

## The Macro-Economy in the 1980s

### Introduction

The economic history of Ireland over the past three decades exerts a powerful bias against any attempt to provide even a rough profile of likely developments in the present decade.

If, at the beginning of the 1950s, one were to paint a picture of that decade in Ireland it would have been broadly optimistic with the main stimulus coming from the trickle-down effects of the general reconstruction in Europe following the physical destruction of the Second World War. The reality of the 1950s in Ireland - falling employment and massive emigration - was so different that inevitably any view of the following decade - the 1960s - would have been very pessimistic. Yet the 1960s in Ireland were characterised by increasing prosperity, rising employment and reductions in emigration. It is fair to say that the 1970s were expected to be a continuation of the 1960s with the society gradually moving to full employment and with income levels increasing rapidly reflecting a structural shift to high income industries under the industrialisation programme pursued by the IDA.

The actual experience of the 1970s, with the recession of 1974/1975 and the later recession of 1979/1980, inevitably colours our view of the 1980s. The picture I intend to provide in this paper is dominated by recent trends and emerging themes. If we are to seek comfort it must lie in the hope that this profile proves incorrect, as with similar exercises in the past - or alternatively that we can knit the society into a cohesive unit to overcome future difficulties.

The plan of the paper is as follows. First, I will discuss, in some detail, the world economic environment over the decade. Secondly, I will discuss the home environment, concentrating on fiscal constraints. Thirdly, I will attempt to put some broad orders of magnitude on the main macro-aggregates in the light of the foreign and domestic constraints. Finally, I ~~hope~~ hope to outline policy measures which might be helpful in changing the way the system works.

## THE WORLD ECONOMIC ENVIRONMENT

The Industrial Countries

In the 1960s the growth in GNP in the major industrial economies lay in the range 5-5½ per cent. In the 1970s this growth fell to 3-3½ per cent with growth in the period 1973-1980 below 3 per cent. The slowdown in growth in the 1970s was due to a complex combination of factors - factors which, if anything, have strengthened and worsened since.

Inflation and Growth

X By the late 1960s industrial countries were experiencing rapid wage and price inflation. Policy in 1970-71 in industrial countries was contractionary in an attempt to dampen inflationary pressure, without much success. A recovery in 1972 led to more rapid inflation, culminating in the commodity price explosion of 1973 and the oil price increase at the end of that year. The rise in inflation rates in 1972 had already induced restrictive policy measures in some major countries and these, coupled with the contractionary effect of the oil price rise, led to the first recession of the 1970s with industrial output, in general, falling. The recession, however, was accompanied by very rapid increases in price and consequently wage inflation. The recovery of 1975/76 also sparked off further price (excluding oil prices) and wage increases in spite of very high levels of unemployment and the comparatively low levels of capacity utilisation. While the rate of growth in output slackened in 1977 there was a further marked recovery in 1978 led by private investment and expansionary fiscal policy (outside the US). In 1978 the rate of inflation was, in general, (excluding US) running well below levels of preceding years. By early 1978 it was possible to consider that the world had returned to some form of pre-1973 pattern. However, the increase in output and demand did lead to an increase in commodity prices and by end 1978 it became apparent that inflationary pressure were accentuating. The 1979/198- recession led to further realisation that the high inflation and high unemployment of the 1974/75 recession were not an accident.

The period from the late 1960s to the late 1970s was one when it became apparent to policy makers that economies had a much greater tendency to inflation than in earlier periods. A given rise in employment or a given rise in capacity utilisation induces a greater degree of wage or price inflation

than previously. Not only that, over the 1970s this inflation tendency has almost certainly strengthened even when allowance is made for poor measures of capacity utilisation which took little account of capital stock obsolescence induced by the oil price increase. If governments were concerned about the rate of inflation in the late sixties the higher rates currently being experienced are a matter of greater concern, and the instruments for dealing with inflation are recognised to be not as efficacious as before. The higher rates of price inflation and the weakening of the power of the instruments would tend to impart a demand deflationary bias to industrial economies over the foreseeable future.

If in the 1960s growth rates were in the region of 5-5½ with inflation at 3-4 per cent, the experience in the 1970s with inflation above 10 per cent and growth rates of 3-3½ per cent suggest that growth rates must be less if inflation rates are to be reduced given the increase in inflationary expectations between the 1960s and 1970s. Simply to prevent inflation rates from worsening we would not expect governments to allow growth rates to reach the pre-1973 levels.

In addition to this there are now very active policies being pursued in the United Kingdom to reduce inflation rates through contractionary policies, while in the United States the shift in policy with the new administration is likely to be demand contractionary whatever one feels about the medium to long term supply side position. The UK experience suggests that it may be extraordinarily difficult to reduce inflation rates, not to mention the costs in terms of lost output and unemployment, and there is little guarantee that inflation rates will not begin to accelerate if output does pick up. The situation with regard to the US is worrying in a global context as the US is lagging behind the UK by about three years in implementing contractionary policies - the US accounts for almost 40 per cent of OECD output. In the US however output is not likely to fall as in the UK. This suggests that the demand picture for 1985 is likely to be very weak. For both of these countries policy is designed to reduce rates of inflation and this involves a greater degree of contraction than simply to stand still in inflation terms. Even if economies were less inflation prone the degree of manoeuvre of governments is limited in any case by the growth of public debt in recent years and the need to service that debt. The very growth in debt servicing imparts a further deflationary bias to the system. Finally, over the 1980s it must be expected that real oil prices will continue to rise and this will add further to deflationary pressures.

In this section I have tried to indicate that the concern with inflation is still a real concern of governments in the industrial world. This concern, coupled with a tendency towards higher inflation for any given growth rate will impart a demand deflationary bias to the industrial world. This will be accentuated by increased debt servicing and higher oil prices over the 80s. Growth in the 1980s is almost certainly likely to be less than in the 1970s. Weaker growth, other things being equal, will affect the growth in industrial exports from Ireland from existing firms.

