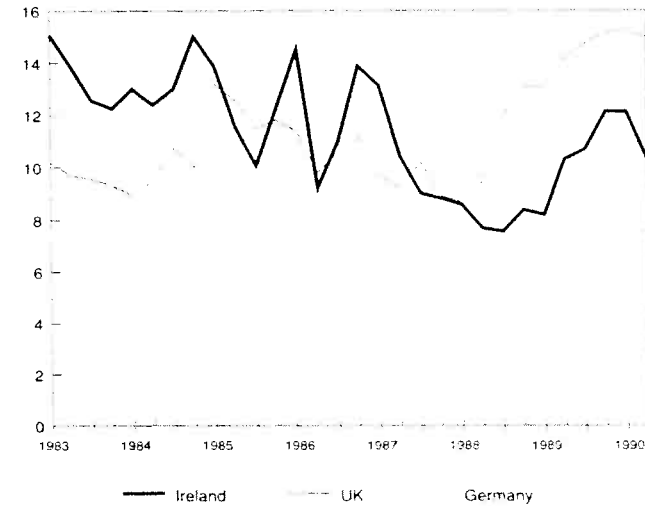
Source: Table A1.9

(viii) Interest Rates/Monetary Economy

The importance of financial developments for the real economy has been highlighted during the 1980s. The public finances and their financing, the balance of payments, exchange rates and interest rates are now closely intertwined in a complex pattern of relationships. In this section we begin with the evolution of interest rates.

Figure 1.11 shows the evolution of short term Irish interest rates, together with UK and German rates since 1983. The striking feature of the Chart is the fall in Irish interest rates below the corresponding UK rates from early 1987. The gap in Ireland's favour widened to almost five percentage points in December 1988. This positive interest rate development is also reflected in developments vis-a-vis Germany. In effect, Irish interest rates have decoupled from UK rates and have begun to track German rates (still with a positive differential) more closely. The reasons for this are explored in more detail in the assessment which follows.

Figure 1.11
Irish and Selected International Interest Rates



Source: Table A10

The financing of the EBR has altered fundamentally in the period since 1986. The share of monetary financing fell from over 70 per cent in 1984 to less than 50 per cent in the 1985-87 period and down further to 18 per cent in 1988 (Table 1.3). 1989 again saw a rapid increase in financing by monetary means back to the absolute levels of 1986 and 1987. An even more significant change has come about within monetary financing through a switch between direct external borrowing and

Table 1.3
Financing of the Public Sector 1980-89

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
Exchequer Borrowing Requirement	1217	1722	1945	1756	1825	2015	2145	1786	619	479
Financed by Monetary Means	846	1442	1358	1023	1289	964	975	873	110	874
of which:										
Exchequer Foreign Borrowing	566	1285	1148	793	649	806	812	592	-443	-29
Sale of Bonds to:										
Commercial Banks	243	120	237	225	418	240	13	84	-130	-214
Sale of Bonds to:										
Non-Residents	-17	-30	-18	35	121	83	240	460	867	1320
Finance by Non-Monetary Means	371	280	587	733	536	1051	1170	913	509	-396
of which:										
Sale of Bonds to Non-Bank Domestic Public	319	204	504	591	375	680	916	727	170	-556
Small Savings	52	76	83	142	161	371	254	186	339	161
Non-Monetary Financing (% of EBR)	30.5	16.3	30.2	41.7	29.4	52.2	54.5	51.1	82.2	-
Monetary Financing (% of EBR)	69.5	83.7	69.8	58.3	70.6	47.8	45.5	48.9	17.8	-

Source: Budget Booklets, Quarterly Bulletins of Central Bank of Ireland.

sales of domestic gilts to non-residents. In fact, in 1988 and 1989 the exchequer repaid £443m and £29m respectively of external borrowing and re-financed it through a three-fold increase in the sales of domestic gilts to non-residents.

4. MACROECONOMIC OVERVIEW AND ASSESSMENT 1986-89

At this stage it is worth summarising briefly the main indicators of macroeconomic performance. These are generally taken to be: growth, employment and unemployment, inflation and the balance of payments. Both inflation and the balance of payments continued on the benign trend which had been established in the early 1980s. Inflation decelerated to below the international average and the balance of payments moved into surplus. The growth performance altered markedly with GNP growth averaging 3.6 per cent per annum over the 1987-89 period by contrast with 0.2 per cent per annum over the 1980-86 period. On employment the turnaround is also evident with a growth of 14,000 in non-agricultural employment contrasting with a decline of 34,000 between 1980 and 1986. The unemployment and migration performance, however, did not exhibit a commensurate improvement. In order to examine the reasons for this and in order to evaluate the overall performance since 1986 it is necessary to look beneath those figures and examine the driving forces in the economy over these contrasting periods.

(i) Driving Forces

It is useful at the outset to make a distinction between two types of factors having an impact on the economy: external environmental factors such as world growth, interest rates and inflation rates, and internal, policy driven, factors. These external variables will be discussed as we move through this assessment. The major internal factor was the Programme for National Recovery, which contained a number of objectives of crucial relevance to the macroeconomic environment:

- (i) reduction of the EBR to between 5 per cent and 7 per cent of GNP to stabilise the debt/GNP ratio by 1990;
- (ii) moderation of pay increases to an annual rate not exceeding 2.5 per cent per year between 1988 and 1990;
- (iii) a firm commitment to linking the exchange rate to the EMS.

Since these are in the nature of intermediate variables, through what mechanisms did they impact on the final performance variables – growth, inflation, balance of payments and unemployment? It is not intended to attempt a detailed quantification of all the relationships – rather to indicate qualitatively the linkages through which effects occur. Two of the major conduits through which the intermediate variables operate on the economy are interest rates and competitiveness.

(ii) Interest Rate Developments and Cost Competitiveness

One of the most dramatic developments during the period was the decoupling of

interest rates from the UK and the tracking of German interest rates. In 1987 and 1988 the rising surplus on the current account and the large capital inflows from the sale of Government securities to non-residents, led to a rise in the official external reserves of over £600m between December 1986 and 1987 and by a further £340m between December 1987 and 1988. The growth in reserves permitted an easing of monetary conditions while still maintaining exchange rate stability. 1988 also saw the repayment of external debt by the Government, such as the extent of excess liquidity on the domestic money market. The reduction of domestic interest rates and maintenance of exchange rate stability is all the more noteworthy given the relaxation of the exchange control measures in 1988 and 1989.

Two elements of the changed policy environment contributed to these developments. *Firstly*, the reduction of the EBR had the direct effect of easing pressure on the domestic financial markets while it indirectly contributed to the current balance of payments surplus through its impact on domestic demand. *Secondly*, the announced commitment to maintenance of the exchange rate within the EMS and, more particularly, the adoption of domestic policy measures to underpin this announcement, minimised the exchange rate risk inherent in investing in Irish securities and increased the confidence of potential investors.⁵

The OECD has examined the nature of the long-term interest rate differential vis-a-vis Germany. The differential is specified as depending upon the differences in consumer price inflation between the two countries and the Irish exchequer borrowing requirement. The differential between the two rates has been on a downward trend since 1982. The OECD analysis suggests that between 1981 and 1986 it was largely the reduction in inflation differentials (from 14 to 4 percentage points) which accounted for the narrowing of the gap, while the effect of the budget deficit reduction is likely to have been more significant since 1987.

The improvements in labour cost competitiveness vis-a-vis our main trading partners has already been documented in Section (v) above. The fall in interest rates and improvements in labour cost competitiveness has also had an indirect impact on the competitiveness of the traded sectors. This occurs through lowering the relative costs of non-traded services, including the services provided by semi-state companies.

(iii) Growth Performance

This reduction in interest rates and the associated increase in investment (4 per cent in 1988 and 9 per cent in 1989) goes some way to explaining why such a good growth performance co-existed with significant budgetary retrenchment. However,

5. There were also some special factors underlying the flow of funds into the purchase of domestic securities, viz. the introduction of a withholding tax on interest earnings in Germany, which led to capital outflows from Germany.

a number of other factors came into play over the 1986-89 period to mitigate the deflationary impact of fiscal policy. The major factors (in addition to the interest rate reductions and improvements in cost competitiveness) were an oil price fall and an acceleration of export market growth. The end-user price of petroleum products fell by 30 per cent between 1985 and 1988 while the growth rate of Ireland's export markets accelerated to 12.7 per cent in 1988 and 9.7 per cent in 1989.

The OECD has estimated that the oil price fall and the acceleration of export market growth added approximately 1.5 and 1.6 percentage points per annum to the growth rate over the 1986-88 period. Fiscal policy is estimated to have reduced the growth rate of GNP by 1.2 percentage points over the same period. The conclusion in respect of fiscal policy must be treated with extreme caution (as suggested by the OECD) since it does not take into account the beneficial effects of tight fiscal policy on interest rates and consequently on growth.

In summary, the growth performance in the period 1986-89 has been due to a combination of highly favourable external developments in the form of export market growth and oil price reductions, and internal factors in the form of cost competitiveness, interest rate reductions and increased confidence.

(iv) Balance of Payments

The immediate cause of the rapid improvement in the balance of payments position has been the merchandise trade balance. The factors giving rise to this movement are similar to those which have underpinned the overall rate of economic growth. Foreign market growth together with a domestic supply side response, driven by the improvement in competitiveness had the effect of pulling exports along at a rapid rate. Domestic demand on the other hand remained depressed over the period due in large part to fiscal consolidation (Table 1.4).

Table 1.4
Growth of Foreign and Domestic Demand 1985-89

	1983	1984	1985	1986	1987	1988	1989
Domestic Demand	-2.2	1.1	0.4	1.3	-0.4	0.2	4.8
Foreign Demand	7.6	10.8	7.4	5.2	8.2	12.7	9.7

Source: *OECD Economic Outlook* (various issues).

(v) Inflation

The continued improvement in inflation over the period 1986-89 is due to a combination of domestic and external factors. The major external factor is the

decline in inflation internationally (Figure 1.3). The domestic factors contributing to our inflation performance were the terms of trade improvement (due to the reduction in oil prices) and lower indirect tax impositions.

The most notable feature of the improved inflation performance is the decoupling evident in Irish and UK inflation performance. From having almost double the UK inflation rate in 1981, Irish and UK inflation rates were virtually equivalent in 1986. Since then the UK inflation rate has been on an upward trend while the Irish rate continued its downward path from 1986 to 1988 before turning up in 1989. Since 1986 the Irish inflation rate has begun to track the German inflation more closely than the UK rate.

(vi) Unemployment

The fourth main variable conventionally used in assessing overall economic performance are movements in employment and unemployment. We have already commented on the turnaround in the employment performance of the economy particularly on the growth of non-agricultural employment. This performance has also to be seen in the context of the significant reductions in public sector numbers consequent upon retrenchment in the public sector. However, the unemployment performance is much less satisfactory, particularly when set against the trends in net migration. These issues will be dealt with in greater detail in later chapters. However, some points should be made at this stage in order to facilitate drawing overall conclusions on the macroeconomic performance of the economy since 1986.

The first point that has to be made is that there is not a one-for-one relationship between increases in employment and reductions in unemployment. This arises because developments in the supply side of the labour market are not independent of developments on the demand side. For example, a pick up in the demand side of the labour market exhibited in growing employment will generate changes in labour supply: those who are not participating in the labour market will be encouraged to participate due to more buoyant conditions while some of those who would have been likely to emigrate will instead join the Irish labour market. In effect, some of the increased vacancies will not be filled by those who were unemployed.

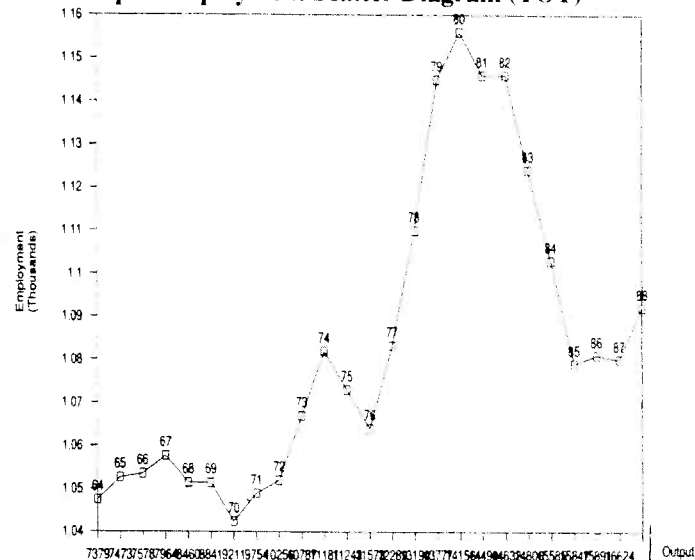
To get a better indication of what has been happening in the labour market, it is worth looking in greater depth at employment growth. We begin by considering what the nature of the relationship is between economic growth and employment growth. Output is usually seen as depending upon the input of labour and the average productivity of that labour.⁶ Turning this relationship around implies that employment is determined by the level of output and the average level of

6. Underlying this statement is an assumption that the capital stock is growing steadily such that its influence is captured in the productivity growth variable.

productivity. The growth of employment is then determined by the growth of output and the growth of productivity. There may of course be lags between changes in output and the corresponding changes in employment. When demand increases, the initial reaction of firms may be to increase output without much increase in labour input (through, for example, increasing hours of work). Thus, even though – with a given rate of productivity growth – a sustained increase in output is not possible without higher labour input, the short-term reaction of employment to a change in output can be relatively slight.

Given that we have specified the underlying relationship between output and employment, it is now possible to test whether the employment performance has been disappointing given the output growth experienced. The way in which we test this is to examine whether there has been any change in the output/employment relationships by comparison with historical experience. Figure 1.12 plots the relationship between total output in the economy and total employment.⁷ As can be seen from Figure 1.12, the nature of the relationship between output change and employment change was altered radically around 1980. On average, over the 1964–80 period, a positive relationship existed between output growth and employment growth with each 1 per cent increase in GDP being associated with 0.1 per cent increase in employment. This implies a productivity component in the output growth of 0.9 per cent. The relationship changed completely in the 1980–88 period, when a negative relationship characterised the data. In effect, each 1 per cent increase in output was associated with a fall of 0.02 per cent in employment.

Figure 1.12
Output/Employment Scatter Diagram (TOT)



7. The most appropriate measure of output for this purpose is Gross Domestic Product at factor cost.

However, the point of our present interest is the period since 1986. This shows a further distinct change from the remainder of the eighties, viz. employment growth is once again becoming associated with output growth. While much further work of a micro nature is necessary to consider the fundamental relationships it cautions against the conclusion that the employment performance since 1986 is disappointing.

5. CONCLUSIONS

The overall macroeconomic performance over the period 1986-89 has been very impressive, particularly when viewed against the background of the disappointing performance of the first half of the decade. On all of the main macroeconomic indicators, performance was significantly better in the 1986-89 period than in the 1980-86 period. While the unemployment performance was not on a par with the other variables, some significant grounds for optimism exist in that economic growth is now leading to employment growth in contrast to the remainder of the eighties.

The reason for the improvement in overall performance is due to a combination of internal and external factors. The external factors were a benign world monetary and trading environment, while the internal policy driven factors were all incorporated in the Programme for National Recovery covering fiscal, monetary and exchange rate policy and agreement on income developments.

There were a number of consistent themes running through the overall macroeconomic framework in Strategy for Development. The first of these was the need for *consistency* within and between the various elements of macroeconomic policy (i.e. pursuit of consistent fiscal, monetary, exchange rate and incomes policies). The second was *continuity*. This was necessary because problems which built up over a number of years require the application of corrective action within a medium term framework (i.e. steady adherence to a particular mix of policies). The third requirement for an effective economic strategy is *credibility*. This is necessary for the stabilisation of expectations and the restoration of confidence in the economy. In essence, credibility is the widespread recognition that Government is committed to its economic strategy. The great strength of the Programme for National Recovery is that it provided consistency, continuity and credibility, thus providing a particularly favourable internal environment. The combination of a favourable internal and external environment serves to 'explain' the impressive performance of the 1986-89 period.

A number of points are worth making at this stage of the assessment about the sharp dividing line which has been drawn between 1980-86 and 1986-89. As with all economic and social phenomena this distinction may be a little too sharp in some respects. For example, some of the monetary variables in the economy had begun to improve prior to 1986. In particular, the inflation rate reached its peak in

1981 at 20.4 per cent and by far the greatest reduction occurred between 1981 and 1985. Similarly, the deficit on the current account of the balance of payments reached its peak in 1981 at 14.7 per cent and was on a continuous downward trend between 1981 and 1986.

One of the features of these improvements in the monetary economy is that they mirrored the deterioration in the real economy. One of the fundamental ways in which the 1986-89 performance differed from the earlier period is that the continued improvement in the financial variables co-existed with the improvement in the real economy.

One point is noteworthy about the nature of the exercise we have conducted here and the general conclusions which can be drawn from it. We set ourselves the limited task of describing and understanding the performance of the economy since 1986. We concluded that the overall macroeconomic performance was very impressive with the exception of unemployment. We cannot conclude from that, that the adjustment required to bring the economy back into internal and external equilibrium was costless. It would be necessary to undertake a full assessment of the entire decade (during which period unemployment increased from 8.1 per cent to 18.6 per cent) to reach such fundamental conclusions.

The improvement in the performance of the real economy is vital in trying to understand the differential public finance performance between the 1986-89 and 1980-86 periods. Leaving aside the issue of the method of adjustment, the efforts to restore order to the public finances in the early to mid 1980s were severely hampered by declining domestic demand and employment, leading to an erosion of the tax base, while rising unemployment led to growing transfer payments. In addition, rising interest rates fuelled public expenditure through debt service payments. By contrast, the strong growth rate, leading to a growth of employment and a stabilisation of unemployment, and the growth of consumer expenditure over the 1986-89 period have had a favourable influence on both the revenue and expenditure components of the public finances.

This contrast brings out a very important point – as soon as the economy breaks out of a vicious circle, improvements can flow rapidly and can feed upon themselves. For example, a reduction of interest rates can ease the pressures on the public finances which can, in turn, ease the pressure on interest rates. Over the period 1986-89, domestic and external variables were mutually reinforcing, thus conferring 'virtuous circle' status on the economy. The corollary of this, of course, is that any change in a particular constellation of variables can have very severe implications. This is particularly the case with an economy very open to international developments. International impulses are transmitted to Ireland very rapidly through the monetary variables of inflation and interest rates, and through the real variables of world economic growth working through both demand for Irish production and the supply of foreign investment.

APPENDIX TO CHAPTER 1

ADDITIONAL TABLES

Table A1.1
Volume Changes in GNP and GDP 1980-89

Year	GNP	GDP
1979	-	-
1980	1.7	2.2
1981	2.1	2.8
1982	-1.7	1.3
1983	-1.2	0.1
1984	1.9	4.0
1985	-0.2	1.4
1986	-0.7	0.1
1987	5.2	4.6
1988	1.6	4.0
1989	4.0(e)	5.2(e)

(e) Estimate

Source: National Income and Expenditure

Table A1.2
Net Factor Income from Rest of World 1980-89

Year	£m	As % of GNP
1980		
1981		
1982	- 927.7	7.4
1983	-1183.9	8.7
1984	-1638.8	11.1
1985	-1965.7	12.5
1986	-1957.0	11.7
1987	-1957.0	10.8
1988	-2542.0	13.5
1989	-3039.0	14.7

Source: National Income and Expenditure 1988, CSO.

Table A1.3
Irish and Selected European Inflation Rates

	1980	81	82	83	84	85	86	87	88	89	90(1)
Ireland	18.2	20.4	17.1	10.4	8.6	5.4	3.9	3.2	2.1	4.0	3.5
Germany	5.5	6.3	5.3	3.3	2.4	2.2	-0.2	0.2	1.3	2.8	2.4
UK	18.0	11.9	8.6	4.6	5.0	6.1	3.4	4.2	4.9	7.8	9.8
OECD	13.1	10.5	7.7	5.3	5.2	4.5	2.7	3.9	3.6	5.3	6.1
EC	14.4	12.1	10.6	8.3	7.6	6.5	4.0	3.9	3.6	5.3	5.5

Source: OECD Economic Outlook No. 47, June 1990, OECD.
Main Economic Indicators, Historical Status, 1969-88, OECD.

Note: (1) Twelve months to July 1990.

Table A1.4
Migration and Unemployment 1980-89

Year	Unemployment		Net Migration	
	000	% of Labour Force	000	
1980	101.5	8.1	-8	
1981	127.9	10.1	2	
1982	156.6	12.1	-1	
1983	192.7	14.7	-14	
1984	214.2	16.4	-9	
1985	230.6	17.7	-20	
1986	236.4	18.1	-28	
1987	247.3	18.8	-27	
1988	241.1	18.4	-32	
1989	231.6	17.9	-46	

Source: CSO

Table A1.5
Balance of Payments: Current Account 1980-89

Year	Merchandise		Invisibles Trade Balance		Balance on Current Account
	Balance	% of GNP	£m	% of GNP	As % of GNP
1980					
1981	-1697.7	-15.6	103.0	0.9	-14.7
1982	-1120.4	-9.0	-195.3	-1.6	-10.6
1983	-521.5	-3.8	-403.7	-3.0	-6.8
1984	-196.6	-1.3	-748.8	-5.1	-6.4
1985	136.6	0.9	-786.7	-5.0	-4.1
1986	435.0	2.6	-944.0	-5.6	-3.0
1987	1310.0	7.3	-1071.0	-5.9	1.3
1988	2025.0	10.8	-1588.0	-8.4	2.3
1989	2244.0	10.9	-1873.0	-9.1	1.8

Source: National Income and Expenditure (various issues), CSO.

Table A1.6
The Exchequer Borrowing Requirement and its Components, % of GNP

Year	EBR	For Current Purposes	For Capital Purposes
1983	13.6	8.0	5.6
1984	12.3	7.0	5.3
1985	12.8	8.2	4.7
1986	12.8	8.3	4.5
1987	9.9	6.5	3.4
1988 (1)	6.0	4.3	1.6
1988 (2)	3.3	1.7	1.6
1989	2.3	1.3	1.0
1990 (3)	2.1	1.2	0.9

1. Exclusive of once-off receipts under the Tax Incentive Scheme
2. Inclusive of once-off receipts under the Tax Incentive Scheme
3. Budget Estimate

Source: Budget Booklets (various issues).

Table A1.7
National (Exchequer) Debt:
Foreign and Domestic as % of GNP, 1982-89

Year	Foreign Debt Interest	Domestic Debt	Total Debt Interest
1982	42.2	51.5	93.7
1983	50.7	55.1	105.9
1984	53.5	60.2	113.7
1985	51.7	66.2	117.9
1986	55.1	74.1	129.2
1987	53.8	77.6	131.4
1988	50.7	80.4	131.1
1989	44.2	76.2	120.4

Table A1.8
Cost of Servicing National Debt (1)
Foreign and Domestic Debt as % of GNP, 1982-89

Year	Foreign Interest	Domestic Interest	Total Debt Service (2)
1982	4.1	5.0	10.0
1983	4.2	5.5	10.7
1984	4.7	5.8	11.5
1985	5.0	6.6	12.5
1986	4.3	6.6	11.9
1987	4.0	6.7	11.7
1988	3.7	6.7	11.4
1989	3.5	5.9	10.4

1. Debt service payments charged on supply services not included in these figures.
2. Include Sinking Funds and expenses of issue as well as foreign and domestic interest.

Source: Finance Accounts.

