BUDGET PERSPECTIVES

Proceedings of a Conference held on 27 October 1998

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Tim Callan and Brian Nolan are Research Professors, Tony Fahey is a Senior Research Officer, Philip O'Connell and Sue Scott are Research Officers, David Duffy is an Assistant Research Officer and John Walsh is a Systems Analyst with the ESRI. Bernard Feeney is Principal Consultant with Goodbody Economic Consultants. The paper has been accepted for publication by the Institute, which is not responsible for either the content or the views expressed therein.

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**Tim Callan, David Duffy,
Tony Fahey, Bernard Feeney,
Brian Nolan, Philip O'Connell,
Sue Scott, John Walsh**

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OPENING ADDRESS

Brendan Whelan

Focus of the Conference

I would like to welcome you all to the Conference. The ESRI is delighted to be collaborating with the Foundation for Fiscal Studies in running the event. It is a fundamental objective of both organisations to see economic research applied to topics of current policy interest and disseminated as widely as possible. To open the proceedings I would like to outline the purposes which we feel the Conference can serve, talk briefly about the topics to be covered and our approach to them, and perhaps also indicate what the Conference is not designed to cover.

The annual Budget is an important component of national economic and social policy-making. In any one year, however, the constraints imposed on the Minister on both the revenue and expenditure sides are considerable. Previous commitments limit his discretion, as do available resources and the general macroeconomic situation. A series of budgets across a number of years can nevertheless be of substantial significance provided the measures adopted are coherent, consistent and effective.

It is, therefore, towards the discussion of policy in this medium-term framework that our Conference is mainly addressed. We have selected a number of key topics on which research has been conducted at the ESRI and have tried to present as clearly as possible the implications of this research for budgetary policy. As with all ESRI research, we do not have a corporate or institutional view: the conclusions you will hear are those of the authors themselves, although grounded in systematic research and honed in the light of peer review by their colleagues.

The Macroeconomic Perspective

The first paper, by David Duffy, one of the authors of the Institute's *Quarterly Economic Commentary*, addresses the macroeconomic framework within which the Budget must be constructed. This paper notes that the factors which have been driving the recent high level of economic growth in Ireland continue in the main to operate. It reviews thinking on the current international difficulties and concludes that the most likely scenario for Ireland is a moderate slow-down, rather than sudden collapse. The overall fiscal stance of the Budget must be prudent so as to avoid putting excessive strain from domestic sources on a rapidly growing economy. The paper also emphasises, as previous *QEC*s have done, the importance of preserving the partnership approach to wage determination so as to secure long-term sustainable growth in incomes.

I would like to emphasise how important this is. Hardly a day goes by without some group or individual publicly bemoaning the fact that they "haven't seen the Celtic tiger around here", and pointing to the relatively modest increases agreed under the Partnership Programme. Such comments ignore the most important benefits of the recent boom: the huge improvement in the job prospects for school leavers, as demonstrated by the Annual School Leavers Surveys, the unprecedented employment growth leading to broadening of the tax base and declining tax rates and the scope for substantial improvements in social services. Sustaining these benefits in the context of EMU requires continued moderation in wages matched by a distribution of the gains which is generally accepted as fair and equitable.

Income Tax and Social Welfare Policy

The second paper addresses key issues about the impact of budgetary policy on the distribution of the gains from growth. How have tax and welfare policy affected the distribution of gains and how can they be directed towards meeting agreed targets for reductions in poverty in the future? The work is based on SWITCH, the ESRI tax-benefit model, which, for the first time, allows us to assess accurately how incomes have been affected by changes in tax and transfer policy. The paper emphasises

the centrality, and cost, of indexing social welfare payments to growth in earnings. But only by linking social welfare rates to overall earnings growth can relative poverty be kept in check or even reduced.

Labour Market Programmes

Philip O'Connell examines a key area of expenditure – active labour market policies. He shows that Ireland is a big spender on such initiatives, both absolutely and relatively. We spend 1.75 per cent of GNP on these programmes compared with an EU average of about 1 per cent. He argues that in our situation of rapid employment growth, combined with continuing high levels of long-term unemployment, too much emphasis on the short-term unemployed is misplaced. He believes that refocusing of active labour market policy on the long-term unemployed is called for.

Transport, Taxes and the Environment

Susan Scott and Bernard Feeney examine taxation in the transport sector and call for shifts in taxation in relation to diesel fuel, public transport, heavy goods vehicles, air transport and free parking. The underlying logic of their paper is to use such fiscal instruments to encourage environmentally benign behaviour.

Childcare

Tony Fahey looks at the issues involved in the provision and tax treatment of childcare. He emphasises the huge costs involved in major initiatives in this area and questions the belief that tax allowances are an appropriate policy instrument for this purpose. On balance he feels that its effects are likely to be regressive, and that superior policy instruments exist or could be introduced instead. The appropriate policy mix depends on the weight attached to conflicting policy goals.

Final Comment

We have not, of course, tried to formulate a comprehensive set of budgetary proposals at the Conference. Our objective is, rather, to focus attention on the medium term issues arising in a number of key areas and to make some suggestions which will lead to effective policy measures.