#### Investment and Growth

The 1970s witnessed significant changes in the pattern of investment in the industrial world. Up to 1973 investment was primarily directed to capacity expansion. The recession of 1974/75 and the rise in energy prices affected investment in two quite distinct ways. Capacity utilisation fell, acting as a brake on new investment, while the rise in energy prices rendered some part of the capital stock obsolete.

The fall in capacity utilisation in 1974/75 affected new investment. It was not until 1978/79 that private investment in the industrial world showed any appreciable increase but this was short-lived. The 1979/198-recession has similarly affected new investment as firms find that installed capacity is excessive. Given, further, that the general economic situation is likely to prove very weak new investment cannot be expected to expand rapidly.

The rise in energy prices affected the cost structure and the capital stock of firms, households and governments. Initially this was not clearly perceived as the real energy price increase of 1974 was eroded over time. The rise in energy prices from late 1978 and more information on world oil supplies and the possibilities of alternatives has clearly indicated that world energy prices will continue to rise - though at discrete intervals rather than continuously. A rise in the real price of energy over the medium to long term will necessitate new investment simply to maintain present levels of output and to reconstitute the cost structure of industry. The slowdown in the growth of new capacity expanding investment in industrial countries will affect the total of investment that countries seeking internationally mobile investment can attract. The present share of total new investment by foreign firms in Ireland, if maintained, would not add significantly to either investment or the supply of industrial exports. Against this there may be continued and

accelerated expansion of replacement investment abroad by firms in industrial countries in an attempt to restore a profitable cost structure.

### Third World Growth

There was a decline in growth rates between the 1960s and 1970s in developing countries as a whole - from just under 6 per cent to just over 5 per cent. There were very large differences between different groupings of countries with newly industrialising countries increasing their growth rates, oil producers having roughly constant growth rates, but making significant terms of trade gains, and finally low income countries of Asia and tropical Africa experiencing declines in already poor growth rates.

In the more rapidly growing countries growth was maintained through export expansion made possible by a very large increase in foreign direct investment and increasing official indebtedness to commercial banks. While external debt for these countries has risen debt service is not currently a problem though real interest rates are now higher than in the 1970s. The technological gap with industrial countries is still very large and these countries are likely to continue to exploit this. The barrier to growth is likely to be lack of access to markets in industrial countries. For the poorer countries their problems are likely to be exacerbated in the 1980s. The oil price rise of 1979/1980/1981 has not been matched by an equivalent rise in foreign aid and these countries find it very difficult to borrow on commercial terms. Where commercial borrowing is undertaken it can create debt service problems for the future given the limited capacity of these countries to utilise commercial borrowing to increase the productive capacity of their economies. Even at this stage in the 1980s it is possible to discern a more active concern with budget and balance of payments deficits in poorer countries. The implication for the future is that growth in the countries will be reduced.

Even before the latest round of oil price increases there appears to have been a loss of faith in development as pursued over the past 20 years. In many poorer countries the "gains" of the past have not been broadly based. In some the condition of the majority has worsened to support an elitist administrative structure. The shift in the development literature and in aid agencies towards "basic needs" programmes is likely to accentuate with an apparent introversion in policy but with welfare gains to the majority.

The weaker growth expected in industrial countries will affect poorer countries on two fronts - the prices of their primary commodities and the flow of foreign aid. Primary commodity prices are very responsive to world demand changes - the lower growth of the 1980s will tend to depress world commodity prices. The aid situation is even more difficult. Both The United Kingdom and the United States have cut back on aid programmes in recent years. The US, if anything, seems prepared to cut back even further. Even among other industrial countries the budgetary difficulties faced by governments may mean a cut in foreign aid programmes.

In total then, I would expect the growth of Third World countries to be less in the 1980s than in the 1970s.

#### Summary of World Growth

The following table presents projections of growth over the 1980s from 'World Development Report 1981' (August 1981) from the World Bank, for the industrial world and the oil importing developing world. The projections are given in terms of High/Low cases. For the industrial world the High Case assumes that the industrial countries will be successful in (i) containing inflation while growing fast enough to reduce unemployment; (ii) adjusting to higher energy prices; (iii) boosting productivity growth through structural adjustment. The Low Case reflects a failure to do this. For oil importing developing countries, the High Case assumes the High Case for industrial countries while the Low Case not only assumes the Low Case for industrial countries but also lower capital flows, less interaction between developing countries and some protectionism.

#### Growth in GDP by Region 1970-1990

	Actual 1970-80	High Case		Projected			
		1980-85	1985-90	1980-90	Low Case		1980-90
				1980-85	1985-90		
Industrial Market Economies	3.3	3.3	4.0	3.6	2.6	3.0	2.8
(W. Europe)	2.8	3.0	3.6	3.3	2.2	2.7	2.4
Oil Importing Developing Economies	5.1	5.0	5.8	5.4	3.8	4.4	4.1
(Low income oil importers in Asia and Africa)	3.0	4.0	4.3	4.1	2.8	3.2	3.0



## The European Community

The main international institutional setting for Ireland is the European Community. Our membership is recent and (possibly) almost entirely motivated by expectations of material gain and prosperity. The European Community was, however, born in the aftermath of the war, with peace, freedom and the preservation of democracy as the ultimate objectives to be achieved by European unity. The Common Market, the Common Agricultural Policy, the European Monetary System, the search for harmonisation over all areas of the economy, the European Parliament, etc., are all stages on the way to unity. Our perception in Ireland of this ideal is less than perfect. The years since entry have been marked by recession, the consequent inevitable re-affirmation of national priorities, the petty squabbling of the UK - a reluctant new member, the attacks on and deficiencies in the Common Agricultural Policy, and the growing pains of institutional change (e.g., the conflicts between the Commission, Council and European Parliament). Yet, in spite of all this, the future of Europe is at the centre of activity in the European Community. The first expansion of the Community was not necessary, in its entirety, for the Common Market per se, nor indeed was the second. The proposed third expansion to include Spain and Portugal is certain to cause even more problems in existing members' economies, yet it is clear that the European Community would welcome these countries in spite of the difficulties. There is a political force and a political will within the Community that is likely to exert more powerful influences in the decade ahead.