Table A1.9
Total Public Expenditure and Taxation as % of GNP (on Budgetary Basis)

Year	Current Spending	Capital Spending	Total Spending	Current Revenue	Capital Resources	Total Receipts
1983	46.6	13.8	60.4	38.7	8.1	46.8
1984	47.3	13.0	60.3	40.2	7.6	47.8
1985	48.5	11.2	59.7	40.3	6.6	46.9
1986	48.5	10.4	58.9	40.1	5.9	46.0
1987	46.2	9.0	55.2	39.7	5.6	45.3
1988*	42.6	7.3	49.9	40.9	5.6	46.5
1989	38.9	6.9	45.8	37.6	6.0	43.5

*Exclusive of once-off receipts under the Tax Incentive Scheme (Tax amnesty).

Source: Budget Booklets (various issues).

Note: There is a discontinuity in the series because of the 1988 changes in the Local Loans Fund subsidy arrangement, which ended a system of circular payments whereby the State provided local authorities with loans and then wholly or partially subsidised the repayments of these to itself.

Table A1.10
Irish and Selected International Interest Rates 1983-89

		Ireland (1)	UK (2)	Germany (3)
1983	- March	15.06	10.19	4.94
	- June	13.88	9.69	5.12
	- September	12.56	9.56	5.75
	- December	12.25	9.31	5.88
1984	- March	13.00	8.94	5.62
	- June	12.38	9.50	5.94
	- September	13.00	10.75	5.81
	- December	15.00	10.00	5.62
1985	- March	13.88	13.19	5.94
	- June	11.56	12.56	5.50
	- September	10.06	11.50	4.50
	- December	12.25	11.81	4.75
1986	- March	14.50	11.38	4.50
	- June	9.19	9.81	4.50
	- September	11.00	10.56	4.50
	- December	13.88	11.25	5.25
1987	- March	13.12	9.75	3.94
	- June	10.44	9.22	3.88
	- September	9.00	10.19	4.06
	- December	8.81	8.91	3.44
1988	- March	8.56	8.69	3.38
	- June	7.69	9.44	4.19
	- September	7.56	11.94	5.12
	- December	8.38	13.12	5.38
1989	- March	8.19	13.06	6.44
	- June	10.31	14.19	7.06
	- September	10.69	14.69	8.00
	- December	12.12	15.16	8.31
1990	- March	12.12	15.23	8.00
	- June	10.31	14.96	8.19

1. Three-month IRE Dublin Interbank

2. Three-month Euro-Sterling

3. Three-month Euro-DM

Source: Central Bank of Ireland, Quarterly Bulletin.

STRATEGIC ISSUES FOR THE NINETIES

1. INTRODUCTION

At the end of 1986 the Council prescribed an overall direction for the Irish economy up to the year 1990 to address the twin problems of unemployment and the public finances. At that time the Council was very concerned by the prospect of the continuation of the policies then in place. The recommendations of the Council comprised four main elements:

- (i) an integrated macroeconomic strategy designed to correct the imbalances in the public finances and provide a favourable environment for the internationally trading sectors;
- (ii) reform of the tax structure to enhance the efficiency and equity of the system;
- (iii) the removal of major inequities in society;
- (iv) long-term policies directed towards resolving structural problems in industry and agriculture.

The Council particularly emphasised that remedial action had to take the form of an integrated strategy and had to be placed firmly in a medium-term context.

The four elements of the Council's recommendation were derived from an overall strategic perspective. This perspective incorporated a view on the economic growth process in a small open economy and the implications of this for policy formation. It also involved consideration of some trade-offs between economic and social policy objectives.

As we now come to the end of the period covered by the original Strategy document and to the end of the Programme for National Recovery 1987-90, the question arises: what comes next? There are two aspects to this question. First, what economic and social policies are necessary, and second, what institutional arrangements are necessary to execute these policies? The choice of these economic and social policies must be made within a strategic perspective. Such a perspective would provide a framework within which all strands of policy can fit together, and be mutually supportive, and where trade-offs can be identified and rationalised. This chapter provides that perspective.

The remainder of this introductory section identifies a set of key tasks which the Council must address. Section 2 briefly reviews the strategy which informed its original set of recommendations in 1986. In Section 3 we very briefly reiterate

what has happened since 1986. Section 4 is entitled Sustaining the Recovery. It follows the framework provided in this introductory section and examines likely changes in the external environment. This sub-section is essential in any strategic planning exercise because, even though the existing strategy may have been successful, it may require modification in the light of changes in the external environment. Section 5 raises some questions regarding the institutional arrangements necessary to facilitate the implementation of policy changes. Conclusions are presented in Section 6.

(i) Key Tasks

The key tasks of the Council in mapping out a strategy for further development over the medium-term include:

- (i) taking a realistic view of the potential of the economy over the medium-term;
- (ii) determining the key objectives which the new strategy should aim to achieve and the relative priorities among the objectives;
- (iii) identifying what is required to achieve the objectives;
- (iv) clarifying conflicts between objectives where these exist;
- (v) choosing optimum courses of action by reference to the highest priority objectives in cases of conflict;
- (vi) addressing the policy priorities which must be pursued should the external environment deteriorate significantly from that presented in Chapter 3.

In this chapter, tasks (ii), (iii), (iv) and (v) are addressed. The first task, viz. taking a realistic view of the potential of the economy over the medium-term, is the subject of Chapter 3. The policy priorities to be pursued should the external environment deteriorate significantly are considered in our overall conclusions and recommendations.

2. STRATEGY FOR DEVELOPMENT 1986-90

In *Strategy for Development 1986-90*, the Council identified unemployment and the public finances as the two major problems to which solutions had to be found. In seeking solutions to these problems, the Council used a simple model of how the economy operates which involved distinguishing between the exposed, internationally trading sectors, (comprising enterprises which compete on overseas markets and those which compete with imports on the home market) and the rest of the economy. These enterprises can be located in either the public or private sectors. It was argued that it is only by securing growth in the internationally trading sectors that sustainable growth in employment can take place.

Given this conception of how the economy functions, it was argued that strong sustained growth could best be assured by giving priority to the requirements of the traded sectors to the greatest extent possible. The performance of the exposed sectors is critically dependent on maintaining and improving their international

competitiveness: government policies in relation to taxation, incomes, interest rates and the exchange rate are of crucial importance in this regard. Of equal importance for international competitiveness are industrial and agricultural policies. Consideration of the structural characteristics of these sectors was considered necessary to ensure sustained output and employment growth.

The Council also argued that a necessary component of any strategy should be the attainment of progress towards social policy objectives. Objectives of social policy include: (i) the securing of an adequate minimum standard of living for the most disadvantaged sectors of the Community; and (ii) the more equitable distribution of opportunities and life chances. It was argued that social policy objectives could not be ignored, even at a time when economic policy objectives prove difficult to achieve. An equity dimension to public policies derived not only from the equity and efficiency rationale for social expenditures and government interventions generally, but also from the need to secure broad agreement on the reforms and policies to be implemented. In particular, in regard to the need in 1986 for fiscal retrenchment, the Council insisted that:

It is particularly important that the burden of adjustment is not borne by the less advantaged members of society. Sacrifices will be accepted if some return can be demonstrated and if major inequities are removed from our economic and social system (NESC, 1986B).

3. EVOLUTION SINCE 1986

The evolution of the economy in macroeconomic terms since 1986 has been documented in Chapter 1. The basic conclusion was that the overall macroeconomic performance over the period 1986-89 was very impressive, particularly when viewed against the background of the disappointing performance of the first half of the decade. On all of the main macroeconomic indicators, performance was significantly better in the 1986-89 period than in the 1980-86 period. While a better labour market performance might have been expected given the rate of economic growth experienced, it was shown that some significant grounds for optimism exist in that economic growth is now leading to employment growth, in contrast to the remainder of the eighties.

This improvement in overall performance was due to a combination of internal and external factors. The external factors were a benign world monetary and trading environment. The internal policy driven factors were all incorporated in the Programme for National Recovery covering fiscal, monetary and exchange rate policy and agreement on income developments. Policy in all of these areas was closely aligned with the Council's recommendations.

Turning to the equity dimension of the Council's strategy, results are somewhat more complex. In the case of social welfare, policies have been pursued which

have, in some respects, improved the system of social security and recognised to some degree the needs of the most disadvantaged. Since 1987, when significant expenditure retrenchment was implemented, the incomes of the most needy social welfare categories have improved in real terms and the structure of social welfare payments has been developed in a direction recommended by the Council. Since social security cash transfers are the most effective means of effecting redistribution, the growth in real social security payments, and significant retrenchment in other areas of public expenditure, has increased the redistributive impact of the overall system of public expenditures.

In the case of health, it is far from clear that the principles of protecting the disadvantaged was generally applied in the period 1986-90. On the contrary, there are some clear instances where the (presumably) unintended consequences of policy were to widen and intensify disadvantage and inequality. In Chapter 9, on Health Policy, it is shown that the reductions in public health expenditure are increasingly associated with an extended role for private health care. Accordingly, the institutionalised inequalities in access to medical care appear to have intensified. This pattern of access to, and provision of, health care derives in part from the hybrid public-cum-private health system and from the framework in which this system functions.

In regard to housing policy, widening social divisions resulting from the interplay of public policy and private markets were also increasingly evident in the system. The Council's comprehensive research on the housing system revealed that the spatial and tenure divisions in the housing system, and the differential subsidisations of the tenures, were creating social class polarisation. This polarisation is reflected in the concentration of very low income persons in public sector housing areas and in the disproportionate incidence in these areas of poverty, unemployment and social deprivation. During the 1980s, policies affecting the public sector housing programme, and wider policies in pursuit of increased owner occupation, exacerbated the underlying divisions in the housing system and further intensified socio-economic class differences.

On the subject of social equity, one very important point must be made. It is not necessarily the *level* of public expenditure or taxation which determines the equity of the policy. More frequently it is the structure of public expenditure and taxation which determines the extent of equity.¹ Reducing the level of public expenditure or taxation, while neglecting to reform the structures, is therefore unlikely to advance social equity.

1. In NESC's redistribution study it was found that the limited amount of redistribution achieved in the system was purchased very expensively with high levels of public expenditure (NESC, 1988).

4. SUSTAINING THE RECOVERY

(i) Introduction

As indicated in the introduction, the first key task of the Council in mapping out a strategy for the next three years is to take a realistic view of the potential of the economy over the medium-term. Taking the twin problems identified by the Council in 1986, two points stand out: (i) there has been a considerable improvement in the public finance position but, even with the growth rate forecast over the medium-term, there will still be a significant debt overhang; (ii) in spite of a relatively rapid growth of GNP, unemployment is set to remain stubbornly high.

Some of the key issues which the Council faced in *Strategy for Development* are, therefore, still very relevant. However, the environment is now different from what it was in 1986. New objectives must therefore be chosen, courses of action plotted and policy instruments deployed in the changed environment. Consequently, before discussing desirable objectives, we will chart the major environmental changes taking place in both the economic and social spheres.

(ii) Changes in the Economic Environment

The many environmental changes facing the Irish economy can be categorised at two levels:

- (i) general changes affecting the world economy; and
- (ii) developments within the European Community.

Three major changes are evident in the world economy – the internationalisation of production, the internationalisation of capital markets and pressure for fundamental changes in agricultural policies.²

Fundamental changes are taking place in the organisation of production across the world. In its recent report, (NESC, 1989B), the Council identified the forces driving geographical concentration of advanced economic activity. Against these were set the arguments deriving from the 'new spatial division of labour' theories that the dispersal of manufacturing activities from the centre to the periphery may create a force for convergence of central and peripheral regional economies. During the nineties the Irish economy will be increasingly subject to such opposing forces.³

The internationalisation of capital markets derives from the interaction of a number of developments: regulatory changes in financial markets, particularly a weakening of capital controls and an easing of restrictions on the entry of foreign firms into domestic markets; and technological advances in telecommunications and data

2. While some of these developments are not totally new, they are now gaining considerable momentum.

3. It was based on these considerations, in addition to a number of others, that the Council concluded that the benefits of completion of the internal market would probably be distributed unevenly.

processing. These trends are likely to continue with the proposed removal of restrictions on trade in services in the current GATT negotiations.

While the changing environment in the industrial and service sectors derives principally from EC developments, the changes in the environment for agriculture derive not only from Community developments but also from global considerations, notably, the GATT negotiations. The current round of multilateral trade negotiations, known as the Uruguay Round, was launched in 1986 with the major objective of liberalising agricultural trade and extending GATT rules and disciplines to agriculture. The Uruguay round is due to be completed at the end of 1990. While the EC is implementing a restrictive policy on agriculture, through quotas and other budgetary stabilisers, some parties to the current GATT negotiations have made proposals for a virtual elimination of protection and support for agricultural production and trade. While the negotiations continue, major differences exist between the parties to the negotiations. Whatever the outcome, it is likely that it will provide a significantly more difficult environment for Irish agriculture.

In an EC context two major developments are underway – completion of the internal market and advances towards economic and monetary union.

The changes deriving from these two developments carry major implications for Irish product and factor markets. Looking first at product markets, the set of measures contained under the programme to unify the internal market will open up formerly protected sectors to international competition through the removal of physical, technical and fiscal barriers. The most obvious example of physical barriers are customs posts at frontiers. Technical barriers are the different standards for individual products adopted in different member states for health or safety reasons, or for environmental or consumer protection. Another set of technical barriers are the national rules and regulations which restrict the provision of services across national boundaries. Fiscal barriers are the various rates of taxes (particularly indirect taxes) in Member States.

Completion of the internal market and EMU will also have implications for factor markets. While labour is already very mobile between Ireland and the UK, and to a lesser extent between Ireland and the US, many of the single European market initiatives will enhance labour mobility within the Community. Specific proposals for a system of mutual recognition of university degrees, apprenticeship courses and vocational training have been put forward, some of which have already been adopted.

In the case of capital markets, the creation of a unified European financial area, as part of the overall unification of the internal market, is simply the European dimension of a general internationalisation of financial markets. The most obvious immediate change necessary to underpin the internal market and to advance

towards EMU is the removal of exchange controls. The resulting freedom of capital flows carries major implications for the taxation and regulation of the financial sector as well as for the overall macro-management of the economy.

While both capital and labour mobility are sensitive to taxation and regulation, it is necessary to see such mobility in a much more fundamental context. Savings flow to sectors and geographical areas where the greatest returns can be obtained, subject of course, to risk diversification. Some types of labour flows to locations, firms and sectors which provide career advancement opportunities and/or higher returns. Consequently, the mobility of capital and labour is influenced not only by taxation and regulation levels but also by the availability of opportunities.

The essential result of the aforementioned environmental changes is that the Irish economy will become more integrated into the European and world economy.⁴ The implications of this enhanced integration are addressed in section (iv) below.

(iii) Social and Environmental Changes

Social policies and objectives for the 1990s must also be formulated in a different context. *Demographic changes* are gradually but cumulatively reshaping the composition of the population. Over time the share of lone parents, one person households, and elderly persons living alone in the population will increase; young persons are leaving their family of origin at an earlier age. Social policy must therefore find instruments and methods better able to deal with this social 'fission' as it has been termed.

Associated with the evolving demographic scene is the well documented structural alteration to the *labour market*. The labour market is now characterised by a high incidence of long-term unemployment, a growth in female labour force participation and the emergence of 'atypical' forms of employment (job sharing, part time employment, home-based work). Labour market and related aspects of government policy must therefore adapt, and develop more flexible and more comprehensive policies and frameworks for training, social security and income maintenance, and child care.

The innate *complexity* of social problems has been increasing and will continue to increase, requiring more co-ordinated and multi-disciplinary definitions of problems and solutions to problems. For example, the problem of homelessness in the housing system has its origins in the complex social, demographic and economic changes which affect the framework in which housing is sought and the types of housing need to be met. Appropriate responses to this issue go beyond the direct production of sufficient quantities of 'standard' public sector housing, and entail co-ordinated elements of social services, health care, and housing

4. A feature common to a number of the environmental changes is that they derive from fundamental shifts in policy, i.e. changes in the regulation of financial markets, changing attitudes to agricultural support policies etc.

interventions in a number of housing tenures. Likewise, the growth of a significant component of very elderly persons in the population requires a multi-disciplinary approach to services for the elderly, one which crosses traditional professional and organisational boundaries and facilitates flexible policies and service delivery.

(iv) The Framework

Key Objectives, Conflicts and Relative Priorities

The objectives of economic and social policy do not change very much from period to period, but the relative priorities which attach to individual objectives are almost certainly likely to change. The first key objective at the time of *Strategy for Development I* was to bring the economy back onto some sustainable position – particularly, back into both internal and external balance. Many of the changes which were prescribed to achieve this were hardly in the nature of choices at all, they were more in the nature of imperatives and were described as such.

The second key objective was to enhance the efficiency of the economy through a fundamental programme of tax reform and a set of improved sectoral policies directed at the structural deficiencies in the productive base of the economy. The third key objective was the progressive removal of the major inequities in society and within this to ensure that the burden of adjustment did not fall on the disadvantaged.

The next step now is to ensure that the current economic expansion is sustained and that we continue to narrow social inequalities. The current economic expansion must be sustained to achieve our overriding objective – the creation of employment. Achievement of this objective would also contribute significantly to our major social objective of narrowing inequalities. In effect the Council is arguing that economic and social policy objectives are not necessarily mutually antagonistic. Unemployment, resulting in poverty or involuntary emigration, is the single most important contributor to inequality. The provision of sustainable employment to those currently out of work and those seeking work in the future would, accordingly, make a major contribution to securing a more equitable distribution of income and opportunities. The enormity of this task is examined in Part III of the report.

While the economic and social perspectives are convergent in regard to the principal objective of policy, arguments are sometimes put forward that narrowing social inequalities might not be consistent with sustaining the current economic expansion and that there may be trade-offs between equity and efficiency.

It should not be surprising that trade-offs arise in particular instances. Governments intervene in the economy for allocative and distributive reasons. The allocative function is an attempt to improve the allocation of resources between different uses where market failures are deemed to occur. Typically, the provision of “public goods” (defence and the like) and “merit goods” (education and health,

for example) comes under the allocative function. The distributive function of Government is achieved largely by means of transfers.⁵ Interventions to achieve allocative objectives nearly always have distributive consequences while interventions to achieve distributive objectives can sometimes have deleterious allocative consequences.

In carrying out assessments of particular policy interventions the fundamental questions become: what can markets achieve and how can Governments improve upon this? In this regard great care needs to be exercised about what economic theory tells us.⁶ Markets nearly always fail in some degree and so do Governments. The relevant question to ask is not whether markets fail, but where, when and how much they fail. Similarly, given a particular intervention by Government, the questions should be, how much information do policy-makers have, how likely are they to be influenced by vested interests and how good are the instruments of intervention available?⁷

The nature of the trade-offs will be different in each particular case and may differ between the short-term and the long-term; no generalisations are possible. Efficiency/equity trade-offs occur most frequently in the areas of public expenditure, taxation and the labour market. In considering interventions in these areas the Council will attempt to strike the appropriate balance between narrowing social inequalities and enhancing the efficiency of the economy, with all the decisions being informed by the Council's overriding objective of increasing employment. The Council sees the narrowing of social inequalities taking place through a restructuring of policies, services and subsidies rather than through increased public expenditure. In fact the Council's recommendation that there should be no overall increase in public sector activity in Chapter 4 implies that if real increases are required in some programme areas they will have to be counterbalanced by reductions in other areas.

Another area where trade-offs need to be considered and priorities established is in regard to living standards and employment. In 1986 we couched our discussion in terms of spreading the burden of adjustment; we are now faced with a somewhat different task – allocating the fruits of growth. As the medium-term outlook shows, we have in prospect a growth in the volume of resources available to society of approximately 3% per annum. A major issue arises as to the appropriate balance to be struck between growing living standards and increasing employment (which in turn feeds into reducing unemployment and reducing emigration) and also the appropriate balance between investment and consumption. Approached from the

-
5. This classification is somewhat crude since the provision of many goods and services is also designed to promote distributional or equity objectives.
 6. In a recent review of the issues, Helm (1986) argues that “economic theory does not provide any evidence to support a general preference either for markets or for planning” page (xxii).
 7. A good example of this type of fundamental assessment is contained in Chapter 9 of Health Policy.

strategic perspective of key objectives, priority should be accorded to the task of increasing employment.

Since investment lays the foundation for future economic growth and hence employment growth, and since consumption growth – both public and personal – by definition does not have such properties, policy should be designed in favour of investment. This again derives from the fundamental, overriding objective of increasing employment.

Requirements for the Achievement of the Objectives: An Economic Perspective

In specifying the requirements for the achievement of the objectives which we have set, we will begin by drawing some lessons from the conduct of macroeconomic policy not only since the adoption of the *Programme for National Recovery* but from contrasting periods of economic performance in the last twenty years. We will then apply these lessons to ascertain which policies should be deployed to achieve the objectives we have specified.

Since the 1970s, up to about three years ago, the Irish economy could be characterised as experiencing a significant degree of macroeconomic instability. This exhibited itself in all of the macroeconomic indicators being at odds with those of Ireland's international trading partners, with many of them on an unsustainable trajectory. In brief: (i) the rate of price and wage inflation was much higher than elsewhere; (ii) Ireland had very large deficits on both the public finances and the balance of payments; (iii) average growth was below international levels, and unemployment increased considerably faster than in other OECD economies.

The macroeconomic environment has now altered considerably, though, as discussed in Chapter 4, there are still considerable constraints on the scope for discretionary policy action. These constraints derive not only from past policy errors but from the very nature of the Irish economy – in particular, its openness. However, even if these constraints did not exist, it is important to ascertain what objectives we can realistically expect fiscal policy to achieve. Fiscal policy was traditionally viewed as an instrument of stabilisation, designed to even out fluctuations in the business cycle. In Ireland, the use of the current budget as an instrument of economic policy (it would not be correct to describe its use as an instrument of stabilisation) began in 1972. Having acknowledged its usefulness as a policy instrument, various Governments proceeded to use it to achieve numerous targets ranging from the maintenance of the economy close to its long-run potential growth rate to the maintenance of employment and living standards.

The suitability of fiscal policy as an instrument for the achievement of either of these is highly doubtful. While the maintenance of the level of economic activity close to its potential level through budgetary action makes sense in a business cycle context, its use is limited outside of this context. Attempts to maintain living

standards through the running of fiscal deficits, particularly in the context of deteriorating external terms of trade, are bound to fail in the long-run.

This discussion yields two very important policy conclusions. *First*, the central objective of macroeconomic policy has to be the encouragement of the *long-term* growth potential of the economy. The consequences of a policy of maximising the *short-term* performance of the Irish economy are well known by now. The Council clearly demonstrated in *Ireland in the European Community; Performance, Prospects and Strategy* that the very poor performance of Ireland in the 1980-86 period was a counterpart of the short burst of superior performance in the late 1970s. However, these two periods did not simply cancel each other out. The level of GNP is well below the level it would have achieved if the trend growth of the 1960s and 1970s had been maintained in the 1980s. *Second*, given the small, open nature of the Irish economy and the constraint of a large debt overhang, fiscal activism can play a very limited role in enhancing the performance of the Irish economy. These two conclusions have very clear implications for the conduct of fiscal policy. The essential theme which must run through the conduct of macroeconomic policy is that of consistency, viz. fiscal and monetary policy must be consistent with the EMS exchange rate anchor. The precise strategies for the individual strands of macroeconomic policy are developed in Chapters 4 (Fiscal Policy) and 5 (Monetary and Exchange Rate Policy without Exchange Controls), having regard to the lessons of the past and with a view to ensuring consistency between the various strands.

A consistent macroeconomic strategy is the first element of a consistent and effective overall approach to economic policy. A second element is a system for the determination of incomes consistent with the macroeconomic policy, which improves competitiveness and which handles distributional conflicts without disruption to the functioning of the economy. It is argued in Chapter 14 that negotiated consensus on incomes at national level is the system most likely to make macroeconomic policy consistent with employment growth and the reduction of unemployment. The structure of the economy is such that conflict over incomes, which could arise in the absence of national consensus, could damage efficiency and reduce output and employment.

We have now discussed two strands of a consistent and effective overall approach to economic policy. The third component is a set of development and adjustment policies which promote structural adjustments in the economy. A suitable macroeconomic approach and a system for solving distributional issues are necessary for development and adjustment but are not sufficient. They will not overcome barriers to long-run development. The reasons are discussed in Chapter 14.

In recent years progress has been made towards achieving two of the three elements which are necessary for an effective approach to economic policy. It is

now urgent that we develop the third element. The Council strongly believes that sustaining the current expansion during the 1990s and increasing employment growth above the 'no policy change' scenario in Chapter 3 is not possible without a fundamental programme of structural reform. This derives in a negative sense from the conclusion that the absence of macroeconomic policy levers puts a premium on the correct use of the remaining policy instruments at the disposal of policy makers. However, it follows in a more fundamental sense from the conclusion that the Irish economy will become more integrated into the European and world economy. The intensification of competition arising from the increased integration means that the effect of internal inefficiencies in impeding growth will be magnified. Changes which increase the exposure of the economy to external forces must be complemented by measures which enhance the internal efficiency of the economy. Correct manipulation of the macroeconomic levers which influence interest rates, costs and inflation, while essential, will not be sufficient in future. The exposure of the economy to international trends places a heavy premium on internal adaptability which, in turn, implies a fundamental programme of action to effect structural adjustment in the economy through a programme of microeconomic policy reforms.⁸

The Council's definition of structural reform is very wide-ranging, covering not only public financial interventions but implying changes which ensure competition in all markets. It is not going to be possible in this limited report to specify each and every reform which might be desirable. What is essential is that policy makers in the individual areas are aware of the fundamental changes in the external environment and recast any policies which impede growth. However, it will be possible to indicate desirable changes in some areas.

The first main heading under which such changes can be considered is in the structure of taxation, the pattern of public expenditure and public interventions generally. It is in the areas of taxation and social welfare especially that specific interventions can have a deleterious impact on economic growth and the labour market. However, changes in the health, education, and housing policy areas are also vital to an efficiently functioning economy from a resource allocation perspective. There are individual chapters on each of these in the report. In some areas where taxation and expenditure instruments interface (housing, for example), they are examined as two sides of the same coin. Governments also intervene in the economy through the creation of public enterprises. Given the necessity for ensuring that interventions through the various modes are managed effectively, a section of the report deals with the management of the public sector (covering both public expenditure and public enterprises).

8. Structural reform is now part of the agenda in many countries. Since the early 1980s the OECD has strengthened its review and appraisal of adjustment/structural policies in individual member countries and has now published a synthesis of these studies in four key areas: labour markets, financial markets, industrial adjustment and the public sector. For a good overview of the issues in this area see OECD (1983), OECD (1987B) and OECD (1989B).

The programme of microeconomic reform also implies changes in both industrial and agricultural policy. In these two areas the Council has already articulated policy positions. They will be drawn on in Chapter 14. Finally, it should be emphasised that Ireland's increasing integration into the international economy means that policy measures which were previously considered of mainly domestic relevance (such as regulatory interventions) will now influence the economic environment in Ireland relative to that in other countries and may, consequently, need adjustment to ensure international competitiveness.

Requirements for the Achievement of Objectives: A Social Perspective

It was indicated earlier that there are potential conflicts between objectives – for example between equity and efficiency. Throughout the analysis of economic and social policy the objective of increasing employment is taken as *the* prime objective. Consequently, in developing a social policy strategy, specific social policy choices must be sought which improve the employment performance of the economy.

Widespread and long-term unemployment has trapped some individuals and families into long-term dependence on social security. This dependence is associated with both a 'hysteresis' type *economic* obstacle to unemployment reduction and with a set of *social* and institutional obstacles to labour market participation. Policies which enhance the growth rate of the economy and increase the overall demand for labour will need to be supplemented by very *specific* policies to increase the re-employment rates of those on the fringes of the labour market. Groups affected by such policies would include the long-term unemployed, lone parents, and early school leavers.

A number of specific social policy initiatives may improve the long-term employment performance of the economy. Firstly, if the 'poverty trap' situation affecting some segments of the unemployed is improved then the increase in employment may be more rapid. Secondly, there is a growing dependence on the social welfare system among lone parents and women. Active policies in the areas of child care and training will facilitate re-employment by removing constraints on labour market participation. Thirdly, the high unemployment rates among early school leavers suggest that significant initiatives in the education and training areas may be necessary. Policies which increase the participation of second level pupils from low income families in the school system, and which improve their skill level have therefore a significant contribution to make to the reduction of unemployment.

The analysis in Chapter 7 showing the strong link between unemployment and poverty merits repetition here. Social policies which improve the employment and labour market outcomes of the high levels of economic growth have, therefore, two distinct but reinforcing rationale: the *economic* benefits of higher employment, and consequently reduced state transfers, and the *social* benefit of reduced poverty and deprivation.

Secondly, the principle of *protecting the disadvantaged* from the burdens of fiscal adjustment will have a continued and, indeed, renewed relevance in the 1990s. In the 1990s, those aspects of public policy which contribute to, and reinforce, social inequalities must be addressed. This principle of policy is not an implicit plea for increased public expenditure or for a generally less restrictive fiscal stance. The Council's analysis of social policies in health, housing, education and social security suggests that *reform* – by which is meant a restructuring of policies, services and subsidies within existing resources – can make a significant contribution to enhancing social equity.

Thirdly, the need for *targeting and priorities* in social policy is no less important now, in the Council's view, than in the recent period of intensive fiscal retrenchment. The approach being advocated here is not one of increased selectivity through greater means testing but rather of careful identification of problems and the design of very specific programmes to confront these problems. In the housing system, for instance, it is clear that some chronic problems require small scale and particular responses. On a more significant scale, the targeting of larger increases in social welfare payments towards the poverty-prone category of the long-term unemployed with families was based on a correct analysis of relative needs and priorities. The continuing need for strict control on the public finances in the 1990s offers a renewed imperative for such targeting. However, the fiscal constraints should not obscure the intrinsic *social policy rationale* for identifying priorities and target groups.

Fourthly, the potential role of *area-based strategies* in social policy should be actively explored. The concentrated incidence of unemployment, low incomes and deprivation in certain communities and regions gives a *prima facie* case for developing area-based social programmes. Currently, social policies and services operate on a 'functional' or 'departmental' basis (Health, Social Welfare and others) without any coherent attempt to integrate services at local levels. Clearly, many low income communities are affected by the services, and receive resources from a range of state agencies – local government, Health Boards, the Department of Social Welfare, FAS, for example. The scope for area 'renewal' and community based co-ordination must therefore be considerable. Evidence suggests that concerted, intensive programmes in small areas, containing elements of housing and environmental improvement, as well as retraining and employment schemes and 'outreach' health and educational projects, can have an impact over and above the separate effects of individual programmes. Furthermore, the more closely involved are local communities in the planning and delivery of area based projects, the more they will reflect local needs and priorities.

Central to any area based strategies of economic and social intervention is the education system. Educational interventions in deprived local areas can:

- improve the level of economic and social skills of particular communities;
- contribute to the long-term productivity and employment potential of young people;

act as a focus for community initiative and community participation across a wide range of community development projects;

complement the role and activities of traditional manpower and training activities.

Finally, the arguments in favour of an area based focus for social policies and social services are reinforced by the high incidence of unemployment, and long-term unemployment in particular, in specific areas and communities. The Council has argued in Chapter 14 that direct, specific measures aimed at the long-term unemployed are now necessary. One element of these measures would be the identification of particular areas and the targeting of long-term unemployment initiatives there. It is likely that such initiatives would have greater impact if combined with the wider type of programme of area renewal and development noted above. A significant programme addressed at the long-term unemployed in any one community could have valuable 'spin-off' effects. Similarly, area based programmes of education and training, child care provisions and community participation could complement and facilitate an intensive re-employment initiative.

The principles outlined above are suggested as refinements to, and not a replacement for, the existing mix of Welfare State policies and services. The general equity and efficiency arguments for state social services and social expenditure will continue, but they will need the refinements of targeting, an emphasis on reducing social inequalities, an attempt to link labour markets to social programmes, and a focus on local areas and communities.

5. POLICY FORMATION AND CHANGE

In the various chapters of this report and in its current and past research programme the Council has identified policy strategies for the future. The broad thrust of these strategies has been agreed by the interests represented on the Council. Some of the policies now being advocated by the Council, for example taxation of property, have been on the agenda for some time, but have not been implemented. This *prima facie* evidence of weaknesses in the policy institutions is one reason for examining the process of policy formulation and implementation. A second reason is the qualitative shift in the type of policies now being advanced. In the future, as the report makes clear, policies must address long-term issues of development and reform as well as issues of macroeconomic management and adjustment.

Consideration of structural change raises fundamental issues about the ability of the institutions of a society to adapt. A crucial factor identified in recent comparative research is the responsiveness of small open economies to their economic vulnerability. This responsiveness arises in some measure from institutional and policy-making systems which facilitate continual economic

adaptation and an equitable sharing of the costs and risks of economic change. The experience of the more successful small European economies (Sweden, Finland and Austria) suggests that their institutional arrangements in the widest sense, may be one of the important factors in explaining their superior economic performance. Comparative research, currently underway, is examining the policy institutions in Ireland and other countries to determine how the responsiveness of these institutions to changing circumstances, and their capacity to address policy problems requiring strategic long-term solutions, contribute to economic development.

A number of specific questions regarding Ireland's policy institutions merit examination:

- (i) To what extent is an improved long-term economic performance contingent on centralised 'corporatist' arrangements and, furthermore, what should the framework and policy agenda of such corporatist institutions be?
- (ii) How can the State autonomously pursue its long-term structural policies in industry, agriculture and other sectors without excessive reliance on subsidies and incentives?
- (iii) What adaptations should be made to the policy-making system to ensure a high level of policy analysis and debate and a capacity for policy reform?
- (iv) What is the appropriate balance between 'local' and 'central' in administrative and developmental functions – is there a relationship across countries between the central/local mix and levels of economic development achieved?

Consideration of some of these issues in Chapter 15 and in future work will act as a framework within which the programme of micro-policy reforms designed to achieve structural changes can be implemented.

6. CONCLUSIONS

In this Chapter we looked back over the strategy for the management of the economy which the Council recommended in 1986 and considered the broad evolution of the economy since then. We went on to consider what changes are in prospect in the future from both an economic and a social perspective. The essential message of this analysis is that very significant changes are likely in both the economic and social environment. Arising from these changes the Council is very strongly of the view that it will not be possible to sustain the current performance unless major structural reforms are undertaken. Macroeconomic stability is, of course, an essential complement to these structural reforms. We will now briefly restate the reasons for this position.

Up to 1986 the Irish economy experienced significant macroeconomic instability. Since then, extensive efforts have gone into restoration of internal and external

stability through a consistent macroeconomic strategy and a negotiated consensus on incomes at the national level. The domestic policy changes accompanied by a benign world monetary and trading environment generated a considerable improvement in economic performance.

The Programme for National Recovery through which these policies were implemented expires at the end of 1990. What can we learn from that programme and indeed from the history of Irish economic policy over the last twenty years? The outstanding lesson is that macroeconomic stability and consensus in the development of incomes is vital to support economic progress in a small open economy. The key contribution which any subsequent programme could make, therefore, is the continuation of macroeconomic stability and consensus on income developments of the past four years.

Much greater attention was devoted over the period of the Programme for National Recovery to restoring macroeconomic stability than in fundamental reforms of microeconomic policies. The prospective changes in the overall environment in which Ireland operates are now very considerable. The GATT talks covering agriculture and services and developments within the EC, in particular the completion of the internal market by 1992 and drives towards economic and monetary union, mean that the Irish economy will become even more integrated into the world economy. Macroeconomic stability and agreement on incomes is not enough to compete effectively in this changed environment. A coherent programme of structural and adjustment policies designed to overcome barriers to long-run development, to enhance structural change and contribute to the internal efficiency of the economy and its adaptability is also required.

A consistent macroeconomic policy and consensus on income developments and a programme of structural and adjustment policies are vital to ensure that the current economic expansion is sustained. This, in turn, is essential to achieve the Council's overriding objective, viz. increasing employment and the consequent reduction of unemployment. However, if the changes in employment and unemployment as projected for the medium-term in Chapter 3 are to be significantly improved upon, a major programme of structural and adjustment policies will be essential. Achievement of the Council's objectives with regard to unemployment would also contribute significantly to the Council's major social objective of narrowing inequalities. The analysis in the report also shows clearly the link between unemployment and poverty. In terms of allocating the fruits of growth over the medium-term, therefore, the task of increasing employment must take precedence over the growth of living standards.

The results of the Programme for National Recovery on the social dimension are somewhat more complex than on the economic dimension. Any future programme will require more fundamental reform of policies which generate social inequalities. In many cases these are policies which have clear social policy-type

THE MEDIUM-TERM OUTLOOK AND ITS IMPLICATIONS

objectives but which are ineffective in achieving these objectives. In other cases, the social consequences may be an unintended by-product of an intervention designed to achieve economic objectives. It should be emphasised that what the Council means by fundamental reform in this regard is a restructuring of policies, services and subsidies rather than increased public expenditure.

While the Council has distinguished between a programme of structural or microeconomic reforms and a programme of social reforms, a common thread actually runs through both. Governments intervene in the economy both to enhance its operation and to achieve certain distributive objectives. However, interventions to enhance its operation will have distributive implications while the pursuit of distributive objectives can impact on economic performance. As a consequence, therefore, assessing any policy intervention will have both economic and social dimensions.

In *summary*, then, the Council sees a strategy for the nineties having three broad mutually supportive components as follows:

- (i) a consistent macroeconomic strategy designed to underpin the continuation of macroeconomic stability so that the economy realises its full potential for increased output and employment;
- (ii) a continuation of the consensus on income developments of the last three years which delivers improvements in competitiveness and handles distributional conflicts without disrupting the functioning of the economy;
- (iii) a coherent programme of structural and adjustment policies designed to
 - (a) improve the economy's internal efficiency, enhance international competitiveness and overcome barriers to long-run development; and
 - (b) fundamentally reform policies which generate social inequalities while minimising any adverse economic impact.

From a policy making perspective a number of points are relevant in regard to these themes. *First*, while an individual measure may not have a large effect in increasing efficiency, improved allocation of resources or enhanced equity, a coherent programme of measures may be highly effective. *Second*, benefits may not be realised quickly as it takes time for business, labour and individuals to re-assess and respond to changing opportunities. *Third*, structural reforms do *not* imply a reversal of social progress. Enhancing the functioning of markets does not necessarily mean removing safety nets. Rather, structural factors as defined here refer to the capacity of economies, institutions and societies in general to adjust to changing circumstances, to create and exploit new opportunities and on that basis deploy and redeploy resources. *Finally*, an approach of this type demands a great deal of the policy-making system. This explains the emphasis which we place on management in the public sector.

1. INTRODUCTION

The likely evolution of the economy over the medium-term provides the context within which the Council will have to discuss and make recommendations on medium-term macroeconomic policy. As discussed in Chapter 2, the strategy which the Council recommends for the management of the economy must begin from a realistic view of the potential of the economy over the medium-term. It is therefore vital to consider the outlook for the major macroeconomic aggregates. This is done in Section 3.

Because the medium-term projections cover the period 1991-1994 we provide a summary of the various short-term forecasts which exist for the Irish economy for 1990 in Section 2. In Section 4 we examine the uncertainties which surround our projections. Section 5 contains the main conclusions.

2. THE OUTLOOK FOR 1990

The general consensus among economic forecasters is that the economy will continue to perform strongly in 1990 with expected GNP growth in the range 3.5 to 4 per cent (Table 3.1). There is now a greater degree of uniformity among the various forecasts with those forecasters who were at the pessimistic end of the range in the early part of the year revising their forecasts upwards. It should be emphasised that these forecasts generally pre-date Middle-East developments.

Growth in consumer expenditure is generally expected in the 3.5 to 4 per cent range, falling back somewhat on the 1989 increase. This growth is forecast to be fuelled by continued growth in real disposable income due to an increase in the numbers at work and the concessions in relation to income tax and transfers in the 1990 Budget. The evolution of farm incomes is the one depressing influence on overall income growth. It is unlikely that the trend in the savings ratio will impart any significant stimulus to consumption growth. The downward trend in the savings ratio of recent years is likely to be halted due to higher interest rates and a slowdown in the rate of growth of asset values.

On investment expenditure, further strong growth of the order of 10 per cent is expected for 1990 by all forecasters. While it is expected that the rise in interest

rates may restrict the growth in some types of private sector investment this will be offset by faster growth in public investment in infrastructure, largely financed by EC Structural Funds.

Table 3.1
1990 Outlook of the Major Forecasters

	Dept of Finance (1)	Central Bank (2)	ESRI (3)	Davy's (4)	NCB (5)	OECD (6)
Consumer Expenditure	4.0	3.50	3.50	3.50	4.00	4.1
Investment	10.25	9.75	10.25	9.40	8.00	9.7
Public Consumption	0.50	0.75	0.00	0.50	0.00	0.3
Exports	6.75	7.25	7.75	6.20	8.00	7.4
Imports	8.00	8.00	8.25	8.20	8.00	7.6
GDP	4.75	4.50	4.75	3.60	4.75	—
GNP	4.00	3.75	4.00	4.10	3.50	3.8
Inflation	3.00	3.25	3.25	3.25	3.00	3.0
Balance of Payments (% of GNP)	1.25	1.75	1.50	2.00	1.50	—
Employment [annual change]	13,000	11,000	13,000	—	—	—
Unemployment [Average Live Register]	221.6	223.0	221.0	—	—	—

1. *Economic Review and Outlook 1990*, Department of Finance.
2. *Quarterly Bulletin*, Autumn 1990, Central Bank of Ireland.
3. *Quarterly Economic Commentary*, August 1990, ESRI.
4. *Irish Interest Rate Outlook*, July 1990, Davy Stockbrokers.
5. *Financial Market Outlook* (July 1990), National City Brokers.
6. *Economic Outlook*, June 1990, OECD.

All forecasters expect significantly slower growth in the volume of exports than was registered in 1989. Export growth of the order of 6 to 7 per cent is the general forecast figure compared to growth of the order of 10 to 11 per cent in 1989. The dominant influence on these forecasts is the weaker outlook for growth in export markets, especially in the UK, although, as indicated above, the outlook for export markets has improved somewhat since the beginning of the year.

All forecasters expect import growth to slow as a result of the declining growth in consumer expenditure and exports. The projected strength of domestic demand, however, is expected by most forecasters to ensure that import volumes rise at a faster rate than exports.

Given the forecast movement in exports and imports and the forecast movements in other variables which affect the balance of payments, there is general agreement that the balance of payments will remain in surplus to the extent of 1 to 2 per cent of GNP.

There is also general agreement among forecasters that inflation will decelerate in 1990 to 3 – 3.25 per cent. Total employment is expected to grow by a figure in the range 11,000 to 13,000 in 1990, with the average live register unemployment forecast to fall in the range 221,000 to 223,000, down from 232,000 in 1989.

3. MEDIUM-TERM OUTLOOK 1991-94

This medium-term outlook is built up from: (i) a set of underlying economic assumptions; and (ii) assumptions concerning domestic Government policies and EC policies affecting Ireland.

(i) Assumptions

Underlying Economic Assumptions

- (i) Interest and exchange rates are assumed to remain unchanged from the levels obtaining at end May 1990.
- (ii) Ireland's export markets are forecast (based on the views of the international forecasting agencies) to increase by 5.5 per cent in 1990, falling back slightly from this in the period to 1994.
- (iii) Pay developments in the public and private sectors are based on continuation of PNR type moderation. This implies a slight improvement in competitiveness against the EMS narrow band countries in 1991 followed by broad maintenance thereafter, which, together with improvements vis-a-vis the UK and USA in each of the years 1991, 1992 and 1993 implies significant improvements in competitiveness each year.

Domestic Policy Assumptions

- (i) The continuation of services on a no-policy change basis with 1990 post-budget real levels as the base-line, and expenditure projections reflecting policy decisions already taken.

- (ii) Indexation of transfer payments and other programme costs to the CPI.
- (iii) Programme volumes altered to reflect demographic changes (e.g. increased elderly population, falling young population).
- (iv) Social insurance receipts and social welfare unemployment expenditure driven by the employment/unemployment projections.
- (v) Broadly, indexation of the taxation system (income tax, excise duties) to the CPI.
- (vi) Ending of export sales relief with the relevant profits becoming liable at the 10 per cent rate.
- (vii) Implementation of profile of EC Structural Funds as set out in the Community Support Framework.

In the taxation area the projection does not deal with: (i) the revenue impact of the harmonisation of the indirect tax system, consequent upon the completion of the European internal market; or (ii) the revenue impact of moving to a 25 per cent/single higher rate income tax system. In a more general sense the projection does not take into account any macroeconomic implications which may arise from: (i) German economic and monetary union; (ii) other developments in Eastern Europe and (iii) recent developments in the oil market. Their likely impact will be considered in qualitative terms when dealing with uncertainties surrounding the projection.

(ii) Main Features of the Outlook

Based on the foregoing assumptions, real GDP growth of approximately 3.75 per cent per annum is forecast for the period 1991-1994 with average real GNP growth of approximately 3 per cent over the period.

These growth figures are driven by an annual volume increase in consumer expenditure of around 3 per cent on average over the entire period, investment growth of approximately 5.5 per cent, and export-volume growth averaging 7 per cent; import growth is assumed to average about 6.5 per cent.

Gross agricultural output is forecast to rise by about 1 per cent per annum on average over the period to 1994. Total manufacturing output is forecast to grow by over 7 per cent per annum, composed of growth in the new sectors of over 9 per cent per annum and approximately 4 per cent per annum in the traditional sectors.

Total Building and Construction output is forecast to grow by under 5 per cent per annum over the period 1991-94. Output in market services is projected to grow by 3.5 per cent per annum; and that of public services to fall marginally.

(iii) Implications of the Outlook

The implications will be examined under three main headings: employment/unemployment, the public finances and balance of payments.

Employment is projected to rise by about 9,000 annually over the period:

annual decline of	(-)	3,000	in agricultural employment
annual increase of	(+)	4,000	in industry (including construction)
annual increase of	(+)	8,000	in market services
	(+)	<u>9,000</u>	

Emigration is projected to decline gradually towards some 16,000 in 1994, but averaging 19,000 per annum over the period. Taking account of increasing labour force participation and natural population increase, unemployment is projected to fall by 2/3,000 annually on average over the period.

For the public finances, the main features of the outlook are a change in the current budget position, moving from a deficit of 1.25 per cent in 1990 to a deficit of 0.75 per cent in 1993 and 0.25 per cent in 1994. With borrowing for capital purposes assumed to increase somewhat from its 1990 level and remain constant thereafter at about 1.25 per cent of GNP, the EBR is projected to rise initially, reflecting carry-overs from the 1990 Budget on both expenditure and revenue sides, to fall back to its 1990 level of about 2 per cent of GNP in 1993 and to fall to about 1 per cent of GNP in 1994. This projected budgetary profile and the assumptions underlying it will be discussed further when considering fiscal policy in the next chapter.

Based on the projected borrowing requirement and the interest and exchange rate assumptions outlined earlier, the national debt/GNP ratio would be around 102 per cent in 1993 and of the order of 98 per cent of GNP in 1994.