The experience of the 1970s was salutary for European governments. In the 1970s the problems of inflation, unemployment and energy proved beyond the power of governments acting alone. The failure to deal with these problems on a national basis reacted on other areas of concern in the Community - the lack of convergence in regional equality, social policy, the expansion of common policies in major areas outside agriculture, the operation of Lome I (and indeed the disappointment of Lome II). Within the European Community there is a realisation that concerted policies on a European scale are necessary to deal with fundamental problems. Without concerted policies there is a danger of a tactical disintegration of the Community, i.e., the Community would putter along with no purpose or aim. For the reasons given earlier I believe that the forces of integration are strong enough and the benefits from greater integration

of policy making will take place. At the national level this will involve some loss of economic sovereignty in decision making, an increase in the financial resources transferred to the Community, policy decisions that adversely affect individual sectors - without recourse to the present system of lobbying - concerted policy on energy, unemployment, inflation, innovation, a commitment to strengthen market forces in an attempt to increase growth rates, the further development of the European Monetary System through monetary union, and finally some fundamental reform of the CAP.

This latter provides an interesting case of the difficulties facing the EC. The reform of the CAP will be a signal test of the EC ideal, cutting across national interests, and sectoral, national and European lobbies. It is idle to pretend that reform is not needed - the shape and form of the reform is important. As things now are the funds allocated for the CAP could run out before the end of this or next fiscal year. There are two ways to go - increased financial resources by members of EC or reduced expenditure. The question of increased resources must inevitably be faced with the enlargement of the EC (discussed in the next section) but present members have resolutely turned away from increasing resources simply to fund the CAP. Reduced expenditure is more likely but the form this will take is of critical importance to Ireland. If agricultural prices are allowed only moderate growth in money terms to reduce surpluses (but with prices still higher than world prices and access to the EC from outside still restricted) then market forces might lead to continued expansion in output from Ireland, albeit at lower income levels. There may be some doubt about this if agriculture is cost constrained. The difficulty with this is that national Governments may seek to provide aid to agriculture through, for instance, direct cash payments or subsidies. This will do nothing to continue the transformation of European agriculture. It is for this reason that policy must be European. If, as an alternative prices are maintained in real terms, then surpluses will be contained by quotas and restrictions on output and this would effectively limit the growth of Irish agriculture - not to mention the effect on the allocation of resources in a European context. In recent years more strategic reasons for surplus production have been given, e.g., the need to feed the world's poor, the need to pay for oil imports, the benefits from being able to provide food aid for Poland etc. Were these any of the stated aims of policy then they could be evaluated in terms of success or failure and, of course, the question of alternative ways of achieving these ends needs to be examined.



In addition to the fact that the resources may not be there for uninhibited growth of expenditure on agriculture there are other compelling reasons for believing that the present system is untenable. First, the UK as a net food importer is resistant to higher food prices. The resistance of the UK provides the immediate spur to reform. Second the gap between CAP prices and world prices for most products is so large that the EC will be under pressure from outside the Community for increased access and from inside the Community to lower prices through imports. Third, there is resistance among outside countries (and in some cases from producers in countries within the EC) to dumping of CAP surplus on world markets. The US in particular could adopt other commercial policy measures to influence the CAP. Fourth, public opinion within the EC is resentful of large surpluses, rotting or destroyed food, wine lakes, butter mountains etc. Fifth, the spirit of Lome I and Lome II will require greater access for food products of the ACP countries associated with the EC, and their products may compete with products of EC members - either directly or indirectly. We cannot simultaneously promote beef production in Black Africa and refuse access to markets to beef producers. Sixth, it is clear that the share of total EC expenditure going to agriculture is disproportionate to agriculture's importance in the Community. There are areas of more pressing need, e.g., unemployment, social policy, energy, where the returns may be greater and where there are clear public demands.

Finally the ultimate objectives of the CAP and the consistencies of these objectives need to be examined. The target population of farmers needs to be identified. The target income of farmers must be defined - including some notion of distribution between farmers. It must be decided whether the CAP is really an element in social policy or something more or something less.

This rather lengthy digression on the CAP is designed to show the difficulties likely to be faced in just one area and the pressure for change.

The situation is more complex when viewed against projections of a continuation of present trends with no further moves towards integration and no concerted policies. At a recent conference\* a broad scenario for the EEC was given, very similar in outline to that quoted earlier for the industrial world. In very broad terms growth was projected at 2 per cent per annum in the period 1980-1985 increasing to 3 per cent in the period 1985-1990. Inflation rates were expected to average 3-4 per cent in low inflation countries and 9-10 per cent in high inflation countries. Employment was expected to fall by

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\* IFO Institute Munich "Europe in the 1980's".

about 1½ per cent in the first half of the 1980s and then to rise by about 2½ per cent in the second half with productivity in the range 2-2½ per cent per annum. Unemployment was expected to continue to rise. World trade was projected to increase by 4-5 per cent per annum in the first half of the decade, rising to 6 per cent per annum in the second half. The European Community as a whole would almost certainly remain in deficit throughout the 1980s because of higher oil prices - balance could only be restored at the expense of other major blocks, e.g., US or Japan.

#### The Expansion of the European Community

In the previous section I have indicated that the expansion of the European Community to include Spain and Portugal is inevitable. This expansion and the recent inclusion of Greece involves changes in the economic environment confronting Ireland within the Community.

The most obvious effect will come through the net contribution to or receipts from the EC budget. The enlargement of the EC will increase the claims on the EC budget without a similar increase in resources, given present methods of determining the resources of the European Community. Recent research indicates that Greece and Spain would be net recipients from the EC with Portugal being marginal. It follows that if resources are fixed there would be a decline in the resources available to Ireland and that the effect would come through the Common Agricultural Policy Guarantee section, because of the importance of agriculture in the new member countries, and reductions in our share of the Regional and Social funds where the claims of the new members would carry some weight given their income levels. Furthermore even though current agricultural products from Spain and Portugal might not seem a threat to Irish exports it is impossible to predict the supply response in the new countries to the much higher prices for a wide range of commodities in the present Community. Even where resources are increased the new members would still be net recipients and the absolute position of Ireland would worsen because of the increased contribution to the budget. This analysis abstracts entirely from the whole question of the reform of the CAP.