The current account of the balance of payments is projected to remain broadly in balance over the period 1991-94. Table 3.2 provides a summary of the main features of the projection.

4. UNCERTAINTIES SURROUNDING THE PROJECTION

(i) The External Environment

Given the exposure of the Irish economy to the world economy, the medium-term outlook outlined in Section 3 is crucially dependent on a benign external environment. The world's industrialised countries are enjoying their eighth year of uninterrupted growth which is the longest period of expansion since the second world war. At issue, therefore, is whether this expansion can be sustained. In its mid-year Economic Outlook the OECD was of the view that OECD activity in the course of 1989 settled on a sustainable medium-term path with growth slowing from the brisk pace recorded earlier in the recovery.

While the OECD at mid-year believed that the outlook remained positive, it was also of the view that the uncertainties surrounding the economic situation had

increased as a result of several factors: developments in central and eastern Europe; the widespread increases in long-term interest rates; changes in exchange rates and fragility in certain sectors of financial markets. A number of further changes have taken place since then and the greatest uncertainty now concerns the price and security of oil supplies as a result of developments in the Middle East. In addition to those general international uncertainties, the Irish economy is particularly sensitive to developments in the two other areas: (a) the outlook for the UK, around which there exists considerable uncertainty; and (b) the effects of a number of developments in agricultural markets. We will now look at each of these developments in turn.

Table 3.2
Summary of the Main Features of the Projection

	Annual Average 1991-1994 (% Change Volume)
<i>Expenditure</i>	
Personal Consumption	3
Fixed Investment	5.25
Exports	7
Imports	6.25
GDP	3.75
GNP	3
<i>Output</i>	
Agriculture	1
Manufacturing	7
Building and Construction	5
Market Services	3.5
Public Services	0
<i>Employment</i>	
	(Change 000's)
Agriculture	-3
Industry	4
Private Services	8
Total at Work	9

Oil Price Developments

Perhaps the greatest uncertainty attaching to any economic projection concerns the outlook for the price of oil and the security of supplies. Concern about recent developments in the Middle East is well placed as the last two major world

recessions have been set off by oil price explosions. It is too early at this stage to make any firm predictions, particularly because it is not yet known at what level the price of oil will settle. Even before the invasion of Kuwait, OPEC had agreed an increase of \$3 a barrel in the price of oil up to \$21. The price at which it eventually will stabilise depends on the military and political situation in the Middle East, which is well outside the scope of economic forecasting.

In spite of not knowing the level at which the price will settle it is possible to present some general scenarios for the industrial world. In offering such comments it is important to note that the context in which the oil price increase takes place influences the likely consequences. For example, the 1973 price increase came at a time of a world inflationary boom and thus considerably exacerbated an already difficult situation. While the present situation is not similar to 1973 in this respect, the OECD argued at mid-year that the balance of risks before the oil price developments lay on the side of higher inflation. On the basis of an average oil price of \$26 per barrel for 1990, falling back to the OPEC target price of \$21 per barrel in 1991, the major industrial countries could suffer a fall in their growth rate of half a percentage point in 1991 and an increase in inflation of the same magnitude compared with what it would otherwise be.

The increase in oil prices is now much greater than \$26 per barrel and appears to reflect the risk of armed conflict in the Gulf. In an initial evaluation of the impact on the Irish economy of the increase in oil prices, Davy Stockbrokers argue that the risk of recession is slight, with a rise in oil prices to \$24 a barrel reducing GNP growth by 0.3 per cent in 1991 and adding 0.5 per cent to the CPI. The corresponding figures for \$36 a barrel are a 1.5 per cent reduction in GNP and a CPI increase of 1.8 per cent.

It is important to distinguish of course between the impact effect and the final effect. The more serious consequences can arise from the reactions to these events and the resultant second round consequences. After 1973 some Governments tried to spend their way out of the problem but had to subsequently change course. After the 1979 increase the reaction of the authorities was to tighten policy so as not to accommodate the inflationary pressures. In 1973 the general reaction was an attempt to resist the transfer of wealth to the oil producing countries inherent in the oil price increase (technically known as a terms of trade loss). Attempts by Government and by society to use fiscal or monetary policy to maintain growth, to escape the reduction in living standards, are ultimately self-defeating.

In the introductory remarks above it was noted that concern about the consequences of increases in oil prices are well founded because of the consequences of OPEC I and OPEC II. However, there are grounds for believing that the results on this occasion are likely to be less severe, as reflected in some of the simulations quoted. This is for a number of reasons. *Firstly*, the increases presently being experienced are nowhere near the kind of magnitudes in previous

oil induced recessions. Oil prices more than quadrupled from 1972 to 1974 and nearly trebled from 1978 to 1981. Even if the price of oil were to settle at \$30 per barrel, the adverse effects on output in the industrial countries would probably be considerably less than those attributable to previous oil price increases.

Secondly, economies are now less exposed to oil. As a result of price increases there has been a dramatic fall in the amount of oil used in the production process because of a shift to alternative energy sources and energy saving technology.

Thirdly, the OPEC economies are now more developed than at the time of previous oil price shocks. Consequently, any sharp rise in OPEC export income is likely to be used to increase domestic growth and development resulting in a sharp rise in imports and demand for exports from the rest of the world. This would facilitate the recycling of potential OPEC surpluses and help to offset the dampening effect on growth of the oil price increase.

In summary, therefore, in the context of the type of scenario explored, i.e. one without major upheavals in the world oil market, and given appropriate policy responses, the impact on world economic activity of recent oil market developments is unlikely to be similar to the adverse effects of the previous two oil increases. Nevertheless, the degree of uncertainty caused by the developments in the Middle East is a matter for additional concern and is reflected in sharp falls in equity and other markets. The longer the stalemate persists the greater the danger that the simulations referred to might prove too optimistic.

Developments in Central and Eastern Europe

On developments in central and eastern Europe, the OECD argues that despite the dramatic political changes, the impact on OECD countries in general of economic developments in these countries, apart from those in the German Democratic Republic (GDR), is likely to be limited in the near term. They argue this case on the basis of OECD trade with central and Eastern European countries being relatively small, representing only 2.5 per cent of total OECD exports. In the case of Ireland, for both exports and imports, less than 1 per cent of our trade is with the eastern block.

While the trade effects may be small, there are two other respects in which developments in Eastern Europe could impact on Ireland. The first is in regard to flows of foreign investment. It is very likely that these countries will provide additional competition for Ireland in the attraction of mobile foreign investment. The other respect in which the impact on Ireland could be more significant is through the receipt of development assistance from the EC. If such countries develop close association with the EC they could become competitors for EC development assistance. Given that the development of such relations is not an immediate prospect and that assistance to Ireland is guaranteed up to 1993, any effects under this heading are likely to fall outside our current projection period of 1991-1994.

Since the trade effects are likely to be small initially and the development assistance from the EC is not an immediate issue, the impact of general developments in Eastern Europe is likely to arise principally through competition for mobile investment.

The impact of developments in the German Democratic Republic (GDR) could be felt much more rapidly. Economic and monetary integration of Germany is starting to become effective with monetary union between the Federal Republic of Germany and the GDR in July 1990. Given the unprecedented nature of such an integration process it is very difficult to anticipate the likely outcome. The OECD projects that: (i) GNP may continue to grow in 1990 at the same high rate as in 1989, slowing only a little in 1991 to a rate closer to that of potential growth; and (ii) that concerns about possible inflationary consequences seem exaggerated given the resolve of the Bundesbank as to its anti-inflationary policy stance. Because of this, the OECD assumes that the recent sharp rise in interest rates will not give way to a decline before mid-1991. The OECD also expects some upward pressures on the real exchange rate in Germany from the policy mix of tighter monetary conditions and a temporarily more expansionary fiscal stance.

Increases in Long-Term Interest Rates

Long-term interest rates began to rise in September 1989 and were higher by 1 to 2 per cent in the first half of this year in a number of countries. The OECD put forward a number of possible explanations for this development: a worsening of inflation expectations; an increase in risk premiums reflecting uncertainty about developments in central and Eastern Europe; expectations that investment demand is likely to be stronger, and returns higher, because of investment requirements and opportunities in central and eastern European economies.

Whatever the cause of the increase in long-term interest rates, Ireland will be unlikely to resist general world trends in this respect (although there may of course be some scope for a narrowing of differentials). Such an increase would adversely affect growth and would also raise the cost of financing our outstanding debt burden. The OECD also expressed some concern about the recent bout of exchange rate volatility and problems in specific sectors of US financial markets.

Evolution of UK Economy

The projection assumes that growth in the UK will soften in 1990 and that the UK would overcome its present difficulties without recession. While the OECD noted that the UK economy had begun to respond to the tightening of monetary policy with aggregate demand slowing and an easing of the housing market, it expected domestic demand in the UK to drop in the near term and recover only slowly thereafter. Buoyant foreign demand was considered likely to prevent GDP from falling but output was expected to remain significantly below that of productive potential over the next year and a half. The OECD attached considerable risks and uncertainties to this outlook. Since then, as indicated above, growth for the UK in

1991 has been revised downwards by 0.75 of a percentage point and is expected on average to be less than 1.5 per cent in 1991. The assumption underpinning our forecast is, therefore, extremely uncertain.

Developments in Agriculture

Also related to oil market developments, but compounded by a number of other factors, both international and domestic, is a less favourable outlook for the agricultural sector. However, the assumptions underpinning the projections had already anticipated a tight policy regime arising from internal pressure in the Community and external trade negotiation pressures. The impact of additional developments is likely to be more significant in the short-term than in the medium-term.

(ii) The Domestic Environment

The risks to the projection arising in the domestic environment derive from two principal sources: wage cost competitiveness and budgetary expectations. The projections assume a continuation of the type of wage cost moderation which characterises the Programme for National Recovery 1987-1990, allowing for only a very limited element of 'drift' beyond the projected CPI increase. The projections outlined earlier envisage a reduction in unemployment and in the level of net emigration.

On the public finance front the technical assumptions upon which the projection is based are: the continuation of services on a no-policy-change basis, and the indexation of payments and programmes, and the taxation system to the CPI.

An accepted principle of medium-term forecasting is that of indexing all nominal instruments to an appropriate deflator and leaving real instruments unchanged. In some cases such a principle is at variance with previous experience. In particular, a policy on indexing social welfare payments to inflation is out of line with our experience over the last ten years. The ESRI, for example, in the assumptions underlying their Medium-Term Review, departed from simple indexation of welfare payments to the CPI. For social welfare payments, other than pay-related and unemployment benefits, they assumed a rate of increase between price and wage inflation to ensure that welfare recipients participate in the economy's growth. Inserting that change into the medium-term projection in Section 3 above would have adverse implications for the borrowing requirement and consequently for the debt/GNP ratio.

No change in the real value of current public expenditure, which derives from the technical assumptions, could prove very difficult to maintain in practice against the background of GNP growth of over 12 per cent over the period and the real increases provided in the 1990 Estimates.

Indexation of the taxation system does not allow for any structural changes in the taxation system. There are a number of such changes in prospect deriving from the

Government's commitment to changes in the rates of personal taxation and moves towards tax approximation. The public finance implications of these changes will be addressed in Chapter 4.

5. CONCLUSIONS

The purpose of this chapter was to provide a framework within which the Council could make recommendations on policy for the medium-term. The short-term outlook is for growth in the range 3.5 to 4 per cent for 1990. Our medium-term projection presented in Section 3 envisages an average GNP growth rate of approximately 3 per cent for the period 1991-1994 with GDP growth of approximately 3.75 per annum. Employment is expected to grow by about 9,000 annually over the period and emigration is projected to decline gradually towards 16,000 in 1994. Arising from a number of developments, itemised in Section 4, a more than usual degree of uncertainty attaches to the projection.

While there have been some very significant improvements in the economy in recent years, it is disappointing that some of the problems which the Council identified in 1986 are still very much in evidence now. For example, on the employment/unemployment front, unemployment stands at 17 per cent of the labour force, and even with the sustained growth envisaged in the projection, only falls by 2000/3000 per annum. On the public finance front, while the conventional measures of the current budget deficit and the EBR have been reduced considerably there is still a significant public finance problem in the form of outstanding debt.

Thus, while the very creditable performance of the economy over the last number of years has eased the constraints on policy, significant progress still remains to be achieved. Additionally, this progress will have to be achieved in a more uncertain international macroeconomic context and in a radically altered international trading environment as described in Chapter 2.

FISCAL POLICY IN THE MEDIUM-TERM

1. INTRODUCTION

As discussed in Chapter 2, dealing with strategic issues for the nineties, one of the major objectives of macroeconomic policy has to be the protection of the long-term growth potential of the economy through the provision of macroeconomic stability. Drawing on the lessons arising from the *Programme for National Recovery* – and indeed from the history of Irish economic policy over the last twenty years – it was concluded that macroeconomic stability is essential to support economic progress in a small open economy.

Looking at fiscal policy in the context of these observations the major observation was that, given the small, open nature of the Irish economy, fiscal activism can play a very limited role in enhancing the performance of the Irish economy. That strategic perspective is the basis for the recommendations in regard to fiscal policy in this chapter.

The other main pillar underpinning the discussion of fiscal policy is the medium-term outlook for the economy presented in Chapter 3. The major features of that scenario were:

- Real GNP growth of 3 per cent per annum on average over the 1991-1994 period.
- A fall in unemployment of 2/3,000 annually.
- The current account of the balance of payments is projected to remain broadly in balance over the 1991-1994 period.
- The current budget to move from a deficit of 1¼ per cent in 1990 to a deficit of ¾ per cent in 1993 and ¼ per cent in 1994.
- The EBR is projected to be no better than its 1990 level of 2 per cent by 1993 but to fall to 1¼ per cent by 1994.
- The national debt/GNP ratio is projected to be about 102 per cent in 1993 and of the order of 98 per cent of GNP in 1994.

While there have been some very significant improvements in the economy in recent years, the medium-term outlook indicates that the problems which the Council identified in 1986 are still in existence. In particular, the twin problems of unemployment and the public finances are still very much in evidence.

The first issue to be addressed in this chapter is, given the medium-term outlook for the economy, what is the appropriate stance of fiscal policy which would contribute to the Council's fundamental objective of macroeconomic stability? The question is addressed in Section 3 of the chapter. In order to provide some background to this discussion, Section 2 examines the changing targets of fiscal policy.

Having decided on the appropriate fiscal target(s) it is necessary to consider how they can be achieved and what the appropriate combination of taxation and expenditure adjustments are. This issue is addressed in Section 4. Into that decision framework, of course, must go the other factors which also impinge upon the expenditure and taxation totals, particularly, policy objectives. In the taxation area, for example, there are the Government's objectives in regard to the personal income tax system and the constraints on the indirect tax front arising from European tax approximation. There are also the possible policy objectives in regard to social welfare transfer payments, i.e. whether the historical pattern of increases above the rate of inflation are desired. All these issues will be considered in Section 4 and an attempt will be made to reconcile the various objectives and prioritise among them having regard to overall strategic objectives.

2. CHANGING TARGETS OF FISCAL POLICY

Since the late 1970s, Irish fiscal policy has been dominated by public finance considerations. Whether appropriate or not, it is certainly the case that successive Ministers for Finance have indicated that they would have liked to pursue a variety of objectives but were constrained by public finance considerations from so doing.

The precise concerns have altered quite considerably since public finance issues came to dominate fiscal policy discussions. This is partly due, of course, to the fact that a continuous public finance problem, if unattended, results in the nature of the problem itself changing. It is worthwhile dwelling briefly on the variety of public finance targets considered as appropriate objectives of fiscal policy.¹ This is because a rationale has to be developed for future targets for fiscal policy.

Prior to 1984, the major concern of economists, policy-advisers and policy-makers was the current budget deficit, the major argument being that borrowing for current purposes was not justifiable. Concern at this time was also focussed on exchequer borrowing for capital purposes, the concern being with the capacity of the capital projects which were being financed by the borrowing to generate the returns necessary to remunerate borrowings.

The National Planning Board focussed attention on the PSBR which is wider than the EBR since it incorporates the borrowings of the Semi-State sector. In its report,

Proposals for Plan, the National Planning Board emphasised that the uses to which the borrowing would be put should yield additional output to pay the interest and debt service costs.

After 1984 the focus of fiscal targets began to change. In *Building on Reality* the focus shifted to the ratio of national debt to GNP. Such a shift was, in part, due to the accumulation of national debt consequent upon the continuous running of fiscal deficits. The critical question in relation to the public finances at that time was one of sustainability. This provided the rationale for adopting the debt/GNP ratio as a target of fiscal policy. The proximate sources of instability were the size of the national debt, its rate of growth and the rate of increase in interest payments relative to GNP. At around the time *Building on Reality* was published, the technical conditions under which the debt/GNP ratio becomes dynamically unstable emerged.² This instability, of course, had its origins in the policies pursued since the 1970s.

It was this instability which provided the fundamental reason for shifting the focus of attention from conventional measures of fiscal stance to the debt/GNP ratio. In that context, pre-occupation with the EBR or the current budget deficit would have missed the point entirely.

While the criterion of sustainability provided a rationale for focussing on the debt/GNP ratio and provided strong justification for the imperative of policy (viz. stabilisation with a view to ultimately reducing it), two other criteria provided further justification: (i) the flexibility which is sacrificed in the overall budget; and (ii) the impact on the growth potential of the economy.

We will look firstly at the constraints on budgetary flexibility. The simple arithmetic of the relationship between the stock of debt outstanding and the cost of servicing it implies that a rising stock of debt involves an increase in servicing costs. Accordingly, a rising debt/GNP ratio means that interest payments also rise as a proportion of GNP. Quite apart from the fact that such a situation is unsustainable, it seriously impairs budgetary flexibility, as interest payments pre-empt an ever increasing proportion of exchequer resources. The budgetary implications of the relationship between the national debt and the cost of servicing it are the more serious and the associated degree of budgetary inflexibility all the greater, the higher is the debt/GNP ratio.

2. Very simply, when the interest rate on the national debt exceeds the nominal growth rate of GNP, the debt/GNP ratio would rise without theoretical limit, all other things being equal. The 'other things' which can be manipulated to offset this effect and which are within the control of Government are the components of the non-interest EBR. In other words, there is a certain surplus on the non-interest EBR which would stabilise the debt/GNP ratio even when the interest rate is higher than the growth rate in GNP. The larger the differential between the interest rate and the growth rate of nominal GNP, the greater the non-interest EBR surplus required to stabilise the debt/GNP ratio.

1. See Dowling (1989) for further observations on the history of the various targets.

Turning to the second criterion listed above, it was argued that the impact on the growth potential of the economy of an increasing debt/GNP ratio occurs through the medium of an increasing ratio exerting upward pressure on interest rates, leading in turn to lower private investment, a smaller capital stock, and consequently diminished growth potential for the economy. While the traditional focus on the exchequer borrowing requirement and current budget deficits would also have thrown up concerns about interest rate pressures and potential 'crowding out', it has been argued that the *stock* of debt exerts interest rate pressures over and above those caused by borrowing *flows*. This argument is developed more fully below.

In *summary*, since the late 1970s, the debate surrounding the public finances began with concern regarding the current budget deficit and the associated arguments regarding the inappropriateness of borrowing to fund current consumption. To these concerns were then added those regarding borrowing for uneconomic capital expenditure and the switch to the EBR as an appropriate target of policy. These gave way in the mid-to-late 1980s to concern about the growing levels of debt and interest payments, to which the cumulative borrowings were giving rise, with the arguments switching to sustainability, flexibility and the impact on future growth potential.

Some concern was expressed at the time of the switch of targets that focussing on the debt/GNP ratio might, in some sense, provide Governments with the rationale for pursuing a "soft-option" in relation to fiscal policy.³ The answer to this, of course, depends upon the precise target adopted for the debt/GNP ratio. It should also be appreciated that targets for the EBR and the current budget deficit are derived from the debt/GNP target. In the Programme for National Recovery, for example, the stabilisation of the ratio implied an EBR of between 5 per cent and 7 per cent, depending on developments in economic growth and interest rates.

This discussion of the changing targets of fiscal policy and the underlying rationale for the changes, was presented in order to provide a backdrop to the current position. In the next section we turn to the current position and consider what the most appropriate target of fiscal policy is now.

3. APPROPRIATE FUTURE TARGETS

The NESc was centrally involved in ensuring the switch to a debt/GNP target for fiscal policy. At the end of 1986 the Council recommended that stabilisation of the debt/GNP ratio should be adopted as the overriding objective of fiscal policy. Stabilisation of the ratio was seen as the first step towards reducing it. Since then, as indicated in Chapter 1, the debt/GNP ratio has fallen from 131% in 1987 to 120% in 1989; debt servicing costs have fallen from 11.7% of GNP to 10.4%; and

the non-interest EBR has moved from a deficit of 2% in 1986 to a surplus of over 7 per cent in 1989.

The questions which now arise are: where do we go from here?; are the arguments outlined above still valid and is the debt/GNP ratio still an appropriate target of fiscal policy?; if the latter is answered in the affirmative, what debt/GNP ratio should be aimed at?

This task will be approached in the following way. The analysis begins with an international comparison of where Ireland stands vis-a-vis other OECD economies in terms of debt levels. This is not done in the belief that others are at an optimal level, but rather to get a broad idea of where Ireland stands in a comparative sense. The criteria which were used as justification for focussing on the debt/GNP ratio – sustainability, flexibility and growth impact are examined to consider whether they are still valid. Having done that and assuming that it remains a valid target, an assessment of what target should be aimed for is given.

(i) International Comparisons

Table 4.1 is drawn from the *OECD Survey of Ireland 1988/89* and shows Ireland as a clear outlier in terms of total debt/GNP ratios, external debt/GNP ratios and outflows of interest to remunerate that debt.⁴ Ireland's debt/GNP ratio fell by approximately 11 percentage points in 1989 to 120% of GNP. This does not, however, result in any significant change on the position of Ireland at the top of the OECD league table.

It was argued earlier that no implications or prescriptions should be drawn from international league tables of debt ratios on their own. There may, however, be some 'confidence' considerations to be taken into account. This effect may exhibit itself through upward pressure on relative interest rates. Dowling (1989) makes an interesting point in this regard. He argues that the need to move the debt/GNP ratio more into line with our EC partners is increased when the possible implications of economic and monetary union are taken into account. He argues that a heavily indebted Ireland within an economic and monetary union could face a higher cost for funds than other less indebted economies. This issue of interest rates and their determinants is discussed further below and is also dealt with in Chapter 5 in the discussion of liberalisation of exchange controls.

(ii) Sustainability

As discussed above, the sustainability of the public finance position in the context of a high debt/GNP ratio hinges crucially around three variables: the growth rate of nominal GNP; the nominal interest rate on the debt; and the surplus on the non-interest EBR (i.e. primary balance). Table 4.2 shows clearly why the position was

3. For discussion of this issue see O'Leary (1987) and Dowling (1989).

4. While one can argue the merits of using GDP or GNP as the denominator in calculating the ratio, it does not make any appreciable difference to the conclusion.

dynamically unstable in 1986 when the Council was drawing up *Strategy for Development*. The interest rate on the outstanding debt was considerably in excess of the nominal GNP growth rate and the non-interest EBR was in deficit to the extent of 2 per cent of GNP.