The expansion of the EC will also adversely affect new foreign investment in Ireland. In an earlier section it has been suggested that total investment in industrial countries will be weak and that this will be reflected in the amount of internationally mobile investment. The membership of Greece and of Spain and Portugal provides firms outside the EC with a wider range of locations with access to EC markets. The new members have the added advantage,

in attracting new firms, of being relatively low wage and low cost countries. Spain, in particular, has a large industrial base a sufficiently large industrial workforce and a common land frontier. For US multinationals with Latin American experience, Spanish and Portuguese are not a disadvantage. It must be expected that the new members will attract new foreign investment that might otherwise have come to Ireland.

Finally, the expansion of the EC is likely to do very little in the way of trade creation between Ireland and the new members. By contrast Ireland is likely to face more severe competition within the EC from the new members. Thus the enlargement of the EC will tend to affect Ireland adversely and this is a further negative influence over the future.

### Protectionism

The slow growth of the 1970s aroused fears of explicit generalised protective measures between countries. There was, in fact, no such general move towards protection. There were, however, a very large number of very specific measures designed to protect individual firms and sectors in response to lobbying. With the expected low growth of the 1980s there will inevitably be pressures for further extensions of protective measures and these may affect access by Irish producers to markets abroad. In general the small scale of Irish industry makes it implausible that specific measures would be taken against Irish firms but they would be affected by sector specific measures undertaken by other countries. Such measures in themselves may be a response to other restrictions - for example newly industrialising countries confined within the Multi-Fibre Arrangement may seek to restrict imports from the EC. Similarly, Japan could extend further its non-tariff barriers in response to the "voluntary restraint" imposed on its car exports.

The large numbers of specific measures of protection already in place increases pressure for new measures. The factors likely to favour the spread of protection rather than trade liberalisation are the present high level of unemployment in industrial countries, the regional concentration of sectors within countries, the extent of monopoly control in adversely affected sectors, the degree of unionisation and centralisation of unions and finally the costs of lobbying. The likelihood must be that commercial policy will be more active throughout the 1980s - sometimes disguised as employment subsidies, capital grants for restructuring etc.

The World Environment - Summary

In this section I have attempted to indicate the type of unfavourable international economic environment we must operate in over the 1980s. World growth and trade will be weak because of concern with inflation, debt service and the deflationary biases from higher oil prices. The poorer growth will adversely affect total investment worldwide and hence the amount of internationally mobile capital. For Ireland within the EC there will be more intense competition for the limited investment from prospective new members of the Community. The benefits from the CAP are likely to be reduced because of limited resources. The EC, however, has an internal dynamic which may push towards greater integration and concerted policies. With the weakness in world trade and output protectionism is likely to spread - not explicitly but in the adoption of specific sector policies.

## THE DOMESTIC FISCAL ENVIRONMENT

The domestic fiscal environment over the coming decade will be dominated by attempts to reduce and eliminate the current budget deficit and by attempts to restructure government capital expenditure. There are, of course, other elements of the domestic economy - most notably the expected growth in the potential labour force discussed in another paper in this Conference - but I am here concerned with the general domestic demand situation as affected by fiscal policy.

In the past year there have been frequent calls to reduce the Government Borrowing Requirement, countered by an appeal to the needs of the society in terms of investment, job creation, growing labour force, etc. Those concerned with the Government Borrowing Requirement, however, are very much aware of "needs" - even if the economy were fully employed and the government were in fiscal balance there would still be needs. The concern with the Government Borrowing Requirement arises because of the belief that its level is unsustainable, that it has its own dynamic and would, if unchecked, automatically worsen over time, that future adjustment would be more costly in terms of output and employment, and finally that its growth induces undesirable effects on the supply side.

The level of the Borrowing Requirement is related to the level of the Balance of Payments Deficit on current account. Movements in the Borrowing Requirement affect the level of aggregate demand in the economy and this in turn affects the level of imports and the state of the current balance of payments. Some changes in the borrowing requirement are automatic and simply reflect changes in the economy, e.g., a fall in unemployment would tend to reduce the borrowing requirement, while other changes are discretionary, reflecting deliberate action. Both automatic and discretionary factors affect the balance of payments on current account. The aim of policy over the period of the cycle should be to have the payments deficit no worse than it would otherwise have been. In practical terms this involves recognising that over the period of the cycle the current budget deficit should be in balance and that capital expenditure be self-financing. If the current budget deficit is not zero over the cycle, then the economy will suffer from excess demand relative to the rest of the world. If simultaneously capital expenditure is not such that the capacity of economy is increased to service the debt then the payments deficit is worsened even further.

The question then arises; does the external payments position matter? The answer is that it all depends. It is possible to imagine a variety of situations where the payments deficit does not matter, e.g., (i) if there were unlimited external reserve, (ii) if foreigners were prepared to use Irish Pounds as a reserve currency, (even here the example of both Sterling and US Dollar are cautionary), (iii) if the payment deficit simply reflected leads and lags in current payments, (iv) if the payments deficit reflected investment - self-financing investment - either by the State or the private sector.

The reality in the Irish case is so very different. The external payments deficit is being financed in the main by increasing the net foreign indebtedness of the State sector. Such borrowing is being used to finance the Central Government current deficit and capital projects of limited value in terms of a return enabling the debt to be serviced. Unfortunately, interest does have to be paid. Corresponding to external borrowing in any year a flow of future interest payments abroad arises and this in itself worsens the payments deficit in the future. Such interest payments also enter into the Government Accounts and the current budget deficit also automatically worsens, at current tax rates. In the most recent Quarterly Economic Commentary (July 1981) it was shown, on what can only be regarded as favourable assumptions, that interest payments abroad would rise from 1½ per cent of GDP to 6¼ per cent of GDP between 1980 and 1985, that Government external borrowing would have to rise from 7 per cent of GNP to almost 14 per cent of GNP simply to pay interest abroad and with no fiscal stimulus, and that the absolute rise in interest payments made abroad would be knocking about 1 per cent off any growth in output. The level of external reserves would also, in the absence of other large private capital inflows, begin to fall in money terms and would be inadequate to finance day to day trading at current exchange rates.

For these reasons the level of the external payments deficit and consequently the level of the Government Borrowing Requirement are unsustainable. It cannot be expected that foreigners will provide unlimited funds to this nation. If people genuinely believed this why borrow so little. Clearly it has always been believed that there are limits and that going beyond them would lead to a withdrawal of funds or higher interest payments. It could then be asked why not push to these limits. There are several reasons why a country should not invite sudden adjustments.

First, the scale of the adjustment would be enormous. By 1985, on a neutral policy stance, external borrowing could be as much as 14 per cent of GNP. Failure to raise this would necessitate cuts in government expenditure and increases in taxation beyond anything we are likely to experience by making adjustments gradually over time. The longer it is left the greater the overhang of debt and the greater the required adjustment. The consequences in terms of future output and employment would be much more serious than action now.

Second, a sudden decline in demand does not allow any changes in other variables in the economy. If the adjustment is made gradually then it is possible that costs can be effected gradually with a consequent adjustment in wage rates and investment. There is always the hope that active incomes policies could be adopted - speeding the adjustment even further.

The difficulty with slow adjustment is that the effect of fiscal policy in many areas is not reversible. There can be little doubt that the fiscal expansion of 1977/78/79/80 led to increased prices in the sheltered sector of the economy and to increased wage rates nationally. A contractionary fiscal policy is unlikely to lead to any fall in money wage rates. Similarly, where expansion took the form of increased public sector employment or new services to the community, or reduction in tax rates, these are almost, but not quite irreversible.

While this might seem to be well known there are still daily requests for increased government expenditure and reduced taxation. It is not immediately clear that the society at large has any clear conception of the nature and scale of the problem. Thus the Government in its decision to eliminate the current budget deficit over four years may be embarking on a course that the society does not understand.

The government commitment to eliminating the budget deficit over four years has to be seen against the size of the deficit this year - about 8 per cent of GNP. It will be impossible to reduce this deficit without severely affecting the overall demand situation. The position is, of course, made more difficult by the dynamics of the debt situation, viz., that interest rates are increasing and that interest payments are constantly growing. Thus government will be required to reduce the budget deficit by more than 8 per cent over the four years. In practical terms this will impart a severe demand deflationary bias to the domestic economy in the first half of the 1980s -

taking perhaps as much as 2½ per cent per annum out of GNP. Also because of the dynamic nature of the debt service it may well be the second half of the 1980s before the budget deficit is eliminated.

\* There could also be supply side consequences of reducing the deficit. If the deficit is reduced by increasing indirect taxes this will create major pressure on wage rates. Similarly, if taxes on labour are increased, as seems to be the intention, this will affect labour costs. We could thus be in a classic bind - reducing the current budget deficit, deflating the economy and increasing unemployment, worsening the cost structure of industry because of higher labour costs, not improving it because of some slight downward pressure on wage rates as a result of higher unemployment. The proposed shift from direct to indirect and employment taxes by the government would have similar effects.

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This very fact should give the government cause for concern in its medium term fiscal strategy. The difficulties on the fiscal front are in large part a result of an inappropriate fiscal stance over the previous few years. I do not wish to go into this here as this point has been more than adequately covered in the past. There is another aspect of recent fiscal policy that is rarely touched upon. This stance was ostensibly neutral between different classes of persons. There can, however, be little doubt that there were beneficiaries and that the prime beneficiaries were those already well off. If one were to characterise the gainers they would be married, middle income, private home- and car-owners. It is impossible to say just how much was gained in GNP from the fiscal expansion, as so much of expenditure of people already well off would go into imports - either directly through for instance holidays abroad, or indirectly through their increased expenditure on, for instance, automobiles. Final demand increased, but so also did imports. The effect of a reversal of previous policy in detail would reduce final demand but would improve the payments deficit and the government finances, without any necessary worsening of the competitive position of the economy. It is possible to feel that the overall stance of declared fiscal policy is correct, i.e., deflationary, but that it could be possible to do it in a manner that would not worsen costs to the same extent.

On the revenue side there are other areas - in particular some aspects of health and education where final users could be asked to contribute directly for services. For instance, if school attendance under the age of five is really a child minding service rather than an educational experience, why not pay for it. Similarly it is difficult to justify the poor revenue/cost



relationship in third level education. There will, of course, often be specific problems with charges for services where income levels are very low. It is hard to see how equity is served by the provision of services to all. The correct approach is to deal with the income levels.

There are also implicit revenues lost under the existing tax code - an example being tax relief on interest payments, in particular on mortgage interest. What was possibly designed as an instrument of housing policy is now an encouragement to bigger houses and trading up and exerts an upward pressure on house prices. If the objective of housing policy is to provide "reasonable" housing for people at different stages of their life cycle it is difficult to see how the system of mortgage interest relief contributes to this. Indeed, if the system of housing could be characterised in any way the abiding feature is a mismatch with people whose incomes are high in housing beyond their needs and the poor either overcrowded or homeless.

Of course, once the notion of charges for specific services is raised it is inevitable that areas of expenditure will be examined. Reduction in current expenditure would in general not worsen the cost structure of industry (an exception to this would be if maintenance of the road system were cut). Before expenditure can be cut, however, it is necessary to ask what exactly is the system implied by the whole of State expenditure trying to do. Does the system have its own dynamic, i.e., are the individual units really separate organisms with their own independent growth potential? Is the contractual nature of public servants' employment such that no change can take place without their consent? I cannot give answers to these questions the research in Ireland is pitiful. The most significant piece of work in the area is contained in the NESC Paper No. 37, "Integrated Approaches to Personal Income Taxes and Transfers" which proposed a scheme to integrate taxes and transfers, reduce the unfavourable labour supply elements of the present system and realise savings in public sector employment. Because of the need to reduce the current budget deficit I would see cuts in expenditure through wastage as inevitable. Whether services to the public are reduced will depend on whether the public service itself can see what the system is trying to achieve in total and then integrate and rationalise.