Table 4.1
International Comparison
Per Cent of GNP/GDP(1)

Total Debt	General government		External debt (1987)	Net government external debt	Net investment income paid abroad
	Deficit	Debt			
1988					
Ireland	3.8	132.8*	Ireland*	54.4*	11.4*
Ireland	3.8	123.3			
Belgium	7.0	126.0	Greece	23.0	3.0
Italy	10.2	95.0	Denmark	18.4	4.1
Netherlands	5.2	80.0	Portugal	16.5	2.6
Greece	13.9	71.5	Sweden	14.2	1.6
Canada	3.1	69.3	Finland	8.1	1.9
Japan	-1.3	68.3*	New Zealand	6.9	5.7(1986)
Portugal	7.0	63.1	Australia	5.0	3.3
Sweden	-4.9	59.0	Norway	3.4	1.4
Austria	2.7	58.6	Spain	1.4	1.0
Denmark	-0.6	55.6			
United States	2.0	51.5*			
Spain	3.3	48.4			
Norway	-3.1	46.7			
United Kingdom	-0.5	45.3			
Germany	2.0	44.6*			
France	1.6	44.1			
Iceland	-0.9	20.3			
Australia	-1.0	18.6			
Switzerland	-5.6	17.5			

1. OECD estimates

* Indicates ratio of debt to GNP. Others show ratios of debt to GDP.

Source: This table is reproduced from the 1988/89 OECD survey of Ireland. The Irish figure for 1989 corresponding to 132.8 is 120.

The prospective position in 1990 is quite different, with the nominal interest rate set to exceed the nominal GNP growth rate by less than one percentage point and the primary balance likely to be in surplus to the extent of 7.4% of GNP. The

constellation of variables determining the evolution of the debt/GNP ratio, if maintained at prevailing levels, are now such as to impel the Debt/GNP ratio on a downward trajectory.⁵ This finding is consistent with the conclusion from the medium-term outlook which showed the debt/GNP ratio declining to 102% by end-1993 and 98% by end-1994 on the basis of unchanged policies. The conditions for technical sustainability are thus now firmly in place. Sustainability, of course, is dependent on the variables maintaining those relationships as specified for 1990.

Table 4.2
Factors Governing Sustainability of Public Finances

	Nominal GNP Growth %	Nominal Interest Rate %	Non-Interest EBR % of GNP
1981	20.0	11.1	8.5
1982	14.2	10.5	6.4
1983	9.1	10.2	3.1
1984	8.8	10.0	1.8
1985	6.1	10.3	1.2
1986	6.5	9.1	2.0
1987	7.8	8.5	-0.8
1988	4.2	8.1	-7.2
1989	9.3	7.9	-7.2
1990(e)	7.6	8.3	-7.4

(iii) Flexibility

The second main factor influencing the recommendation that the debt/GNP ratio should be stabilised as quickly as possible and thereafter reduced, was the impact on budgetary flexibility, as interest payments pre-empted an ever increasing proportion of exchequer resources. Such interest payments severely limit the ability to control the growth of public expenditure, to adjust the overall composition of expenditure and to use fiscal policy for demand management purposes. The impact of the pre-emption can be clearly seen in Table 4.3. Even though the current budget was in deficit all through the eighties, the non-interest balance on current account moved into surplus in the early eighties and increased steadily to reach almost ten per cent in the late eighties.

The inflexibility generated can perhaps be more clearly seen in the proportion of current Government expenditure accounted for by debt service. In the early 1980s,

⁵ Stabilising the debt/GNP ratio at its end-1989 level of 1.23, assuming the 1990 relationship between nominal GNP growth and nominal interest rates, could be achieved with a non-interest EBR surplus of one per cent.

it accounted for somewhat under 20% and rose continuously through the eighties and stood at 28% in 1989. The increase in the late-1980s partially reflects the significant retrenchment in current expenditure other than debt-service. This, of course, is the very nature of pre-emption – debt service squeezing out government spending on essential public services and social expenditure programmes. The figures in Table 4.3 are testimony to the continued budgetary inflexibility occasioned by debt service even in the face of the considerable reduction in borrowing over the last three years. It serves to highlight the different implications of the borrowing rates and the debt levels.

Table 4.3
Cost of Servicing National Debt 1980-89

	Total Debt Service				
	£m	% of GNP	% of Gov Current Expenditure	Current Budget Deficit % GNP	Non-Debt Service Current Balance % GNP
1980	661	7.3	17.8	6.1	-1.2
1981	885	8.1	18.5	7.4	-0.7
1982	1249	10.0	21.2	7.9	-2.1
1983	1456	10.7	21.8	7.1	-3.6
1983 (adjusted)(1)	1456	10.7	21.8	8.0	-2.7
1984	1706	11.5	24.4	7.0	-4.5
1985	1967	12.5	25.8	8.2	-4.3
1986	1989	12.0	24.5	8.3	-3.7
1987	2118	11.7	25.4	6.5	-4.2
1988 (inclusive)(2)	2141	11.4	26.7	1.7	-9.7
1988 (exclusive)(3)	2141	11.4	26.7	4.4	-7.0
1989	2141	10.4	28.0	1.3	-9.2

1. There is a discontinuity in the series because of the impact on the budgetary aggregates of the transfer of responsibilities to An Post and Bord Telecom. The first line for 1983 gives the outturn on the old basis and the second line gives the data on the new basis.
2. Inclusive of once-off receipts under the Tax Incentive Scheme (Amnesty).
3. Exclusive of once-off receipts under the Tax Incentive Scheme (Amnesty).

Source: Finance Accounts.

Associated with the budgetary inflexibility is the vulnerability of the Exchequer and the economy generally to interest rate and exchange rate changes. A number of factors combine to determine the vulnerability of the Exchequer to interest rate and exchange rate changes. The major factors are the level of debt, its duration and the level and direction of interest rates. A high level of public debt combined with a low duration means that small sustained movements in interest rates can have a

major impact on interest expenses. The Irish position can currently be characterised as high debt/short duration.⁶

(iv) Impact on Future Growth Potential

There has been a significant degree of research and discussion on the impact of government budget deficits and debt accumulation on interest rates and consequently on the real economy. Since the late 1970s there has been a *prima facie* association between Government debt accumulation and high real interest rates, although there has been some dispute about the direction of causality. Empirical evidence as to whether persistent high real bond yields partly reflect the 'crowding out' effects of government budget deficits is provided by estimates reported in the 1988 OECD Survey of Belgium. The budget deficit/savings ratio emerged as a significant explanatory variable with a 1 percentage point increase in the ratio raising the long-term interest rate by between 5 and 7 basis points.

However, the stock of debt may matter for interest rates as much as the deficit. Portfolio balance principles – the wish of financial investors to hold a balanced portfolio of bonds, equities, money etc. suggests that increases in debt/GNP ratios could affect interest rates.⁷ In the cross-section analysis alluded to above, the government debt emerges as a significant determinant of interest rates, although a public sector size variable works just as well. A presumption might be that the higher the public debt or public expenditure burden, the higher the inflation-risk premium demanded by savers before they will invest in bonds.

In a recent examination of Ireland's experience in the EMS, it is noteworthy that the evidence cited did not support this hypothesis. Dornbusch (1989) found that debt ratios *per se* do not appear as determinants of long-run interest rates. Indeed, he states that this is a striking finding because it runs so much counter to the belief that extremely high debt ratios should be predicting financial trouble. Instead, the evidence supports the view that current flow variables, such as the non-interest budget and current inflation, are better predictors of long-term interest rates.

(v) Future Targets

We have now examined some of the major considerations which are appropriate in determining whether the debt/GNP ratio is still an appropriate target of policy and whether the criteria against which recommendations for reductions in the ratio were made are still operative. The main conclusions reached are as follows.

- (1) The debt/GNP ratio is still an appropriate target of fiscal policy, since focussing on the borrowing flows (EBR, PSBR, current budget deficit) only, does not allow an appreciation of the conditions necessary for a sound fiscal strategy.

6. See Dowling (1989) for the calculation of the duration of Irish debt.

7. Another causal factor may be the fears of an inflationary debt liquidation, with a higher debt/GNP ratio implying a higher expected rate of inflation and hence a higher interest rate, see Dornbusch (1989).

- (2) With regard to sustainability, it has been shown that the nominal interest rate, the nominal GNP growth rate and the primary balance, the interaction of which determine sustainability, are now in a position to ensure a falling debt/GNP ratio over the medium-term. This, of course, is dependent on these variables not deviating significantly from their present position.
- (3) From a flexibility perspective, the servicing of the debt still places a very high burden on exchequer resources, pre-empting resources from the pursuit of other policy objectives. The proportion of expenditure devoted to debt service also leaves the exchequer very vulnerable to adverse external and internal developments.
- (4) In regard to the impact of the fiscal position on the future growth potential of the economy, it is *possible* that the stock of debt in the form of the debt/GNP ratio as well as the annual borrowing requirement exerts upward pressure on interest rates.
- (5) On an external comparison, Ireland is a clear outlier at the top of the debt/GNP league table.

Based on these considerations, the reduction in the debt/GNP ratio and the associated interest costs must be a central feature of medium-term fiscal policy. This is primarily driven by the need to enhance the flexibility of the budgetary system, reduce its vulnerability to external shocks and protect the medium-term growth potential of the economy. These considerations suggest that the target of a debt/GNP ratio of around 100% by 1993 is the minimum target consistent with achieving these objectives.

4. IMPLICATIONS FOR TAXATION AND EXPENDITURE

(i) Pressures in the Expenditure/Taxation System

This objective for the debt/GNP ratio implies certain targets for the exchequer borrowing requirement and the current budget deficit. These, in turn, imply the necessity for adjustments in the overall levels of expenditure and taxation. However, it is necessary to also include in the expenditure/taxation decision framework a number of factors not taken into account in the central projection for the economy in Chapter 3. The first set of factors are external in nature, arising from developments in the European Community. The second set concern desired objectives in respect of personal taxation. The third factor concerns the technical assumption used in the projection of indexing social welfare payments.

In order to complete the European internal market, the removal of physical, technical and fiscal barriers to trade has been set in train. In the 1990 Budget the Minister for Finance indicated that "we must also begin the process of adapting our tax system to the needs of the EC internal market". What are the consequences of these developments for the indirect tax system? There has been a clear shift in the

European Commission's proposals on indirect tax approximation towards a 'market forces' type approach. The abolition of restrictions on purchases by individuals, allowing market forces to operate fully, inevitably means that states will have to approximate their rates.⁸ What market forces would be likely to become operative in the Irish case following the removal of fiscal borders? The greatest pressure would be likely to arise in the case of the common land frontier with the UK. Given that the UK does not have an 'increased' VAT rate (it has only standard and zero rates) and that its current standard rate is 15 per cent, it is likely that the UK's standard rate will remain at this level. It is also likely that the UK will retain the zero rate on a number of items including food. Under a 'market forces' arrangement, the Irish standard rate could not remain appreciably above 15 per cent, and rates appreciably above zero on items zero rated in the UK would be unsustainable.

Assuming that the Irish top VAT rate has to come down to say 18 per cent, on the basis that a 3 per cent differential vis-a-vis the UK is sustainable, the revenue forgone would be considerable. It would involve a five percentage point drop in the VAT rate – giving rise to an exchequer loss of at least £300m.⁹ In addition, there would be a once-off net loss to the exchequer of £150m due to the abolition of VAT at the point of entry. Against that would have to be set the likely revenue gain arising from the imposition of say a 3 per cent VAT rate on currently zero rated items. It is estimated that this would yield of the order of £75m. However, against this has also to be set the revenue cost of redressing the adverse distributional consequences of the measure.

On the excise taxes front, while little detail is available on the revised Commission proposals, the Minister has begun a process of adjusting some of the less important excise duties to accord with the pattern of harmonisation likely to emerge from the EC. The Minister also refrained in the 1990 Budget from increasing the duties on the 'old reliables' in line with inflation. This latter policy again calls into question our technical assumption of indexation of excise duties in the medium-term projection which also has adverse implications for the public finances.

The formation of a unified financial market will also require major changes in tax systems in the financial area. At present, the treatment of interest and dividend income, securities transactions, capital gains and bank deposits varies greatly from country to country. A major factor facilitating the persistence of these differences in taxation is the existence of exchange controls. Consequently, the removal of exchange controls will generate considerable pressure for convergence since they are a crucial factor in the ability of the financial service businesses to compete internationally. It is possible that the Community will adopt a similar position for

8. For further discussion of this issue see Chapter 6.

9. The Minister estimated in the 1990 Budget speech that the two percentage point reduction in the top VAT rate (25 per cent to 23 per cent) would cost £125m in a full year. This estimate excludes any positive revenue implications from consumption effects.

the tax treatment of interest and dividend income as it did for VAT, i.e. set a minimum rate, with each member state being free to impose a higher rate. A possible minimum rate is 15 per cent, which represents an approximate average of the national rates. This development again would have negative revenue implications for the exchequer given that Ireland currently operates a withholding tax (DIRT) of 30 per cent on interest paid to residents and no withholding tax on non-residents.

European developments have implications for the personal income tax system also. As discussed in Chapter 2 dealing with strategic issues, many of the single European market initiatives will enhance labour mobility within the Community. This mobility will greatly increase the existing pressure for approximation of direct taxes within the Community if distortionary tax-induced migration of labour is to be avoided. In the case of Ireland, the increased pressure for approximation of direct taxes on labour amounts to pressure to reduce high average and marginal rates of tax on earned income. The tax system at present bears most heavily on the most mobile sectors of the labour force and also the most valuable in terms of human capital. In Chapter 6 the Council recommends that average and marginal rates of tax on earned income should be reduced.

The objectives for the personal income tax system in the Programme for Government were "to reduce the standard rate of income tax to 25% by 1993 and move towards a single higher rate of tax".¹⁰ This objective was further articulated in the 1990 Budget and the Minister for Finance subsequently indicated that "a single top rate of 48% can be achieved by 1993".¹¹ Following the 1990 Budget, the standard rate is 30%, the top rate is 53% and there is also a 48% rate. The taxation objectives of Government, therefore, require the reduction of the 30% rate to 25% and the 53% to 48% acknowledging that, even though the latter is not a formal objective, the Minister indicated that it can be achieved. It is estimated that each percentage point reduction in the standard rate would cost the exchequer of the order £60m, while each one per cent reduction in the top rate is estimated to cost the exchequer £11m.

Turning now to the expenditure side, it will be recalled from Chapter 3 that the technical assumption of indexation was found not to accord with previous experience in the social welfare area. A more appropriate assumption would probably have been to allow for some real increases in the rates of payment. Each 1% real increase would cost of the order of £25m.

The major implication of all these changes is that, if implemented without any offsetting changes in the form of expenditure reductions or tax increases, the budgetary situation would deteriorate significantly by reference to the position

indicated in the medium-term outlook. The question which faces the Council therefore, is: what adjustments are required to total expenditure and taxation, given the Council's objective for the debt/GNP ratio and given the other pressures on the taxation and expenditure levels outlined above?

(ii) Reconciling the Objectives

At this stage the Council must try to reach a recommended position having regard to: (i) the medium-term outlook for the economy and its implications for the budgetary position; and (ii) desirable changes in the taxation and expenditure areas derived from the strategic considerations in Chapter 2. Before setting out a recommended position we will consider some general considerations surrounding taxation and public expenditure levels.

Some General Considerations

On the decision regarding where the burden of adjusting the public finances should fall in *Strategy for Development 1986-1990*, it was argued that whether fiscal balance should be attained by means of tax increases or expenditure cuts depended on which of these strategies would be more likely to improve the prospects for economic growth in the medium-term. The conclusion was that the burden of fiscal adjustment should be borne by reductions in expenditure, to be effected primarily on the current account of the budget.

A similar set of questions must now be faced:

- (i) Are there benefits to be gained from reductions in public expenditure over and above those deriving from the indirect benefits arising through its impact on borrowing requirements and debt ratios?
- (ii) Should policy-makers strive to restrain public expenditure more than is warranted by the borrowing objective, in order to permit a reduction in taxation?
- (iii) Is the 'problem' with the taxation system one of its level or its structure?

The answers to these questions depend on the impact of taxation, public expenditure and deficit financing on the economy. A considerable amount of detailed research has been carried out internationally on these issues.¹² For Ireland there is a dearth of evidence on some of the issues.

Taxation and expenditure cannot be considered in isolation. Any assessment of the impact of taxation must begin with the recognition that the prime reason for taxation is to raise the revenue required by Governments to finance their expenditure programmes which are introduced to achieve various policy objectives. The benefits arising from the various public expenditure programmes must be set against any efficiency losses derived from raising the taxation needed to finance the expenditure.

12. For useful summaries of this research see OECD (1983), OECD (1987B) and OECD (1989B).

10. The Fianna Fail - Progressive Democrats Programme for Government 1989-1993. In the National Interest.

11. Address by Minister for Finance to Institute of Taxation, Friday 2nd March 1990.

The problem for Government, therefore, is twofold. The first problem is one of selecting Government expenditure programmes which generate sufficient benefits to cover not only the cash costs but also any efficiency losses resulting from the taxation needed.¹³ The first critical distinction which arises in this regard is that between current and capital expenditure. The strategic objective of promoting the long-run potential of the economy must inform this choice. Public capital expenditure, rigorously evaluated, enhances the potential of the economy through the provision of improved infrastructure and the enlargement of the productive base. Current expenditure with the exception of a number of sub-programmes such as education, in contrast, does not expand the productive base of the economy.

The *second* problem for Government becomes one of selecting a tax system which minimises undesired distortions while simultaneously seeking to achieve a balance between this and competing objectives of the tax system, viz., equity, simplicity, feasibility and flexibility. In this regard it is important to note that different tax structures have different economic efficiency implications. A bad tax structure may lead to welfare costs which can compound any efficiency loss which may arise from an increase in the overall tax burden. Internationally, the pursuit of more economically-neutral tax systems has been as important a budgetary influence as controlling the overall burden of taxation. This implies movement towards a system of revenue-raising which minimises the impact of taxation on economic behaviour. The type of tax system which this implies in practical terms is considered in Chapter 6.

The Council's Objectives

In regard to the major issues raised in the previous sections, the following are the Council's objectives:

- (i) a target debt/GNP ratio of around 100 per cent by 1993, which is the minimum level consistent with enhancing the flexibility of the budgetary system, reducing its vulnerability to external shocks and protecting the medium-term potential of the economy;
- (ii) in the personal income tax system the Council believes that it is desirable to reduce the high average and marginal rates of tax on earned income;
- (iii) in the case of indirect taxes, the Council is strongly of the opinion that the removal of frontiers must be part of the completion of the internal market. It therefore supports the changes in indirect taxation which are necessary to underpin this;
- (iv) the Council believes that it will be necessary to adjust DIRT tax rates to avoid capital movements based on tax differences and to ensure that indigenous financial institutions can compete in a unified financial market.

13. This efficiency loss is generally known as the deadweight loss – see Honohan and Irvine (1987) for a good discussion.

Given these objectives and the considerations outlined earlier, the Council believes that the task of bringing the debt/GNP ratio to around 100 per cent should be attained principally through restraint on current public expenditure. More specifically, the Council recommends that current public expenditure should not increase in real terms in the period up to 1993, effectively implying no real increase in overall public sector activity.¹⁴ Real increases in particular areas should be offset by real reductions in other areas. Capital spending projects which are rigorously evaluated and yield an appropriate rate of return should not be abandoned to achieve fiscal targets.

What does this really mean for public expenditure? Against the background of the real reductions in current public expenditure over the past number of years documented in Chapter 11, does it imply a much less demanding scenario? The answer to this question depends on a number of factors. *Firstly*, the recommendation of no real increase in current public expenditure is not equivalent to a recommendation of no-policy-change. In respect of the total level of public expenditure, policy adjustments are likely to be required to bring expenditure to a no real change position, i.e. policy adjustments will be required where expenditure, in the absence of policy changes, would rise in real terms. This is particularly the case in 1991 because of the carryovers from 1990.

A *second* factor influencing the overall adjustments necessary arises from the impact of underlying trends on demands for services. The decline in unemployment and increases in earnings, for example, will reduce demands on income maintenance services and also lift families and households above the eligibility criteria for services. Likewise, the falling child population affects expenditures on child benefit and family income support, primary education, housing and child health services. Some programmes may require real increases over the period. However, where these arise they should be balanced by real reductions in other areas, thus requiring a restructuring of expenditure across a range of programmes. Such restructuring should be informed, not only by underlying trends but also by specific policy criteria (see Chapter 11).

A *third* factor impinging on public expenditure choices depends on the scope within programmes to effect savings through efficiency initiatives and structural reform. That such savings are possible is exemplified in the analysis of the health and housing systems (Chapters 8 and 9).

All of these factors will impinge on the evolution of total public expenditure and on the evolution of its composition across programmes. We can conclude that a policy recommendation of no real increase in overall public sector activity with desired volume increases in particular areas being offset by real reductions in other areas is not a soft option and will give rise to difficult policy decisions.

14. If one were to be more specific still the recommendation would apply to non-capital supply services, thus excluding expenditure associated with servicing the national debt.

We know that significant improvements can be obtained from changes in the structure of taxation. Thus, in the Council's view, the medium-term growth potential of the economy can be enhanced through reductions in the debt/GNP ratio while simultaneously reaping efficiency gains through a thorough restructuring of the tax system. The scope for a significant fall in the overall tax burden is limited in the context of the overall objectives of the Council. This means that the changes considered desirable will have to be accommodated through a widening of the tax base. The precise nature of the restructuring of the tax system will be addressed in Chapter 6.

The Minister for Finance used the opportunity of the 1990 Budget to set new medium-term objectives for fiscal policy. The Minister announced that:

over the period up to and including 1993 the aim will now be to maintain a significant rate of progress in reducing the debt/GNP ratio towards 100 per cent and, as part of this, to achieve broad balance on the current budget for the first time in twenty one years. Borrowing for capital purposes, and the overall exchequer borrowing requirement, will need to be held to the minimum level consistent with this strategy and with the needs of balanced economic growth and stable monetary conditions.

When these medium-term objectives for fiscal policy are linked with the Government's objectives in relation to the personal income tax system and the desire to make progress on indirect tax approximation, it implies further real reductions in public expenditure unless the tax base is significantly broadened.

Three principles have characterised the approach to policy since 1987. They are: consistency (pursuit of consistent fiscal, monetary and exchange rate policies); continuity (steady adherence to a particular mix of policies); and credibility (the widespread recognition that Government is committed to its economic strategy). While acknowledging the need for flexibility in relation to future budgetary targets, the Council believes that continued adherence to the above principles requires the articulation of more specific targets in regard to the medium-term evolution of the public finance aggregates.

An issue which arises for any set of medium-term recommendations designed to make progress towards particular targets concerns the pace and timing of adjustment. The Council has recommended above that, *on average, over the period 1991-1993* current public expenditure should remain constant in real terms and that there is limited scope for a reduction in the overall tax burden. We have already indicated that this will involve restructuring within both total expenditure and taxation. An issue arises as to whether the recommendation should be taken to mean no real change in each year or whether real reductions in one year can be compensated for by real increases in other years. In terms of the current budget deficit (CBD) and the EBR the issue is analogous: should one have the EBR and

the CBD falling in three even stages to achieve the desired position or could no change in one year be compensated for by two steps in the following year? The reason the issue is raised is that such a problem arises in respect of the 1991 Budget.

In Chapter 3 the main features of the public finance projection were a move from a current budget deficit of 1¼ per cent in 1990 to a deficit of ¾ per cent in 1993 and the EBR to be still in deficit to the extent of 2 per cent of GNP in 1993. However, on a no-policy-change basis (which is the technical basis on which the projections are based), the EBR would be expected to show a deterioration in 1991 and 1992 before falling back to 2 per cent in 1993. This is due to the carryover effects of 1990 decisions into the 1991 budgetary arithmetic, which would imply significant real changes in expenditure and taxation. Thus, following the medium-term objective of holding public expenditure constant in real terms will necessitate a tough budget in 1991 with the prospect of somewhat easier conditions in the 1992 and 1993 budgets. If, on the other hand, public expenditure is not held constant in real terms in 1991, and if the EBR is not reduced by as much as it would otherwise be, the budgetary requirements will be that much more onerous in 1992 and 1993. The Council, while not wishing to make specific recommendations about individual budgets, is of the view that within its overall medium-term recommendations on taxation and expenditure, the current budget deficit and EBR should be maintained on a sustained downward path each year.