In addition to concern with the current budget deficit there must also be some very serious concern with public capital expenditure. There is a convention in Ireland that expenditure labelled capital is automatically to be undertaken - without reference to its ability to generate a return when

benefits are widely interpreted. Social project appraisal has never been widely used in Ireland yet some central rational means must be found of distinguishing between projects and rejecting some. This applies equally to projects undertaken by semi-State companies. In the nature of project appraisal, some projects would, in fact, be rejected and others expanded. The net effect would almost certainly be a reduction in expenditure denoted as capital. It is difficult in looking at public capital programme expenditure over the past few years to feel that there was an equivalent increase in the productive capacity of the economy from this expenditure. Given the need to reduce the payments deficit through reductions in the borrowing requirement it must be expected that financial stringency would force project appraisal on the public sector and that on balance capital expenditure will fall.

In this section I have concentrated fairly narrowly on fiscal constraints likely to operate in the 1980s. The general picture that emerges is of a major deflationary bias in the system perhaps well into the second half of the decade. On the current side the current budget deficit is expected to be reduced gradually, while on the capital side project appraisal techniques will weed out worthless projects.

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## A PROJECTION FOR THE 1980s

It is necessary to get a feel, in terms of rough orders of magnitude, of likely developments in GNP and some of its components over the 1980s on the basis of the previous analysis. I will summarise the main factors on the demand side.

The world economic environment will remain very weak in the decade. At best growth could be marginally higher than in the 1970s but the likelihood is that it will be lower because of worldwide inflationary fears. This will affect the Irish economy in two ways. First, through the growth of industrial exports from the existing industrial base and secondly through the growth of new investment from abroad. Both are likely to be weaker than in the 1970s because of the weaker international climate. Proposed expansion of the European Community will also adversely affect us in economic terms. There will be increased pressure on expenditure from EC funds without a consequent increase in resources and this will affect the CAP, and the various funds that we currently receive aid from. The expansion will also reduce the relative attractiveness of Ireland for new foreign investment seeking access to EC markets. There will also be pressure to reduce real agricultural prices. Finally, on the external side real oil prices are likely to continue to rise over the decade (discretely rather than continuously) so that the terms of trade will continue to worsen. Throughout the 1970s there was an annual worsening of about 1 per cent per annum, and this could be about the same in the 1980s reflecting weaker agricultural prices and higher energy prices. A continuous deterioration in the terms of trade of this order of magnitude does a great deal of damage to the balance of payments. In 1982, for instance, a 1 per cent deterioration in the terms of trade adds about £80 million to the payments deficit - a sustained rise is, of course, much more serious as it cumulates over time.

The domestic environment is also likely to be weak through demand deflationary measures. This will affect government consumption expenditure directly through reorganisation and rationalisation, capital expenditure through more control of projects and finally consumer expenditure through the effects of increased taxation. Consumer expenditure will, of course also be weaker because of the induced effect of declines in other variables.

Together the external and internal demand deflationary bias add up to a poor picture for developments in the 1980s. If we assume no change in the competitive position of the economy, the picture for the 1980s - in very broad terms - is given in the table below. The assumptions on the demand side are as given above and the projection is based on average experience in the 1970s for the relationship between exports, investment, government, consumption and imports.

## GNP GROWTH 1970-1990

	1970-1980	1980-1990
% Change		
Private Consumption	2½	½
Government Consumption	5	-1
Investment	5	1
Exports	7½	6
Imports	6½ . . . ? . . .	2½
GDP	3½	2½
GNP	3½	2
Terms of Trade	-1	-1
% GNP in	1980	1990
Current Budget Deficit	6½	0
Current Balance of Payments Deficit	8½	6

The figures in the table are those consistent with the picture we have drawn of developments in the 1980s. In spite of the elimination of the current budget deficit the external payments deficit still remains at about 6 per cent of GNP. The principal reasons for this are the effect of the growth in interest payments abroad and the deterioration in the terms of trade. Indeed, adjusted for the terms of trade GNP would grow by little over 1 per cent. The figures should not be taken as suggestive of a smooth path. In reality the real weakness is concentrated in the first half of the decade with some recovery in the second half as world trade grows more rapidly and when the current budget comes back into balance.

The assumption of no change in the competitive position of the economy is equivalent to an expectation that wage inflation will remain very high following the high degree of price inflation already in train. High wage inflation will then be validated by exchange rate movements reflecting

differences over the decade in relative cost inflation.

The projection implies a fall in the growth of GNP from  $3\frac{1}{2}$  per cent per annum in the 1970s to 2 per cent per annum in the 1980s. As overall employment between 1971 and 1981 grew by about 1.1% per annum the implication is, other things, remaining equal that employment will not rise over the decade. What this means in terms of unemployment is that the level of unemployment could increase by over 300 per cent between 1980 and 1991, given the age structure of the population. However, one only has to carry out this exercise to realise its futility. An increase of this order of magnitude (with one quarter of the potential labour force unemployed) cannot but affect the way in which the economy functions. The emergence of increased unemployment will induce changes in the economic system. The most obvious ways will be through the effects on wage rates, increased emigration, the continued growth of the black economy, more movement in and out of the labour force and reductions in participation rates. The adjustments in the economy will come through primarily in the effects on wage rates and the growth of the black economy. If the existing institutional framework for wage negotiation is not modified under the pressure of increased unemployment then there will emerge a dual type economy with very high wage rates in one sector and low wage rates in the other sector. Because these sectors will be competitive with each other in many areas, wage rates and employment in the high wage sector will be forced down. This process takes time and causes severe hardship. During this process emigration as a factor will also tend to emerge once again. As wage rates are forced down inflation will be reduced and exchange rate movements will be less or non-existent. It is possible that the shift in wage rates may result in competitive gains. Even with these sort of adjustments the unemployment situation will remain serious simply because of the lags in the system.