Another factor which needs to be considered in the context of future fiscal policy is the treatment of budgetary receipts from the sale of state assets. There is a danger (see the UK for example) that such receipts could be used to finance budgetary deficits, thus ensuring a looser budgetary strategy than would otherwise prevail. The Council wishes to emphasise that receipts from state assets do not alter the fundamental budgetary position. Consequently, it recommends that such receipts should not form part of the budgetary arithmetic, i.e. they should be kept off-budget.

5. CONCLUSIONS

In Chapter 2 it was argued that the central objective of fiscal policy should be the protection of the long-term potential of the Irish economy with a view to generating sustainable economic and employment growth. The analysis undertaken in this chapter indicates that one of the main ways to achieve this is through continued reductions in the debt/GNP ratio and the associated interest costs. In addition to enhancing the growth potential of the economy, such a policy would increase the flexibility of the budgetary system and reduce its vulnerability to external shocks. In the Council's view, a target debt/GNP ratio of 100% is the minimum consistent with achieving these objectives.

The Council also has a number of specific objectives in regard to the indirect and direct tax systems, notably, the reduction of average and marginal tax rates on

MACROECONOMIC POLICY WITHOUT EXCHANGE CONTROLS

1. INTRODUCTION

As part of the completion of the European internal market, legal restrictions on the movement of money into and out of Irish pounds are being removed on a phased basis. The first phase occurred in January 1988. In October 1988 further relaxation of controls on investment flows was announced. The third stage came into operation on 1 April 1990 and the government is committed to completing the liberalisation of all capital movements by the end of 1992.

In setting the agenda for a new strategy for development one of the issues which arises is whether the abolition of exchange controls requires any changes in the conduct of macroeconomic policy. This chapter addresses this issue.

When the issue is considered it quickly becomes apparent that the broad principles which should govern the conduct of macroeconomic policy are not changed by the abolition of exchange controls. To emphasise this point this chapter opens with a brief restatement of those principles (Section 2). It follows from this that, at most, those principles need to be extended somewhat. Alternatively, it may be that the principles governing policy are adequate but that the conduct of policy under those principles needs to be clarified or refined, or the decision making process for the conduct of monetary policy at Community or national level may need to be reviewed. The day to day conduct of monetary policy is a technical matter and the Council, being concerned with the principles which guide policy, does not in general offer advice on the detailed conduct of policy. However, the decision making structures which will underly the conduct of monetary policy in the Community, and in Ireland, are matters which undoubtedly fall within the principles of economic and social policy. These are discussed in Section 6.

In Section 3 we survey different views about exchange controls and their abolition. Some of these views about the likely effects of capital liberalisation are accompanied by recommendations for the conduct of policy. In Section 4 we outline how the validity of these different arguments might be assessed, both theoretically and empirically. There is, as yet, very limited evidence available on how financial markets will work without exchange controls. In Section 5 we review Ireland's recent balance of payments experience. Some issues which arise from this experience are discussed in Section 6. Finally, in Section 7 we draw

earned income and the implementation of changes consistent with European tax approximation. The Council also believes that pressures for reduction of DIRT may be impossible to withstand, while historical experience in regard to social welfare transfer payments indicates that they increase in real terms. These objectives, together with the debt-reduction target, leads the Council to the recommendation that there should be no real increase in overall public sector activity in the period to 1993, while the scope for a reduction in the *overall* tax burden is extremely circumscribed. The public expenditure recommendation does not imply that all public expenditure areas should remain constant in real terms; where real increases are considered desirable in particular areas – social welfare, for example – they should be compensated for by real reductions in other areas. Capital spending which is rigorously evaluated and yields an appropriate rate of return should not be used to achieve fiscal targets. In the context of limited scope for a reduction in the overall tax burden, tax base broadening is vital to the achievement of the Council's objectives.

While the pursuit of this objective does not appear onerous in the context of the real reductions achieved over the past number of years, it will nevertheless require policy adjustments where on a no-policy-change basis, expenditure is set to increase in real terms. In regard to the precise implementation of the Council's recommendations, the Council acknowledges that the circumstances prevailing in individual years may place constraints on following the Council's recommendations on a year-by-year basis. This arises particularly in regard to 1991 when the carryover costs of the 1990 Budget will fall to be absorbed. However, the Council argues that, notwithstanding those constraints, the current budget deficit and the EBR should be maintained on a sustained downward path each year. The Council also recommends that receipts from the sale of state assets should not form part of the budgetary arithmetic.

The major avenue through which the overall efficiency of the economy can be increased, thus providing growth and dynamism, is through structural change. This applies particularly in the public expenditure and taxation areas. Nearly all OECD economies have now adopted the position that tax reform is vital to improving the overall functioning of their economies. The issues facing all the economies are broadly similar, primarily due to the fact that the tax systems had previously evolved in a similar manner. The main constraint which emerges from a fiscal policy perspective is that such objectives will have to be achieved in the context of limited scope for change in the *overall* tax burden. A tax reform strategy is recommended in Chapter 6.

some tentative conclusions concerning economic policy without exchange controls.

2. THE MAIN TENETS OF EXCHANGE RATE POLICY

(i) The Principles of Policy

In *Strategy for Development* the Council adopted a position on the role of exchange rate policy. It was argued that exchange rate devaluation could not and, consequently, should not be used to achieve or restore competitiveness and that an explicit non-accommodating exchange rate policy creates expectations of a stable currency and would thereby allow Irish interest rates to converge to international levels (NESC, 1986B, pp. 173-80). In its report *Ireland in the European Community* the Council endorsed the policy of maintaining the nominal value of the punt within the EMS (NESC, 1989 B). As discussed in Chapter 1, commitment to the EMS since 1987 has secured our impressive inflation and interest rate performance.

Pursuit of this policy requires that the authorities take whatever actions are necessary to maintain the exchange rate peg in the EMS. Indeed, membership of the ERM *obliges* the authorities, between realignments, to intervene to prevent the punt diverging more than 2.25 per cent above or below its 'central rates'. In addition, the principle stated above implies that, if at all possible, the authorities should not use realignments to alter the punt's positions relative to other EMS currencies – especially the DM.

The need to do 'whatever is necessary' to maintain the value of the currency is, of course, a very indefinite requirement. The reason is that what is necessary depends on the sentiment of those involved in the foreign exchange markets. Furthermore, what is necessary is neither known with certainty nor is it constant. Indeed, an important argument for eschewing realignments is that this will build long-run credibility in the exchange rate and, consequently, reduce the interest rate differential with Germany and the amount of intervention needed to maintain any given exchange rate.

(ii) Day-to-Day Execution of Policy

Subject to these basic elements of policy – which derive from general principles – the Central Bank has identified its day to day role as reducing the short-run volatility of interest rates. It does this by management of liquidity:

Liquidity management by the Central Bank is for the most part, devoted to smoothing out short-period imbalances in the interbank market. In the absence of Central Bank intervention, demand and supply of liquidity on the interbank market would determine interbank interest rates and these, in turn, would determine retail bank lending and deposit rates. Without Central Bank liquidity management, however, interbank interest rates could be extremely

volatile, responding to sharp day-to-day movements in demand and supply arising from, say, the lumpiness of tax payments, variations in the pace of Government expenditure or foreign-exchange flows. The Bank's role is to iron out these fluctuations; in other words, to provide liquidity or absorb liquidity (Doyle, 1990).

A corollary to this policy of smoothing out interest rates by preventing short-term fluctuations is that the Central Bank does *not* resist more fundamental increases or decreases in rates:

In the Central Bank's management of market liquidity, difficulties arise when market imbalances persist in the same direction, particularly if they increase in size over time, since this would indicate that interest rates were being prevented from performing their basic market-clearing function by Central Bank action – or inaction... At some point, the Bank must make an assessment of whether this artificial restraint of the interest rate – for that is what it is – is warranted on the basis of the underlying causes of the imbalance. For example, seasonal and other short-term increases in liquidity demand are normally facilitated, since these will clearly be reversed after a short period. Liquidity shortages arising from persistent financial outflows, however, are a very different matter. In the face of such outflows, holding down interest rates through the provision of ever-increasing levels of support may be the exact opposite of the policy response required. Instead of curbing the outflows, such action merely finances them, which in turn can only mean that they will persist and will, very likely, increase (Doyle, 1990).

So, in the execution of this policy the *distinction* between short-run, fitful, and ultimately random capital flows and interest rate changes, on the one hand, and long-run, fundamental and persistent changes, on the other, is crucial. Sometimes the determinants of a capital flow or a change in foreign interest rates will be sufficiently obvious to allow an easy diagnosis of whether the event is merely volatility or is a change in underlying conditions. However, the expectations and sentiment of market participants can influence both the volatility of financial variables and the level around which they fluctuate. In addition, such expectations and sentiments are not observable. As a result it can frequently be very difficult to identify which kind of change is underway. It follows that it can be difficult to decide whether to ignore and/or resist certain developments, on the grounds that they are temporary, or whether to react to them, on the grounds that they signal a change in underlying conditions which cannot be resisted for long.

Attitude to the Risks in Liquidity Management

Given this element of uncertainty, there exists a risk of misreading events and making an error. For example, if the authorities read a capital outflow, and consequent loss of liquidity, as purely temporary, when in fact it was more permanent, the exchange rate could come under pressure. By contrast, if the authorities responded to a loss of liquidity and reserves by raising interest rates,

when in fact the outflow was temporary, or was destined to undo itself soon, then interest rates could be higher than was really necessary and the level of investment and consumption could be dampened. The final element of the overall policy position is the *attitude to each of these risks*. It seems accurate to say that in 1989 and 1990 the Central Bank has had a definite preference between these two risks. That is, it has been anxious to ensure, at all costs, that the punt can maintain its position in the narrow band of the EMS. In other words, the Central Bank would prefer to err on the side of higher interest rates than on the side of downward pressure on the exchange rate.

(iii) A Complicating Factor

The Position of Sterling

It is widely agreed that the exclusion of sterling from the ERM greatly complicated the execution of Ireland's exchange rate policy (Breen, 1981). It did this in two ways which should be distinguished.

First, at a number of points in the 1980s the weakness of sterling against the ERM currencies brought to light an ambiguity within Ireland's overall exchange rate policy. Membership of the ERM implied, by definition, a *nominal* exchange rate target. Given the belief that domestic prices and inflation would adjust to foreign levels, this also implied a *real* exchange rate target. But Ireland's implicit real exchange rate target was concerned, to a considerable extent, with maintenance of competitiveness *with the UK*. While sterling was strong, this real exchange rate target was compatible with the EMS nominal exchange rate target. However, when sterling weakened sharply in 1983 and 1986 these targets became incompatible. Forced to choose between them, Ireland chose to devalue the punt within the EMS. This almost certainly made subsequent pursuit of the nominal exchange rate target more difficult, by introducing an element of uncertainty about Ireland's commitment to the EMS central rates. The policy position outlined above differs from that pursued in 1983 and 1986 in that it proposes that the nominal exchange rate target within the ERM be given priority. In addition, the circumstances since 1987 are quite different from those prevailing in the 1983-86 period.

Second, even when the ambiguity within Irish policy had been ironed out (in favour of EMS), the exclusion of sterling continued to complicate the day-to-day execution of Irish policy. The entry of sterling to the ERM is thus very welcome, even though the adoption of the wider band still allows considerable scope for fluctuation.

This section has set out the main tenets of the exchange rate policy currently pursued by the authorities and supported by the NESC. There are a number of elements to the overall policy position: the principle of adherence to the EMS narrow band, the day-to-day management of liquidity including an attitude towards the different risks which inevitably arise from uncertainty and, thirdly, recognition of the fact that the use of the wider band by sterling still allows a significant margin for fluctuation.

3. ABOLITION OF EXCHANGE CONTROLS: POSSIBLE EFFECTS

This section surveys a number of different views about exchange controls and the likely effects of their abolition. As a preliminary to this discussion we briefly consider the nature of capital flows.

(i) Four Types of Capital Flow

It is important to distinguish between the four major categories of capital flows: direct investment, portfolio investment, trade finance, and foreign exchange. The extent of capital controls and the effects of their abolition on each of these types of capital flow differs.

Direct Investment

Direct investment involves the acquisition or construction of physical assets abroad. Although the Central Bank supervised such investment it is not clear to what extent outward direct investment was actually restricted by capital controls. For many years there was a net inflow of direct investment to Ireland. It is clear that exchange controls were not a major determinant of the size or direction of direct investment.¹

Portfolio Investment

Portfolio investment is the purchase of interest-earning assets such as shares or bonds. Investment in foreign securities was highly restricted under Ireland's capital controls. Consequently, there can be little doubt that the removal of controls would have a significant effect in this area. One important aspect of portfolio investment which should be considered when thinking about the removal of exchange controls is the market for government securities.

Trade Finance

The third form of capital flow is trade finance – loans to finance the purchase of imports and exports. These flows were not restricted by exchange controls; Irish residents could borrow foreign currency and Irish banks could issue punt loans to foreigners, in order to finance trade. Alterations of the timing of these loans allowed agents hold assets in the currency of their preference for some time. When we note the size of trade flows as a proportion of Irish income then it is clear that, even before the relaxation of Irish exchange controls, there was considerable scope for unregulated capital flows.

1. It is sometimes said that direct investment abroad *causes* a reduction of investment in the Irish economy. To do this it would have to reduce the supply of funds available to finance investment and, furthermore, it must have been the case that these funds, had they been available, would have been used by domestic industry. Neither of these propositions seems likely. There is little evidence of a *general* shortage of finance for investment in Ireland – although the form in which finance is available is not always ideal (NESC, 1984).

Foreign Exchange

The final category of capital flows is foreign exchange – changes in Irish residents holding of foreign money (currency and bank deposits) and changes in foreigners' holdings of punts. Ireland's exchange controls limited Irish residents holdings of foreign currency to what was necessary for trade and travel. Restrictions still apply in this area.

In the remaining parts of this section we identify some alternative views of the effects of the removal of Ireland's exchange controls in a situation which still precedes the establishment of economic and monetary union.

(ii) Abolition and Compensating Inflows and Outflows

When we consider portfolio investment, there can be little doubt that the removal of controls would initiate a certain outflow as Irish investors adjust their portfolios to attain their desired proportion of foreign equities and other assets. However, there are a number of reasons why this outflow should be matched by a certain inflow of funds into Irish securities. First, when the controls were imposed, they permitted existing holdings of foreign securities to be retained or to be switched to other foreign securities. Some proportion of funds "held" in these foreign securities may be moved into Irish securities on the removal of exchange controls. There is evidence to suggest that this has already happened in response to the capital liberalisation measures of 1989. Second, as Irish investors diversify by purchasing foreign equities this would have a tendency to reduce the prices of Irish assets and attract foreign investors to purchase them. A very simple model would predict that these compensating inflows would exactly match the increased financial investment in foreign assets by Irish residents (Hemmings, 1981). While that seems somewhat unrealistic, some effect of this sort is possible.

An important corollary of this analysis is that "when the prices of securities themselves can change there is no need for the price of the currency in which they are denominated to change in a third market, that for foreign exchange, as well" (Hemmings, 1981). Thus, on certain assumptions, abolition of controls on portfolio investment should not put pressure on the exchange rate. However, when we extend the same type of analysis to foreign exchange itself, and to the eventual abolition of controls on such flows, a different picture emerges. Under the exchange controls, Irish investors are prevented from holding cash balances in anything but punts. In the absence of exchange controls, many would wish to hold money balances in a combination of currencies – given that exchange rates are liable to fluctuate. Irish residents will wish to hold more foreign currency in their money balances. To persuade foreigners to hold more punts to compensate for this, a somewhat higher interest rate differential may be necessary.

(iii) Capital Controls as an Unnecessary Distortion

It has been argued that the exchange controls introduced by Ireland in 1979 were of little or no benefit and imposed considerable costs (Kelleher and McCarthy,

1980). Consequently, their abolition should pose no additional problems for macroeconomic management and should remove a harmful distortion from the Irish economy.

Exchange Controls and Macroeconomic Management

The argument that exchange controls do not enhance the authorities policy' power runs as follows. Even assuming that exchange controls are effective in limiting capital outflows, the money stock (in a small open economy with a fixed exchange rate) is beyond the control of the monetary authorities. This is so because an important element of the money stock is determined by the autonomous international current and capital transactions of private agents. What the authorities can influence is not the money stock but the balance of payments deficit or surplus or, put another way, the level of foreign exchange reserves. Indeed, the central argument against exchange controls is that any target level of reserves can be attained by an appropriate policy on domestic credit expansion (Kelleher and McCarthy, 1980).²

Exchange Controls and Speculative Capital Flows

It would be possible to accept much of this analysis and still argue that exchange controls are, nevertheless, helpful in resisting short-term speculative capital flows which could drain the reserves or force fluctuations in domestic interest rates.

This line of argument was anticipated by those who rejected the necessity of exchange controls. They argued that the riskiness of foreign exchange markets is such that operators tend to avoid substantial exposure to currencies unless they perceive basic inconsistencies between a country's macroeconomic policies and its exchange rate position. Consequently, they argue that speculative flows reinforce 'genuine' flows and are not an independent source of arbitrary fluctuations in foreign exchange reserves. Of course, others would describe the same thing in a different way – saying that foreign exchange speculation can be in the nature of a self-fulfilling prophesy (Bean, Malinvaud, Bernholz, Giavazzi and Wyplosz, 1990).

Exchange Controls and the Costs of Distortion

This negative view of the *macroeconomic* benefits of exchange controls is frequently allied to a negative estimate of their *microeconomic* costs. In the view of some, the effect of exchange controls in lowering domestic interest rates is a 'distortion' of the competitive market which has harmful effects. In particular, it increases domestic investment and thus creates a capital stock that exceeds what is socially optimal (Kelleher and McCarthy, 1980). Abolition of the controls would confer welfare gains by allowing a more efficient allocation of resources.

2. Furthermore, the monetary approach to the balance of payments, which underlies this analysis, says that any desired level of reserves can be achieved and will be consistent with full employment.

(iv) Balance of Payments and Public Finance Deficits

The Significance of Public Deficits

Another view of Ireland's exchange controls, which received official sanction, sees them as related to the task of launching a new currency in the context of large deficits in the balance of payments and the public finances. Thus, Breen, of the Central Bank, expressed the hope that the exchange controls would be 'temporary in nature' (Breen, 1981). On this view, the existence of exchange controls is directly related to the fact that:

having regard to the existing development needs of the economy, national savings are not sufficient to meet our investment requirements. This is expressed in our balance of payments deficit... The deficit is, in the main, being financed by official, foreign borrowing. Private sector outward portfolio investment, if permitted, might well have to be compensated for by further external borrowing, most probably by the Government, (Breen, 1981).

This provides a clear reason for exchange controls and some criteria to judge when they could be safely abolished. Indeed, Breen said explicitly that:

we all look forward to the day when the balance of payments and public finances no longer present such serious problems and the more restrictive elements in our exchange-control system can be removed.

We will see, in Section 4, to what extent these conditions have been met in recent years.

Exchange Control Abolition and Public Debt Management

It has recently been argued that abolition of exchange controls may place considerable strain on some currencies within the EMS. Specifically, it has been suggested that countries with high public debt may face unsustainable speculative attacks on their currencies if they attempt to liberalise capital movements while maintaining fixed or quasi-fixed exchange rates. While the general issue of the sustainability of the EMS after the abolition of capital controls will be discussed below one specific aspect of the issue should be considered here since it relates to public finance and debt management.

Giavazzi and Pagano argued that when considering the possibility of unsustainable speculative attacks "it is not only the level of public debt that matters for the viability of fixed rates, but also the way one manages the debt". Their analysis suggests that the probability of the authorities withstanding a confidence crisis is critically affected by the way in which the debt is managed. They identify four debt management rules:

- (i) lengthen the average maturity, so as to reduce the average amount of debt maturing at each date;
- (ii) smooth the time pattern of maturing debt, so as to reduce the variance of maturing issues;

- (iii) minimise reliance on Central Bank loans, in order to persuade the public that the Treasury will not turn to extensive monetisation in the event of a crisis;
- (iv) develop a well-functioning market for foreign-currency debt, where the Treasury can finance its deficit if a confidence crisis leads to a jump in domestic interest rates (this could also be achieved by ensuring that foreign Central Banks will co-operate by lending foreign exchange in the event of a crisis).

Their study of the structure of the debt in the highly indebted Community countries suggested that, in contrast to Italy, Greece and Portugal, Ireland's debt management is already largely in line with the policy prescriptions mentioned above. This is because Ireland's debt has a relatively long average maturity, with no reliance on Central Bank loans and substantial recourse to foreign markets (Giavazzi and Pagano, 1989).

If this analysis has validity then it is clear that abolition of exchange controls has important implications for at least some department of domestic macroeconomic policy – debt management. However, it is possible that abolition could require new approaches in other areas of domestic policy and new developments at Community level.

(v) Capital Liberalisation – the Central Bank's View

The Central Bank has identified the benefits of capital liberalisation – the greatest of which is that it is part of the completion of the internal market and the general process of European integration. Indeed, the Bank has argued emphatically that capital liberalisation, like other forms of liberalisation, must be accompanied by enhanced Community measures to ensure that the benefits are distributed evenly. In this the Bank has declared itself in agreement with Herr Pohl when he says:

in a monetary union with irreversibly fixed exchange rates the weak would become ever weaker and the strong ever stronger. We would thus experience greater tensions in the real economy in Europe. For this reason alone, monetary union without simultaneous integration in fields like fiscal policy as well as regional and social policy is completely inconceivable. In this context it is certainly valid to speak of asymmetry in Europe.

The Central Bank considered that "there is a danger of large and continuing shifts of funds from the countries which have newly liberalised" their exchange control regimes (Reynolds, 1988). These capital flows could be of two types: portfolio investments and speculative flows. First, it was argued that "portfolio shifts could be of major proportions and that flows could be of a continuing nature". This view was explicitly contrasted to the textbook view that capital will automatically flow from richer to less prosperous regions and thereby tend to equalise the productivity of different regions and countries.

Second, greater speculative capital flows will be facilitated by the relaxation of exchange controls and the globalisation of financial markets. It was recognised that freedom of capital movements will exert discipline on monetary and other policies – thus tending to reduce the incentive for currency speculation – but noted that attainment of the degree of policy convergence sufficient to *remove* that incentive “will be a demanding task” (Reynolds, 1988).

Given its perception of these dangers which would accompany the relaxation of exchange controls it is not surprising that a number of policy measures were advocated by the Central Bank. These included both changes in the technical arrangements of the EMS and parallel developments in Community economic policy.³ In particular, it was argued strongly that there “will be a need for much greater co-ordination of monetary policies, if the disruptive effects of volatile capital flows on the EMS are to be minimised” (Reynolds, 1988). In addition, three other policy developments were identified. First, the Bank was emphatic that full participation in the exchange-rate mechanism on equal terms for all Community countries is crucially important for the further development of the EMS. “Were sterling to remain outside the ERM when capital movements are fully liberalised, the degree of pressure on the Irish pound at times of strain could be much greater still, with adverse implications for interest rates, investment and employment” (Reynolds, 1988). Second, the orientation of Community policies should pay more attention to the achievement of growth, full employment and the reduction of regional disparities because, in contrast to the inflation objective, “the record in achieving these broader objectives has not been impressive”. Third, the Community must correct the tendency to develop monetary arrangements more quickly than its fiscal, regional and other policies. This imbalance reflects “a tendency to seek monetary solutions to problems that are not monetary in nature”. What is required, in the context of capital liberalisation, is greater “agreement at Community level on the co-ordination of appropriate fiscal, regional and other policies” (Reynolds, 1988).