The Ireland I have described in this section is not even remotely close to an ideal. It is an economy of little change in living standards in the aggregate, and of much hardship and poverty in the particular. The primary reason for this is the need to sort out the public finances to avoid a worse situation, coupled with the growth in the potential labour force. It is possible through social welfare payments and public works programmes to contain the worst aspects of hardship and poverty if the poor and unemployed are quiescent, but it is doubtful if that sort of society is worth having.

## POLICY FOR DEVELOPMENT

Faced with the situation described in the previous section there are quite different individual responses.

For the economist the traditional instruments of demand management policy are such that they can only be used to prevent a worsening situation. There is no possibility of fiscal expansionism. The semi-state sector is currently going through a period of financial retrenchment and there are no obvious new projects or areas that new state companies can expand into. If anything is to be done through the public sector e.g. direct employment it will involve increased taxes for finance and the scale of required taxation would be enormous.

For the citizen the scale of the problem is hardly understandable yet they have an expectation that the problems can be sorted out. This expectation has been fostered by a belief that there are costless solutions to all problems, by the claim of economists to understand how the system works and by the claims of politicians to represent and lead the people.

For the politician the future is unenviable. It is clear that traditional policy instruments can provide nothing to ease the necessary adjustment of the decade. It is not merely a question of re-election but the livelihoods of very many people. This is not a game with numbers or debating points in parliament and for that reason the politician can legitimately ask what changes in institutions or parameters would be required to ease adjustment and to initiate employment growth. In essence given the demand situation outlined earlier this amounts to asking how costs in Ireland can be improved to increase market share abroad and reduce competitive imports.

Alternatively, given the productive potential of the economy - as indicated by the capital stock and the growth in the potential labour force - can the cost structure of the economy be varied to realise balance of payments and employment gains?

Variations in the cost structure of the economy do not come within the ambit of traditional policy instruments seen as a whole. The cost structure reflects the specific natural resource endowment of the country, the legal system and enshrined constitutional rights, the physical infrastructure (roads, harbours, communications), the size of the domestic market, the size

of the domestic market, the size of the non-farming self-employed labour force, the level of incomes and the shape of income distribution, work customs and practices. Seen this way changes in the cost structure would affect perceived natural and constitutional rights, and behavioural relationships e.g. the relationship between unemployment, wage rates and the distribution of income. Of course changes in any event would be inevitable - induced by the weight of unemployment in the coming decade. It is idle to pretend that present property rights or wage rates could be maintained in the face of the hardship and poverty of the future. The question that arises is: is the society prepared to sacrifice perceived rights and change behaviour patterns as a response to expected difficulties, or will those changes be induced with a lag in reaction to actual difficulties. I still retain the hope that society will in fact voluntarily vary the cost structure.

The largest single element in domestic costs is labour costs. If we are prepared to treat labour costs as an instrument of policy this would provide an instrument for significantly easing the difficulties over the future. This occurs in several ways.

First, in the exposed sector of the economy it increases cost competitiveness at the margin. An increase in cost competitiveness will be reflected in increased market share abroad and at home. This may come about for purely price reasons or because improved profitability can be used to increase marketing, improve quality, increase stocks and improve delivery dates.

Second, variations in labour costs affect the relationship between the price of labour and the price of capital at the margin. There would thus tend, again at the margin, to be some substitution towards labour in new investment. This would apply in both the exposed and sheltered sectors.

Third, variations in labour costs would reconstitute the financial position of the corporate sector providing them with the funds for increased capacity expanding investment.

Fourth, variations in labour costs would provide some control in the growth of average public sector pay and hence in the extent of tax increases necessary to reach and maintain a current budget balance.

Fifth, variations in labour costs would provide income relief for farmers caught in a low CAP price rise/high domestic inflation situation.

It is easy to see the obvious benefits from variations in labour costs. It is quite another thing to realise these benefits. Among industrial countries there are few examples of successful policies on labour costs to maintain employment. The most outstanding is Austria which simultaneously has few fiscal problems and low inflation. Both Norway and Sweden have been successful in decelerating income and price inflation - but in Sweden's case at the cost of a deterioration of the fiscal system which cannot be maintained. Germany and Japan have also been successful in moderating wage and price inflation but this has involved severe fiscal and monetary restriction. Belgium by contrast has not been successful in moderating wage inflation and has suffered high unemployment, high inflation and fiscal imbalance - but it seems that with a long lag wage and price inflation may be moderating under the impact of high unemployment. In the U.K. the lags seem to be as long.

Any success with variations in labour costs depends on the structure of industrial relations and on a common understanding of the problems, and a willingness to deal with fears that arise. All these factors are important, singly and jointly.

First the structure of industrial relations is important. There should be: central organisations of employers and trade unionists; a forum for regular contact and discussion between these central organisations; agreements negotiated and contracted at the national level; contact between members and central organisations to ensure compliance with agreement on both sides; and finally a body recognised as independent providing objective data, forecasts and analysis to the social partners.

Secondly there should be a common understanding of the nature of the problems faced by the economy. Without this we can throw our hat at change.