Here, therefore, are further policy changes which were considered necessary if relaxation of exchange controls was not to have potentially damaging consequences.

(vi) Capital Mobility and the Future of EMS

The Role of Exchange Controls in the EMS

An important school of thought has developed according to which the retention of exchange controls by weaker currency countries has been one of the main reasons for the success of the EMS. On this view the existence of capital controls has

3. The technical developments which “would alleviate the difficulties created by capital liberalisation for a country like Ireland should include an adequate transition period for the implementation of the new Directive, the availability of a safeguard clause and adequate back-up facilities in the form of medium-term financial support assistance” (Reynolds, 1988).

discouraged active trading in certain currencies and thus allowed these countries to avoid excessive fluctuations in domestic interest rates (Giavazzi and Giovannini, 1986; De Grauwe, 1990). In addition, the use of exchange controls has “made possible periodic realignments, thus allowing some countries to maintain substantially different rates of inflation over the medium-term, without experiencing a chronic loss of competitiveness” (Bean, Malinaud, Bernholz, Giavazzi and Wyplosz, 1990).

Although this interpretation of the role of exchange controls in the EMS accords well with the evidence, and has become fairly widely accepted (De Grauwe, 1990), it by no means commands universal support (Gros and Thygesen, 1988). One of the possible effects of exchange controls is to separate the domestic and offshore markets for a currency thus allowing different interest rates to prevail in each. The evidence confirms that the EMS created a wedge between domestic and offshore interest rates for the French franc and the Italian lira, but not for the Irish punt (Artis and Taylor, 1989).

Abolition of Exchange Controls – A Threat to the EMS

It is not surprising that this view that exchange controls were central to the success of the EMS made its adherents anxious about the effects of the abolition of exchange controls. Padoa-Schioppa, for example, argued that simply removing exchange controls would seriously disrupt, and possibly destroy, the EMS. This is because capital controls have reduced the amount of exchange market intervention and of ‘defensive’ interest rate changes needed to cope with expectations of a realignment.⁴ He predicted that, in the absence of controls, the amount of intervention needed would be greater, while the effectiveness of intervention would be less. As a result substantial interest rate adjustments would be necessary to stem capital flows. In these circumstances countries may prefer to abandon the defence of the exchange rate and he predicted that the frequency of realignments would increase (Padoa-Schioppa, 1987).

Capital Mobility, Monetary Independence and Fixed Exchange Rates

Much of the exchange controls that mattered most for France and Italy were abolished by 1988. By and large the predictions outlined above have been confounded rather than confirmed. The EMS has not come under greater strain, pressure for realignments is less than before and interest differentials between other EMS countries and Germany have continued to narrow.

The explanation seems to be that the abolition of exchange controls has made policy-makers decide that realignments are virtually impossible (Giavazzi and Spaventa, 1990). This is because EMS realignments involved discrete changes in exchange rates. At the moment of a realignment those holding assets denominated in the devaluing currency face large capital losses. “Consequently, rational

4. He noted, however, that such leeway was limited for small countries such as Belgium and Denmark. Presumably this applies to Ireland also.

behaviour by participants in the foreign exchange requires switching out of these assets *completely* in the face of an anticipated change in parities" (Bean, Malinvaud, Bernholz, Giavazzi and Wyplosz, 1990, emphasis added). The argument is that, since the abolition of exchange controls, governments have been more committed to the existing EMS parities than they were before. De Grauwe argues that "freedom of capital movements will enforce a significantly higher degree of convergence of monetary policies between the major EMS partners than has been the case up to now. The Dutch-German regime stands as a model of the kind of convergence that must occur" (De Grauwe, 1990).

Interest Rate Differentials

It should not be inferred that the EMS has completely adjusted to the abolition of exchange controls and that those who warned about possible destabilisation have been proven completely wrong. The idea that governments now consider realignments to be virtually impossible is not an adequate explanation of *all* recent developments. In particular, if capital is mobile, and if markets believe that exchange rates are more or less fixed, then interest rates should be equal, or very nearly equal, in all EMS countries. But we know that large interest differentials continue to exist. This requires explanation; and it is important to know whether the abolition of exchange controls plays any role in the explanation.

Furthermore, although governments may be more committed to their EMS parities, the underlying forces are not necessarily consistent with those parities. Inflation rates still differ between major EMS countries and current account imbalances are significant. In addition, the relaxation of capital controls has coincided with large capital flows *into* Italy and Spain (so threatening monetary targets and the disinflation effort) and *out* of Ireland (which have on occasion depleted the reserves and driven up interest rates). Consequently, the system is by no means immune to future tensions and, from now on, these will have to be dealt with without the use of exchange controls.

(vii) Summary

This section has considered the possible effects of the abolition of exchange control. We began by distinguishing between four types of capital flow and identified portfolio investment and changes in the holding of foreign exchange as the major flows likely to be influenced by the relaxation of capital controls. We then considered five different views of the likely effects of abolition. The first two of these views see abolition of exchange controls as simply the removal of a market distortion which previously prevented a 'competitive' equilibrium and therefore prevented an optimal allocation of resources. From this standpoint full capital mobility will be an unambiguous benefit to Ireland, and requires no changes in domestic or Community policy. We then considered the view that the significance of exchange controls, and of their abolition, depends on the state of public finance and, in particular, on the management of public debt. The Central Bank's perception of the likely effect of abolition of controls was also outlined.

The Bank considered the harmful and persistent portfolio capital flows and destabilising speculative flows could occur unless a number of policy requirements were met. Finally, we considered the view that exchange controls contributed to the functioning of the EMS from 1979 to 1989 and their abolition could destabilise the system.

4. ASSESSING THE ARGUMENTS

In order to decide whether abolition of exchange controls requires any alterations in policy it is necessary to assess the validity of the various views outlined above. Two approaches can assist in our judgement of the validity of these views: the first is to assess the logical or theoretical credibility of the various arguments, the second, is to judge them by reference to the developments which have unfolded since relaxation of controls in January 1988. However, as will be seen presently, the task of interpreting Ireland's very recent experience is far from simple.

(i) Theoretical Credibility

Broadly speaking we find the first two viewpoints discussed in Section 3 unconvincing, because they rely on very strong and fairly implausible assumptions. It does not seem likely that any desired level of foreign exchange reserves can be achieved by an appropriate level of domestic credit expansion *without any effect on the level of domestic employment and output*. It is surely implausible to suggest that speculative capital flows *merely* enforce changes in exchange rates which are dictated by economic 'fundamentals' (Bean, Malinvaud, Bernholz, Giavazzi and Wyplosz, 1990, p.28). It seems hard to attribute much welfare significance to the supposed 'distortion' of having an 'artificially' low domestic interest rate.

The idea that the significance of exchange controls, and their abolition, depends in part on public finance and public debt is, in general terms, persuasive. For a start, the public deficit can be a very significant determinant of the balance of payments deficit. In addition, it seems entirely plausible that the size of the outstanding debt and its composition will, in certain circumstances, influence both the size and direction of flows and the *effects* which they have.

We have rejected the idea that speculative flows are simply the means whereby equilibrium is attained; consequently, we have accepted the Central Bank's fears concerning short-term capital flows. What of the idea that portfolio capital flows could be large and continuous? In stating this view Reynolds says that "models of investment behaviour that predict flows of capital to less prosperous regions, where the marginal efficiency of capital is allegedly higher, seem to me to take inadequate account of various constraints on growth in these areas" (Reynolds, 1988). Although this statement is brief it can be supported by both empirical and theoretical arguments (Williamson, 1987; Dow, 1986; Chick and Dow, 1988).⁵ In their analysis of the relationship between banking and regional development Chick and Dow develop an historical and theoretical argument for the proposition that "as

the financial sector in general becomes more developed, the tendency for periphery deposits to be lost by capital outflows to the centre will increase, particularly in periods of high liquidity preference" (Chick and Dow, 1988).

Finally, we have to assess the argument built around the idea that exchange controls played an important role in the EMS since 1979. It was initially thought that, if this view is valid, then abolition of controls would definitely threaten the EMS (Padoa-Schioppa, 1987). More recently, it has been argued that this view of how EMS has functioned with exchange controls, does not imply any definite view of how it will work without them. In particular, De Grauwe has argued that "there may be a subtle interaction between capital mobility and monetary co-operation" and hence abolition may lead to more convergence and symmetry in the EMS (De Grauwe, 1990). While the analysis of the role of exchange controls in EMS is convincing it seems that the effects of abolition is largely an empirical matter.

(ii) The Experience of Capital Liberalisation

Although a study of the experience since the relaxation of controls is necessary it is, in fact, difficult to use such a study to draw general conclusions about the effects of exchange control relaxation and about how Ireland will experience the new EMS. First, the period since the relaxation of controls is too short to permit firm inferences to be drawn. In addition, we face the difficulty of distinguishing between the effects of exchange control relaxation and the effects of domestic policy.

Different interpretations have been offered of Ireland's experience since the relaxation of exchange controls. Given the limited data available, the Council considers it fruitless to try to resolve conflicts of interpretation of very recent monetary and interest rate developments. Instead, the Council suggests that recent balance of payments experience, and future developments, be examined in the context of Ireland's balance of payments since 1976. Secondly, the Council suggests that past and future developments be examined using a broad set of measures of the balance of payments.

In Section 5 we undertake such an examination of Ireland's recent balance of payments experience. The purpose of this analysis is to bring to light two issues

5. In summarising the effects of international capital flows Williamson (1987) says "No one doubts that the golden age of international lending prior to 1914, with capital flowing from the industrialised centre to the capital-hungry areas of recent settlement, brought gains to the world as a whole (though the optimality of exporting over half of British savings has often been contested from a nationalistic United Kingdom viewpoint). Since then, however, the record is dismal. Overriding to Germany in the 1920 thwarted adjustment; the capital inflow then dried up at the time that world depression made adjustment excessively costly, so precipitating default. Hot money flows undermined economic management in the 1930s. Revival of an international capital market again led to excessive flows that thwarted adjustment in the 1970s, and then to a precipitate cutoff of new credit in the midst of a world recession that almost compelled a new round of defaults in the 1980s. Capital is now flowing on a vast scale to the most capital-rich country on earth and is fleeing areas where its real productivity is almost certainly higher. The net benefits of unrestricted capital mobility are indeed debatable".

concerning the balance of payments and monetary policy about which the Council is concerned. First, some of the balance of payments and monetary pressure experienced in very recent years reflects structural features of the Irish economy. Second, the movement into a 'new-EMS', without exchange controls, and eventually into economic and monetary union, requires a fresh examination of the structures which set Irish monetary policy and the reporting requirements placed on those structures.

5. IRELAND'S RECENT BALANCE OF PAYMENTS EXPERIENCE

We stated above that the Council believes that balance of payments and monetary developments are best viewed in as broad a way as possible. In the context of the 'new-EMS' – EMS without exchange controls – this is helpful in obtaining a perspective on the source of monetary pressure on interest rates or the exchange rate. A broad approach is vital if we are to assess the implications of the relaxation of exchange controls using the small amount of data. Consequently, this section begins with a brief review of different approaches to analysing the balance of payments accounts. This is followed by an application of this approach to Ireland's balance of payments experience since 1976. The section ends with a discussion of the two issues mentioned above: the structural factors in the real economy and the structures for setting monetary policy.

(i) Approaches to Analysing the Balance of Payments Accounts

One of the main purposes of balance of international payments accounts is to identify forces for change or adjustment within the economy. The two major components are the current account and the capital account.

Autonomous Versus Accommodating Transactions

In general it would be desirable to be able to distinguish between *autonomous* international transactions and those which are *accommodating*. For example, if a current account deficit is not matched by autonomous capital inflows then some adjustment is required. The most immediate adjustment is to *induce* an accommodating capital inflow. While this example is useful (because it seems intuitive that current account items like the export or import of goods are autonomous transactions) it is also dangerous in that it may create the mistaken impression that the distinction between autonomous and accommodating transactions coincides with the distinction between the current account and the capital account. In fact, many capital flows must be considered as autonomous and consequently grouped with the current account when distinguishing between autonomous transactions ('above the line') and induced or accommodating transactions ('below the line').

Balance of payments accounts can be analysed in many different ways depending on the purpose of the analysis. In general, there has been a trend towards broadening the category of autonomous transactions and entering more and more categories 'above the line' (see below).

There are strong arguments for considering a number of alternative measures of the accounting balance (Cohen, 1969). Some of the possibilities can be illustrated for the 1989 balance of payments statistics – those most relevant to the question of the relaxation of exchange controls. These different measures of the accounting balance are explained in detail in an Appendix. Here we merely summarise their main characteristics.

The Current Account

This approach views the current account as containing the main autonomous transactions and the balance on the current account as the major subject for analysis and policy consideration. Ireland has had a current account surplus since 1987.

The Basic Balance

This approach treats long-term capital flows as autonomous and, consequently, includes them, with the current account, 'above the line'. The sum of the current account and the long-term capital flows is known as the basic balance. Ireland has had a deficit on basic balance every year since 1976, and a very large one in 1989.

The Official Settlements Balance

This approach is based on the idea that short-term private capital flows are largely autonomous and, therefore, includes these – with the current account and private long-term capital flows – 'above the line'. As a result the only items 'below the line' – are *official* capital transactions.

In fact there are a number of slightly different versions of the official settlements balance. One version includes all official capital transactions below the line; Ireland has had a deficit on this accounting balance every year since 1978. A second version leaves only official *reserve* transactions below the line; in 1989 Ireland had a deficit on this measure of the accounting balance – i.e. a fall in the reserves of £640m. This has followed increases in the reserves in 1987 and 1988.

Summary of the 1989 Balance of Payments Experience

The experience of 1989 and other recent years is important in identifying whether relaxation of exchange controls necessitates changes in macroeconomic policy or monetary management at national or Community level. To summarise, 1989 saw very substantial capital outflows and the Central Bank raised its Short-Term Facility (STF) rate of interest by 1 percentage point on four separate occasions. Despite this the external reserves fell sharply, by £640m, for the year as a whole. The differential between Irish and German 3-month rates increased from 2.5, in January 1989, to around 4 per cent at year end - having fallen below 1.5 per cent in February. Overall, the decoupling from British financial influences to German ones, which was widely believed in 1988 to have finally materialised, has been partially undone.

We have briefly described four different measures of the accounting balance: the current account, the basic balance and two versions of the official settlements balance. Only on the current account approach did Ireland record a balance of payments surplus in 1989.

There should be little doubt that 1989 saw definite and genuine balance of payments pressures (we put aside the question of whether the pressures were temporary or more fundamental). This is confirmed by the fact that three different measures of the accounting balance reveal a deficit ranging from a fall in the reserves of £640m to an overall official financing requirement of £1603m. On the face of it the experience of 1989 tends to confirm that the absence of exchange controls implies larger swings in interest rates.

(ii) Ireland's Balance of Payments 1976-1989

Introduction

The Council strongly believes that the recent balance of payments experience, and future developments, be examined in the context of Ireland's balance of payments over the medium-term.

Table 5.1 presents the balance of payments accounts from 1976 to 1989. Estimates of four different accounting balances are shown: (1) the current balance; (2) the basic balance; (3) the official settlements balance (version 1) and (4) the change in the external reserves (official settlements balance, version 2). In addition, each of the major items in the current and capital accounts are displayed.

Was 1989 Unusual?

Our view of whether the abolition of exchange controls will require any changes in macroeconomic policy will depend, in part, on whether we see the development in 1989 as unusual. The answer seems to be that while some categories of international transactions did, indeed, behave unusually in 1989 this novelty should not be exaggerated.

Comparing 1989 with other recent years it is apparent that the only really significant *changes* in 1989 were the very sharp increase in private capital outflows and the switch from a surplus to a deficit in banking transactions. In other respects 1989 was very similar to other recent years: the outflow of factor incomes exceeded the surplus on goods and services, private capital outflows exceed inflows, and both the basic balance and the overall official settlements balance were also in deficit. The change in net external reserves in 1989 (line 4) was unusual in both sign and size when compared with all other years in this table. However, this has more to do with earlier official willingness to undertake foreign borrowing on a large scale. Since the overall official settlements balance was in deficit every year (except 1977) the increase in net reserves recorded in most years (see line 4) merely reflects the fact that official capital inflows exceeded total official financing requirements (i.e. official settlements – line 3). In other words, the increase in reserves was generally borrowed.

Table 5.1
Balance of Payments 1976-89
Four Measures of Accounting Balance

	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
Goods & Services	-369.8	-519.8	-669.6	-1298.8	-1261.3	-1613.6	-981.2	-412.5	-45.1	341.8	491	1317	1967	2303
Factor Incomes	-36	-108.4	-228.2	-283	-358.1	-504.6	-927.7	-1183.9	-1638.8	-1965.7	-1957	-1957	-2542	-3039
Transfers	167.7	328.7	453.6	555.9	581.5	523.5	593.2	671.2	738.5	973.8	957	879	1011	1108
1. Current Balance	-238.1	-299.5	-444.2	-1025.9	-1037.9	-1594.7	-1315.7	-925.2	-945.4	-650.1	-509	239	437	371
Private Capital	145.6	295.1	160.3	303.8	331.6	276.9	285.3	87.2	-137.6	-108	-407	-723	-826	-1870
Official Capital	299.2	214.8	338.7	374	568.9	1197.3	1220.7	712.7	854.3	1028.9	1198	1231	523	964
Banking Trans	106.7	290.8	107.8	138.5	425.2	12.3	132.2	605.6	368.2	285.7	554	-79	365	-186
Residual	-129.5	-267.4	-88.3	-76.4	58.7	116.8	-231.8	-253.2	-172.2	-360.8	-908	-63	-147	82
4. Ext Reserves*	-183.9	-233.8	-74.3	286	-346.5	-8.6	-90.7	-227.1	32.7	-195.7	72	-606	-352	640
2. Basic Balance	92.5	-4.4	-283.9	-722.1	-706.3	-1317.8	-1030.4	-838	-1083	-758.1	-916	-484	-389	-1499
3. Official Settlements (1)	-115.3	19	-264.4	-660	-222.4	-1188.7	-1130	-485.6	-887	833.2	-1270	-626	-171	1603
Official Capital	299.2	214.8	338.7	374	568.9	1197.3	1220.7	712.7	854.3	1028.9	1198	1231	523	964
External Reserves	-183.9	-233.8	-74.3	286	-346.5	-8.6	-90.7	-227.1	32.7	-195.7	72	-606	-352	640

* For accounting reasons an increase in the foreign exchange reserves is shown as a negative number and a decrease as a positive number.

Structural Factors Revealed in the Balance of Payments

Several of the transactions which contributed to balance of payments pressure in 1989, and which were not essentially unusual in that year, reflect very important structural features of the Irish economy in the second half of the 1980s and the early 1990s. First, the huge and growing outflow of profits, dividends and royalties (much the largest component of factor incomes) reflects the remarkable structure of Irish manufacturing industry. There is a sense in which Ireland's trading balance should be calculated net of these profit repatriations. To do so would show an unambiguous trade deficit in every year reported in Table 5.1.

Second, the outflow of national debt interest (a large component of factor incomes) reflects the external indebtedness of the Irish state. This must be regarded as a structural feature of the economy.

Third, examination of Table 5.1 shows that private capital flows have been in deficit since 1984, and the size of that deficit has increased considerably. This forms part of a remarkable turn-around in the overall pattern of Ireland's balance of payments. From the late seventies to around 1984 the balance of payments was dominated by huge trade deficits, in the current account, financed by official foreign borrowing, in the capital account. Since 1984 the trade balance has been in surplus and official capital inflows have been financing, not a trade deficit, but private capital outflows and repatriation of profits and dividends.⁶

While it can be argued that a proportion of the private capital outflow in 1989 reflected a once-off portfolio adjustment, following the relaxation of exchange controls, a look at the growing capital outflow since 1984 should serve to qualify this view. An important determinant of private capital movements is the rate of cashflow into the long-term institutions relative to the supply of domestic securities. In other words, the size of domestic savings relative to profitable investment opportunities. These savings seem likely to exceed those investment opportunities for the foreseeable future. It can be said that this gap between the cashflow into the long-term institutions and the supply of domestic securities currently available is a problem that has its source in structural imperfections in the Irish financial system. We may add that this in turn reflects a series of structural problems in the *real* economy (NESC, 1981, 1982A, 1986B and 1989).

These structural factors revealed in the balance of payments clearly lend some support to the fears expressed by the Central Bank (Reynolds, 1988) and Chick and Dow (1988) that in certain circumstances, capital flows from poorer regions can be continuous. If this is really the case then it raises important issues for economic policy, at both national and Community level, *but it is not clear that it justifies criticism of interest rate policy in 1989 and 1990.*

6. It is possible that transfer pricing is occurring. This will tend to inflate the recorded level of exports and profit repatriation.

This analysis suggests that economic management in the new EMS, or even the early stages of EMU, requires both vigilant monetary policy (i.e. management of liquidity and setting of interest rates) and policies which address the underlying problems – such as the shortage of domestic securities and barriers to industrial development.

(iii) Conclusion

The analysis undertaken above confirms the value of using a number of alternative measures of the accounting balance. Application of this approach to the 1989 balance of payments accounts shows that, despite the surplus on current account, 1989 saw definite and genuine balance of payments pressures. Three other measures of the accounting balance all record a deficit – ranging from a fall in reserves of £640m to an overall official financing requirement of £1603m.

It is not possible at this stage to fully explain the large current and capital account flows which have occurred since the relaxation of exchange controls. The relaxation of controls coincided with a weakening of sterling against the Irish pound and, possibly, a changed underlying market valuation of Ireland's exchange rate within the EMS: opinions naturally differ on relative significance of these three factors. But we can state with some confidence that events since 1988 confirm the view that the absence of exchange controls implies larger fluctuations in Irish interest rates. This period is of course, effectively one of transition.

The analysis also confirms the value of viewing the balance of payments in a medium-term context. Placing the 1989 accounts in the context of developments since 1976 shows that, while some categories of international transactions did indeed behave unusually in 1989, this novelty should not be exaggerated. In particular, in most recent years the outflow of factor incomes exceeded the surplus on trade, private capital outflows exceeded inflows and both the basic balance and the overall official settlements balance were also in deficit.

The analysis shows that the monetary and interest rate pressures, experienced with varying intensity in recent years, reflect not only structural features of Ireland's financial system but also deeper structural characteristics of the *real economy*. This has important implications for policy at both the national and Community level. It reinforces the significance of the industrial and other structural policies advocated by the Council.

6. STRUCTURES FOR MAKING AND REPORTING MONETARY POLICY

Movement towards economic and monetary union is now being actively discussed in the European Community. One important topic of debate is the desirable nature of the European system of central banks sometimes called the EuroFed. The Council strongly believes that the development of EMS to date, and the impending

move to a new system of central banks, requires a review of the institutional structures of Irish monetary policy.

What principles can we draw in designing new structures for decision making and accountability? We can identify three concepts which are helpful but which are frequently confused with one another: decentralisation, representation of interests, and independence.

(i) Decentralisation

In a union such as the European Community there is clearly a strong case for as much decentralisation in monetary policy and central banking as possible. Indeed, the central banking system of a union such as the United States has a federal structure and is often described as decentralised.

However, a consideration of the nature of monetary policy and study of the practice in federal states, such as the US and the Federal Republic of Germany (FRG), shows clearly that there are severe limits to the amount of decentralisation which is possible in this area. Genuine monetary union requires a single Community monetary policy and a single exchange rate policy. This was clearly recognised in the Delors Report:

A new monetary institution would be needed because a single monetary policy cannot result from independent decisions and actions by different central banks. Moreover, day-to-day monetary policy operations cannot respond quickly to changing market conditions unless they are decided centrally. Considering the political structure of the Community and the advantages of making existing central banks part of a new system, the domestic and international monetary policy-making of the Community should be organised in a federal form. This new system would have to be given the full status of an autonomous Community institution.

This is a clear recognition that in the case of monetary policy the principle of subsidiarity does not imply decentralisation of decisions about monetary policy. In fact, even the principle of subsidiarity implies the creation of a Community institution, in which policy decisions are taken centrally. These arguments, based on the logic of monetary policy, are fully confirmed when we look at the United States Federal Reserve System or the Bundesbank. Despite their regional structures monetary policy is unambiguously set in the centre.

(ii) Representation of Interests

It is most important not to confuse central decision making with decision making which is completely unconnected to those affected by monetary policy. There can be no doubt that in both the Federal Reserve and the Bundesbank policy decisions are made centrally; but both institutions are carefully constructed so as to include representation of various interests. Few would deny that this fact has important

implications for the European central bank. The Council strongly believes that it also has implications for the Irish Central Bank which is, after all, to be a constituent institution of the EuroFed.

Consider the US case first. The Board of Governors of the US Federal Reserve system consists of seven members appointed by the President. In nominating members, the President is required to "have due regard to a fair representation of the financial, agricultural, industrial and commercial interests, and the geographical divisions of the country". In the case of the US it is not surprising that the 'representation of interests' has a strong regional component. One implication of this requirement is that no more than one member may come from any one of the twelve Federal Reserve Districts. Within the Fed, authority over the tools of monetary policy is divided between the Board of Governors and the Federal Open Market Committee. "The whole system thus has a mixed public-private aspect and representation of both geographical and functional interests" (Harden, 1990).

The German system also provides for representation of interests. The Central Council of the Bundesbank is composed of the President and Vice-President, up to eight members of the Bank's Directorate, and the 11 presidents of the Landeszentralbanken – the state central banks. As a result regional interests are strongly represented in the central policy making process.

Application of this principle – 'representation of interests' – in the design of the European system has important implications at both the Community and national level. At the Community level it is clear that the constitutional design of the EuroFed will have to ensure some representation of member states - indeed, it is hard to see that anyone intends to dispute this. However, the Council strongly believes that the principle of representation of interests must be applied in the domestic policy system also. In Ireland's case the principle of representation of interests could not, sensibly, have a regional dimension. It does, however, have a clear functional dimension. It implies that, by some means or other, the decision making structures which determine monetary policy should, to use the American formulation, "have due regard to a fair representation of the financial, agricultural, industrial and commercial interests".

(iii) Independence

It is clear from what has been said above that representation of interests is not inconsistent with independence of the central bank – since the Fed and the Bundesbank are widely viewed as among the most 'independent' central banks in the democratic world. In current discussion of EMU there is considerable emphasis on the idea that the European Central Bank, or EuroFed, should be 'independent'. The Council considers that this concern for the independence of the central bank is entirely appropriate; however, in saying this it draws attention to what independence means in practice.

In defining the independence of a central bank the only sensible approach is to look at actual systems of government since modern money and money creation depends for its existence on the state. When we do this we find out what 'independence' is not, before we can see what it really is.

Objectives of Monetary Policy

First, an independent central bank does not mean a central bank that has an overriding legal duty to prevent inflation.

The legal duties of the Bundesbank, as defined in 1957, provide that it must regulate money supply and credit so as to safeguard the currency; the 1967 law on stability and economic expansion defines the banks functions as to ensure "stable prices, high employment, balanced foreign trade and constant and reasonable economic growth".

The legislation which governs the US system says that the Fed shall manage money and credit aggregates "commensurate with the economy's long-run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates". In addition the Fed must submit twice-yearly reports to Congress specifying its monetary policy. More significantly, these reports must explain the relationship between these objectives and plans and the short-term goals set out in the President's most recent Economic Report and any short-term goals approved by Congress.

"The result of these provisions is that the Bundesbank and the Fed are not *legally* constrained to adopt any particular monetary policy nor to give priority to anti-inflationary goals at the expense of other economic objectives" (Harden, 1990). It is clear therefore, that 'independence' does not mean a central bank which is insulated from political pressure by any overriding legal duty to prevent inflation.

Legal Independence

Second, 'independence' of a central bank does not derive primarily from its legal status.

In the case of the US there is no constitutional or legislative provision guaranteeing the independence of the Fed. It is true that the executive arm of government has had no representation on the Board of Governors since 1935. In addition, the Fed is not subject to any appropriations process – which, of course, frees it from one of the most powerful weapons used by Congress and the President. In the case of Germany, the extent to which constitutional law guarantees the independence of the Bundesbank is a matter of debate (Harden, 1990). In contrast to the US, members of the German federal government have the right to participate in meetings of the Bundesbank's Central Council, but not to vote. In both the US and German cases, appointment of governors for lengthy periods, with little or no

provision for removal, is considered of some significance in guaranteeing independence from government.

These views of what independence does not mean – derived from a study of the two most independent central banks – are confirmed when we consider the least independent – the Bank of England. The Bank of England is commonly agreed to be the least independent Central Bank in Europe. It largely executes policy decisions made in the Treasury. Yet, compared to the Fed or the Bundesbank, the Bank of England does not have its responsibilities and objectives defined clearly by any outside authority, law or constitution. Furthermore, it is much less accountable than other, more independent, central banks. This combination of non-independence and non-accountability has, understandably, been described as “the worst of all worlds” (Brittan, 1990).

What Determines Independence?

If the independence of the Fed and the Bundesbank does not derive from an overriding legal duty to guarantee price stability, and does not derive from legally or constitutionally defined independence, what does it derive from? The answer to this question may help to identify what arrangements are necessary, and possible, in the case of the EuroFed and the Irish central bank.

The independence of the Fed and the Bundesbank would seem to derive from the fact that they are political actors within a political and constitutional system which gives them some power against other actors – especially other parts of government. The reason for this differs radically in the cases of the US and Germany – for historical reasons. Glossing over these differences we can move to the following clear statement of the case:

For a central bank ‘independence’ is thus a matter of degree. It means not that the bank pursues its own policies regardless of what anyone else is doing, but that as an institution it has the power to make its own political choices about which policies it will pursue. Such power is only partly dependent on specific legal provisions. Furthermore, it is neither unlimited nor irrevocable. Ultimately if a central bank is to remain an autonomous political actor its role must be accepted as legitimate. That is, it must not just exercise power but also be generally acknowledged as possessing the constitutional right to do so (Harden, 1990).

It is clear, therefore, that the independence of a central bank depends on its legitimacy, which in turn depends on the constitution within which it functions. These two findings are very helpful when thinking about European monetary union and the decision making process in Ireland.

(iv) **Designing the Decision Making Process at Community and National Level**

The concepts of decentralisation, representation of interests, and independence can, and should, be applied in designing the EuroFed and adjusting domestic decision making structures to the new realities. But the implications of these principles are not always fully recognised, reflecting the fact that the principles themselves – especially independence – are misunderstood.

Implications for the EuroFed

We noted that the principle of subsidiarity implies a single Community institution with the power to set a single Community monetary policy. However, subsidiarity also implies that, subject to sufficient independence, the national central banks do not all have to have the same decision making procedures (see below).

What are the implications of independence for the design of the EuroFed? At a very minimum it is clear that the EuroFed must be a new Community institution – in order to be independent of the member states. Secondly, the EuroFed must be subject to reporting requirements which provide the kind of accountability that is consistent with an independent policy role. In establishing this new institution, the Community will have to define its objectives and duties, establish its legal status and guarantee the independence of its Board by, for example, making appointments for long periods and devising a system of voting which balances the influence of members appointed by the member states against that of members appointed by the European Council.

But our discussion of the true nature and source of independence, of the US Fed or the Bundesbank, suggests that the independence of the EuroFed can be assisted, but not guaranteed, by its formal objectives, its legal status and its method of appointment or voting. In practice, its independence and accountability will depend on the overall constitutional and political constellation within which it will be an important body. This point has been well put as follows:

Whether it will be possible for the EuroFed to achieve legitimacy as a political actor depends on who the other actors are and on the constitutional framework in which they operate. This means that the legitimacy of the EuroFed cannot be considered simply in relation to monetary union; it depends on the broader constitutional framework of the Community. In particular, it depends on the allocation of power over economic policy, both as between different Community institutions and as between those institutions and member states. In other words, from a constitutional perspective, monetary union cannot be sensibly examined except in the context of economic union. ...It is important that between the details of monetary union and the aspirations of political union, the constitutional framework of economic union should also be tackled (Harden, 1990).

The implication of this is that the Inter-Governmental Conference which discusses EMU must also discuss the allocation of power over economic policy. This somewhat more legal analysis fully confirms the central conclusion reached by the Council on the requirements and implications of genuine economic and monetary union (NESC, 1989B).

Implications for the Decision Making Process in Ireland

Subsidiarity cannot imply national control of monetary policy. However, it does imply a federal structure for the EuroFed. Furthermore, it does imply that the constituent banks of the EuroFed need not all have the same decision making structure – provided they are all sufficiently independent of their respective governments. This implies that member states can design their decision making structures in accordance with their own administrative and political traditions. It certainly implies that a country which had, or is developing, a consensual approach to economic and social management could reflect this in the institution which executes monetary policy.

Representation of interests plays an important role in ensuring the legitimacy of the most independent and effective central banks – the Fed and the Bundesbank. Furthermore, we have seen that their independence depends, in large measures, on their legitimacy. This has implications for Ireland's decision making structures, in the context where many core monetary policy decisions are determined at Community level. The legitimacy and acceptability, and ultimately the independence, of the national central bank will depend on a fair representation of financial, agricultural, industrial and commercial interests. This suggests some reform of the decision making structures and reporting requirements in the Irish system.

This point is strongly confirmed when the interdependence of monetary policy, fiscal policy and incomes policy are recognised. In *Ireland in the European Community* the Council concluded that:

Satisfactory implementation of the decision to join the EMS required not only recognition and acceptance of the macroeconomic policy conditions, plus acceptance of the implications for wage increases in the private sector, *but also* consensus on the management of the public finances, especially taxation. This was not adequately appreciated by either government or the social partners at the time (NESC, 1989B).

Since monetary policy is closely linked to other policies, consensus must extend beyond incomes and the public finances, to monetary policy. But we cannot expect this to happen over an extended period without adequate representation of interests in the structures which set monetary policy.

Turning to the principle of independence, we find that the Irish Central Bank already has a fair measure of independence. In this context it might be argued that

introduction of the two other principles – decentralisation and representation of interests – in the manner outlined above, could threaten the independence of the monetary authority. Our analysis suggests that this fear is unfounded. First, independence depends ultimately on legitimacy, which is likely to be enhanced rather than undermined by representation of interests. Second, the introduction of more reporting requirements is, in fact, likely to increase independence. Having surveyed different systems, Brittan concluded that “the general moral is that accountability and independence go together” (Brittan, 1990). The explanation for this lies in the true nature of independence, and the contrast between this and what many, including some of its supporters believe it to be. This misunderstanding has been nicely identified by Brittan:

The case for an independent central bank is often put as if it were a pure gift to that bank to enable it to do what it likes. As such the idea is rejected by populist democrats... The truth is almost the opposite. Independence, with a carefully designed framework of responsibility and a clear policy goal, is likely to make central banks more accountable rather than less (Brittan, 1990).

7. ECONOMIC POLICY IN THE ABSENCE OF EXCHANGE CONTROLS

(i) Reduced Macroeconomic Flexibility

While the abolition of exchange controls may have consequences for a number of individual areas of policy, its greatest impact is likely to lie in the further reduction of the degree of manoeuvre which a small open economy has with regard to its overall macroeconomic policy. As indicated in Chapter 1, the explicit non-accommodating exchange rate policy underpinned by consistent domestic policies in the monetary, incomes and fiscal area was a major contributor to the decoupling of Irish and UK interest rates and the convergence with German rates. This has been achieved partly through a flow of foreign funds into the Irish economy as perceived exchange rate risk was reduced and the confidence of potential investors increased.

Such funds are particularly sensitive to changes in financial factors which are closely related to the domestic policy stance. The abolition of exchange controls facilitates capital flows; any perceived change in the policy regime would thus rapidly give rise to financial flows. This indicates that, in addition to sustainability, flexibility and impact on growth potential, fiscal policy will now have to have greater regard to external confidence. Similar considerations apply to monetary policy.

Free capital movement is also likely to bring pressure to bear on the taxation system – particularly in regard to the manner in which we tax interest and dividend income. This issue is considered in both Chapters 4 and 6.

(ii) Increased Volatility

The discussion above lends some support to the view that the relaxation of Irish exchange controls implies an increase in the volatility of capital flows and hence in the volatility of interest rates. This observation is not inconsistent with the argument that abolition of controls in the EC has forced some greater convergence of economic policy and that, consequently, the additional volatility has been somewhat less than expected. While it is part of monetary policy to reduce fluctuations in liquidity, and hence in interest rates, it is not clear that the scale of liquidity management interventions can be unilaterally increased. If it cannot, then some of the additional volatility will, in general, show up in interest rates. It would seem that abolition of exchange controls will, other things being equal, increase interest rate volatility unless the potential for system-wide intervention was increased.

(iii) Debt Management

There seems little doubt that the risks emanating from abolition of exchange controls are influenced by both the *level* and *management* of public debt. While the level of public debt can only be reduced in the medium-term the management of debt is an immediate issue. In Section 3 we reported the guidelines suggested by Giavazzi and Spaventa. While it is appropriate for the Council to draw attention to the principle that debt management is an area of policy which requires review in the light of exchange control abolition, it is not intended that the Council offer detailed advice on the conduct of this policy.

(iv) The Sterling Factor

Some difference of opinion exists on whether the difficulties of 1989 reflected the abolition of exchange controls or the re-emergence of the sterling problem which has complicated Irish EMS membership on several occasions since 1979. It is probable that both factors were at work in 1989. Against this background the entry of sterling into the ERM is particularly welcome, although the margin of fluctuation is wide at 6 per cent.

(v) Long-Run Capital Outflow

The developments in 1989 and other recent years lend some support to the view that capital outflows may be a continuous feature of Ireland's experience. This could reflect structural differences between the Irish economy and financial system, on the one hand, and the more advanced EC economies, on the other. There are limits to the ability of domestic *macroeconomic* policy to address this problem. Instead, it highlights, once again, the importance of developmental measures such as industrial policy, financial sector policy, technology policy and manpower policy. This problem also reinforces the argument that European financial and monetary integration must be accompanied by the harmonisation of a wide range of national policies and the development of Community policy in new areas (NESC, 1989B).

(vi) Decision Making Structures at Community and National Level

The current discussion of the design of a European central bank provides an opportunity to consider what structures and procedures are necessary for the successful conduct of monetary policy at both Community and national level. The Council considers that three principles – subsidiarity, representation of interests and independence – should be used in creating or reforming policy making structures.

The European Central Bank

Application of these principles leads the Council to favour a federal structure for the European central bank. The Council strongly favours an independent EuroFed but stresses that independence will depend less on legally binding objectives or legal status, than on the overall constitution within which the EuroFed will function as a political actor. This implies that the forthcoming Inter-Governmental Conference must not confine itself to the powers of the EuroFed: the constitutional framework of *economic* union must also be addressed.

Decision Making Structures in Ireland

The changing role of monetary policy, and moves towards EMU, suggest that the structures and processes of Irish monetary policy be reviewed. Application of the principles of subsidiarity, representation of interests and independence shows that reforms are necessary, and indeed, feasible. In particular, there is a case for a greater representation of interests and development of reporting requirements. The Council supports the development of the consensual approach to economic and social management and considers that this requires both a widening and a deepening of consensus. One implication of this is that consensus must now extend beyond incomes and the public finances, to include monetary policy. This is vital given the close inter-connection between monetary policy and other policy areas. In this context, reform of the decision making structures would enhance the understanding of monetary policy and broaden its acceptance within the context of fiscal policy, incomes policy and other arms of policy. Furthermore, they would increase rather than decrease the independence of monetary policy.

The Council acknowledges some of the concerns that might be expressed in regard to its proposals in this area. There are a number of points to be made in this regard. First, the Council wishes to emphasise that it is acutely aware of the *fundamental* constraints which surround policy in this area – namely, the vital necessity of a non-accommodating exchange rate policy as part of a consistent policy stance and the necessity for interest rate policy to support exchange rate policy. Second, to secure maximum support for and understanding of monetary policy and of its implications for the economy, the Council believes it is desirable that various sectors of the economy be linked to these policies. Third, the Central Bank has important regulatory and related responsibilities: other public bodies with such responsibilities benefit from the representation of a wide spectrum of interests.

APPENDIX TO CHAPTER 5
APPROACHES TO THE BALANCE OF PAYMENTS

APPROACHES TO THE BALANCE OF PAYMENTS

This appendix explains the four approaches to the balance of payments accounts used in the body of the chapter. These different measures of accounting balance are best explained using an actual year's accounts as an example. For this purpose we use the 1989 balance of payments accounts.

The Current Account

This approach views the current account as containing the main autonomous transactions and the balance on the current account as the major subject for analysis and policy consideration.

Table A5.1 shows that in 1989 Ireland achieved a large surplus on merchandise trade of over £2 billion – equivalent to around 11 per cent of GNP. Ireland also recorded a small surplus on trade in services (the breakdown into transport, tourism and others is provided in the table). However, the current account balance in Ireland is no longer dominated by the trade balance. Factor incomes (items 6 and 7) recorded a very large net deficit of over £3 billion. The major component of this was repatriations of profits and dividends by foreign companies. If it were not for international transfers of £1,108m (most from the EC) Ireland would have recorded an overall deficit on the current account. This yielded a net current account surplus of £371m.

If we focussed on the current account alone we would see the whole capital account as 'funding' the current account; in the case of a current account surplus this 'funding' consists of a capital outflow – the accumulation of foreign assets. But even using this extreme approach the existence of a net current account surplus would not be completely comforting. The size of the outflow of trading and investment income relative to the trade surplus reveals an underlying economic structure which remains vulnerable.

The Basic Balance

It is clearly incorrect to see all capital flows as simply accommodating or funding current account transactions. Long-term capital flows are based on autonomous calculations of profit opportunities. Furthermore, it seems clear that the current account balance does not adequately explain the movement of currencies. Consequently, an exclusive focus on the current account could seriously mislead policy-makers as to the pressures on a given exchange rate.

One approach is to include long-term capital flows with the current account, above the line, and view other capital flows as accommodating ('below the line'). The sum of the current account and long-term capital flows is known as the basic balance. We can gain some idea of Ireland's basic balance by disaggregating the capital account and moving private capital flows above the line. This is done in Table A5.2. However, since the item 'private capital' in the Irish accounts includes

Table A5.1
Balance of Payments 1989
Current Account Approach

	£m
1 Merchandise	2244
2 & 3 Transport & Freight	342
4 Tourism and Trade	153
5 Other Services	-337
6 Remuneration of Employees	16
7 Trading & Investment Income	-3055
Components of debit items in 7.	
Profits, dividends, royalties	-2337
National debt interest	-973
Others	-1001
8 International Transfers	-1108
Net Balance on Current Account	371
Net Balance on Capital Account	-453
Net Residual	82
	0

Table A5.2
Balance of Payments 1989
Basic Balance Approach

	£m
Goods and Services	2303
Factor Incomes	-3039
Transfers	1108
Total Current Balance	371
Private Capital	-1870
Basic Balance	-1499
Official Capital	964
Banking Transactions	-186
Official External Reserves	-640
Residual	82
	0

some short-term capital flows the accounting balance in Table A5.2 does not accord exactly with the concept of basic balance. In 1989 private capital recorded an extremely large deficit of £1,870m. This is commonly believed to reflect, in part, the rearrangement of Irish financial institutions portfolios in response to the relaxation of capital controls on 1 January 1989 (for further discussion see below). Table A5.2 shows that Ireland had a sizeable net deficit, of £1499m, on basic balance in 1989.

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Our judgement on the significance of this for monetary policy will depend on whether the main items which determine this basic deficit (the trade balance, factor incomes and private capital) are viewed as temporary or persistent.

The Official Settlements Balance

There are a number of valid criticisms of the concept of the basic balance. In particular, the distinction between long-term capital flows and short-term banking flows is now questionable. Many countries have responded to this by distinguishing not between types of transactions (long-term and short-term) but between types of transactors – private and official. This has given rise to an approach which moves all private capital flows above the line and treats official capital transactions as financing or accommodating. This yields a measure known as the official settlements balance.

In fact there are a number of different versions of the official settlements balance.

We will initially consider a version nearest to the basic balance and then proceed to a more extreme version.

Table A5.3 presents the 1989 accounts in such a way as to identify the total amount of official financing made necessary by the outcome of all private current and capital transactions. This approach also shows how deficits arising in this way can be financed. There are three methods of financing: government foreign borrowing from either official agencies or the private market; drawing down the official external reserves; and support from foreign monetary authorities (Thirlwall, 1980).

Table A5.3
Balance of Payments 1989
Official Settlements (Version 1)

	£m
Total Current Balance	371
Private Capital	-1870
Banking Transactions	-186
Residual	82
<hr/>	
Total Official Settlements	-1603
<hr/>	
Financed by:	
Official Capital	964
Official External Reserves	640
	<hr/>
	0

The table shows that in 1989 Ireland had a deficit of £1,603 as measured by this version of the official settlements balance. In an accounting sense the authorities had a choice of how they would generate a capital inflow of £1,603m. The inflow was generated by net official borrowing of £964m and a rundown of the external reserves of £640m. However, most of the official borrowing consisted of the purchase of Irish government securities by non-residents rather than foreign currency borrowing. This is a purely accounting description of the authorities actions. In terms of exchange rate and other policies the authorities may not view all three methods of financing as equivalent. Indeed, this is certainly the case since they have expressed reluctance to undertake foreign borrowing and they have increased interest rates four times during the year in order to stem the loss of foreign exchange reserves (Doyle, 1990).

The Official Settlements Balance (Version 2)

The balance of official settlements calculated in Table A5.3 effectively involves a measure of change in Ireland's gross reserves. It shows that the country's gross

reserves fell by £1,603m in 1989. However, given that official borrowing generated a net inflow of £964m the net reserves fell by only £640m.

An alternative version of the official settlements balance focusses on the net reserves. This version moves further items, in particular government foreign borrowing, above the line, on the grounds that it is not possible to identify what portion of it is long-term investment and what portion is short-term 'financing'. Consequently, only official reserve transactions are included below the line on the grounds that these alone, reflecting official intervention in the foreign exchange market, truly represent accommodating flows (Cohen, 1969). It might also be argued that this accounting balance is the best one for deciding the appropriate stance of monetary policy since it gives a measure of the financial pressure on the monetary authorities from the point of view of maintaining the external value of the currency (Thirlwall, 1980).

The official external reserves fell from £3,161m in December 1988 to £2,521m in December 1989 – a fall of £640m or 20.2 per cent.

This second version of the official settlements balance for 1989 is shown in Table A5.4.

Table A5.4
Balance of Payments 1989
Official Settlements (Version 2)

	£m
Goods and Services	2303
Factor Incomes	-3039
Transfers	1108
<hr/>	
Total Current Balance	371
<hr/>	
Private Capital	-1870
Official Capital	964
Banking Transactions	-186
Residual	82
<hr/>	
Official External Reserves	-640