Assuming that the structure of industrial relations has the characteristics listed above - some could argue that we already have them - and this common understanding of problems are the difficulties likely to be faced. The difficulties are legion. Any call for variations in labour costs reduces to a call for reductions in wage rates of organised workers. Since we are concerned with the external account this might seem to reduce further to workers in the exposed sector of the economy, (in industry and the tourist service sector) - people who by the standards of workers in other sectors and by the standards of the self employed are not well paid. This difficulty is heightened by the more obvious fact that the call for income restraint comes



in general from those already well off and indeed engaged in a ceaseless quest to become better off. There seems little that can be done but to face this issue honestly. I have already referred to the bias of taxation and expenditure changes over the past years. This needs to be reversed, not only because of the immediate balance of payments requirements of the economy but also on simple equity grounds. Not only this, income restraint must be seen to operate between the exposed and the sheltered sector. In many areas in the sheltered sector incremental salary scales are the norm, whereas this is not common in the exposed sector. Incremental scales are often a contractual right (as indeed is promotion in some areas), yet they can make nonsense of an income restraint policy. The situation vis-a-vis the self employed is even more difficult as we know so little about their incomes, it is widely believed that income tax allowances are too generous and that incomes are deliberately understated to reduce the tax burden. Where it is believed that tax receipts from the self employed are too low this is simply a question of a change in the net incentive, changes in allowances and more resources through the Revenue Commission. A move towards a general negative income tax structure could provide all of these. Where income levels are already very high it is necessary to decide if these are due to restrictive practices on entry, temporary shortages or monopoly pricing. If so then freeing the labour market would act as a powerful brake on income growth.

In addition to these more obvious problems of equity there are problems arising from differences between sectors and firms. At the sectoral level some sectors may be in long term decline. Variations in labour costs at best can slow down this decline since there will be no expansion or investment from restraint. In other cases management, even in a growing sector, may simply not be up to it, and restraint is lost in bad management. Finally of course owners may see restraint solely in terms of higher dividends. At any point in time all these factors will be at work pulling against the notion of restraint and increased cost competitiveness. Where sectors are in long term decline these can be identified beforehand and realistic expectations formulated. Bad management is more difficult to track particularly if a sector is in decline - movements in financial aggregates and ratios can perhaps provide a clue to individual company performance and problems, but these have to be available in a timely manner. Where investment is not taking place in spite of increased profitability the tax system can be used to cream off excess profits. This might prove necessary in any event for many small firms where investment expansion is not practical simply because of the very small size of firms.

For the corporate sector the most significant changes would be the necessity to provide accounts for other than tax purposes, to have performance monitored by other than owners and by the transfer of rights to workers because of labour cost variation.

Over the past 20 years there have been constant calls for effective incomes policies. Unfortunately it has never been possible to state with absolute certainty that for instance if income levels were 1 per cent lower than employment would be  $\frac{1}{4}$  per cent or  $\frac{1}{2}$  per cent or 1 per cent higher. Nor was it possible to indicate the timing of increases in investment and employment as there may be long lags in the system. The growth of new industry and the changes in industrial structures over the last two decades renders the results of statistical analysis very uncertain. This does not mean that such a policy is incorrect, merely that we cannot be certain of the magnitudes or the timing. We can be certain of the direction i.e. positive. The much feared, but rarely quantified, effect on domestic consumer demand of variations in costs are short term and may even be overcome in the short run by the external impact, depending on the phase of the world trade cycle. Next year world trade growth is likely to be greater than in the recent past and offers a suitable opportunity for variations in costs.

As an interesting example of what might be expected from variations in costs the most recent medium term strategy for the Swedish economy envisages two alternatives up to 1985. In the first, the Swedish Economy experiences cost advantages vis-a-vis competitors and in the second, development remains as it was in the 1970s. In the first case average hourly earnings up to 1985 are assumed to grow by 8.5% per annum whereas in the second case average hourly earnings grow by 11.2% per annum. The differences come through primarily on exports and imports with exports and imports rising by 7.3 and 3.5 per cent per annum under the first alternative and 2.6 and 4.1 per cent in the second. GNP in the former case increases by 2.5 per cent per annum and employment rises by 1.2 per cent per annum. In the second alternative GNP rises by 1.1 per cent and employment would fall. Because of the importance of the sheltered sector the different wage assumptions lead to differences in the rate of inflation  $8\frac{1}{2}$  per cent in the first case and  $10\frac{1}{2}$  in the second. In the first case budgetary balance is restored by 1985 and the economy can continue reasonable growth while in the second the deficit worsens and by 1985 the Swedish economy has to do it all over again.

What drives this particular economy to virtue is the variation in labour costs - in effect a 2 per cent per annum reduction in the growth of labour costs leads to a restoration of budget balance, steps to external balance and increased GDP - of 1.4 per cent.

It is of course very risky to translate these types of figures for one economy onto another. The Irish economy is more open, the product range is quite different, and competitive imports are almost certainly less than in Sweden. Yet even preliminary investigations of our own suggest that the results of variations in money incomes on employment and GDP are not trivial. A reduction of 2 per cent per annum in labour costs relative to other countries could have a significant cumulative effect on output, employment and inflation - what this means is that if labour costs on average in other countries are rising by about 10 per cent we should be aiming for increases of about 8 per cent.

If the growth rate of GDP were 4 per cent over the decade because of competitive gains the employment position would be very much better with employment increasing by  $1\frac{1}{2}$ -2 per cent at worst leaving the present level of unemployment, and at best reducing it to about 60 thousand.

While a variation in labour costs is clearly the most important element in increasing cost competitiveness it is not the only element. The State does have a supportive role in other areas. The most obvious is in infrastructural development - more particularly in road and communications expenditure. In all of this there is a need to be cost effective. It would be interesting to compare costs in roadbuilding here with those in other European countries from the initial conception of a road to its completion. How far does the existing legal and planning system and property rights add to costs. Similarly in terms of the telephone system it would be interesting to know why new installations per person employed are so low.

Over and above this the State can seek to anticipate changes in industrial structures and ease change. If skill shortages are likely to emerge then training programmes can be adapted. If skill shortages already exist the State can help in reducing barriers to entry and in encouraging new entrants through training schemes. If regional mobility is a problem for purely institutional reasons e.g. different requirements for Local Authority Housing, then the State can seek to ease regional mobility. The role for the State would be interventionist to make the market elements in the society function better and the non-market elements function in a more cost-effective manner. If the

State sector sees profitable investment opportunities these opportunities should be pursued. Finally the State has an information role e.g. in marrying up needs and suppliers in industry and in indicating new products and processes.

It is only through measures such as these that we can mitigate the worst effects of necessary deflationary action and take some steps to increasing employment. If we cannot even do this, once having been warned, then in truth, the dream is over.