We do not envy the Minister his task in trying to bring coherence to the plethora of claims, counter-claims, demands and suggestions to which budget negotiations give rise. It is to be hoped that our analysis will clarify his choices and perhaps help to produce some measure of consensus on the steps to be taken.

Chapter 1

BUDGET 1999: A MACROECONOMIC PERSPECTIVE

David Duffy

1.1 Introduction

In any consideration of a Budget, past or impending, it is necessary to remember that it is a multi-faceted event. At the macro-economic level the Budget surplus or deficit can play a role in stabilising or destabilising the economy. The pattern of expenditure, and more particularly taxation, can influence the distribution of income and thus the nature of society. Various economic and social goals are targeted through spending decisions. Less obviously, policy aims can be approached through the impact of taxation on relative prices. All of these aspects will be considered in different papers to-day, but in each case it should be borne in mind that, whichever facet is under direct consideration, the other facets cannot be ignored.

This initial paper deals with the macro-economic aspect of the coming budget. As with the other aspects, an individual budget needs to be seen as a single step in a continuous process, so that it is partly conditioned by previous budgets and will affect future ones. Thus an excessively short-term view should be avoided, and a reasonably long time horizon is needed to gain a perspective of the environment in which the budget will be delivered. Before considering the immediate prospects for 1999, it is thus important to understand the forces which have been driving growth in the Irish economy.

1.2 Recent Performance

The Irish economy has displayed very strong growth in recent years and since the late 1980s has transformed itself from the "poorest

of the rich"[1] to "Europe's shining light".[2] The 1997 *National Income and Expenditure* accounts show that growth in GNP between 1991 and 1997 averaged 6.3 per cent. Much of this has occurred since 1993. Between 1994 and 1997 real GNP growth averaged 8.1 per cent and appears to be well balanced between domestic demand and exports. At the same time, despite some recent upturn, the growth in inflation and in average industrial earnings has remained low (see Table 1.1).

The high public deficits experienced since the late 1970s have also been corrected, the average Exchequer Borrowing Requirement as a percentage of GNP in the period 1991-1995 was 2 per cent compared with an average of 13 per cent in 1981-1985. Since then the public finances have further improved and a general government surplus was recorded in 1997 and will be repeated in 1998.

Employment growth has been strong over the past few years. The numbers at work increased by 40,000 in 1996 and 64,000 in 1997. Reflecting this positive performance the unemployment rate has declined steadily since 1994, although it is still substantially higher than average rates in the 1960s and 1970s, a legacy of the prolonged recession of the 1980s and the depressed labour market in that period.

1.3 Forces Behind the Success

Much has been written about what underlies the success of the Irish economy. In truth there are a number of factors, both short- and long-term, none of which alone account for the performance of the economy. A more comprehensive account of what has been driving growth than is contained in this paper is given in the ESRI *Medium-Term Review*[3] but it is useful to highlight those elements which have contributed to the success. The factors which have had an impact include:

Demography and the Labour Market

The Irish population structure during the 1990s is unusually favourable. The expansion in the labour force is resulting from the

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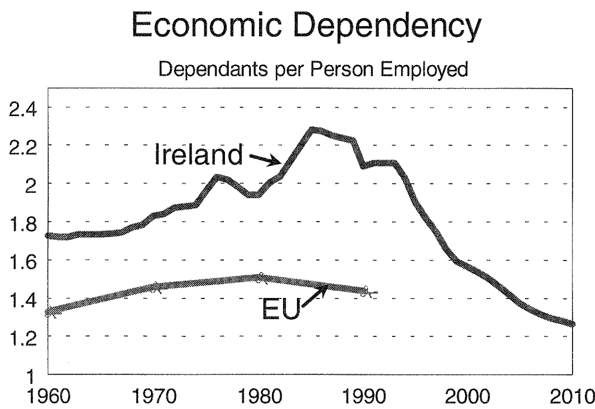
[1] *The Economist*, January 16th (1988).
[2] *The Economist*, May 17th (1997).
[3] Other commentators include Honohan (1997); Leddin & Walsh (1997); Tansey (1998); Walsh (1996).

natural increase in the working age population reflecting the baby boom in the 1970s. In addition, there has been a rise in female labour force participation rates and in recent years strong net migration inflows.

Since the 1960s the Irish economy has had to cope with economic dependency levels (the numbers not working in the population compared to the numbers in paid employment) that were exceptionally high (see Figure 1.1). At the peak of economic dependency in the mid-1980s, there were nearly 230 dependants for every 100 workers. The Irish economy is now entering a period when the demographic structure has moved in its favour. ESRI demographic projections suggest that this will last until about 2010 when the dependency ratio will have fallen to 125 dependants per 100 workers and thereafter, the demographic situation again starts to become less favourable.

Figure 1.1:



Source: Duffy, Fitz Gerald, Kearney and Shortall (1997)

Growth of Human Capital

Ireland made the decision to provide free secondary schooling in the late 1960s with an obvious effect on the stock of human capital. Of the age cohort now retiring, born 1930-1935, 60 per cent had only primary education and only 12 per cent third level. The cohort entering the labour market, born 1975-1980, have 6 per cent with only primary education and 47 per cent with third level.

Figure 1.2:

Source: Labour Force Surveys & ESRI Forecast.

Long-term Stable Industrial Policy

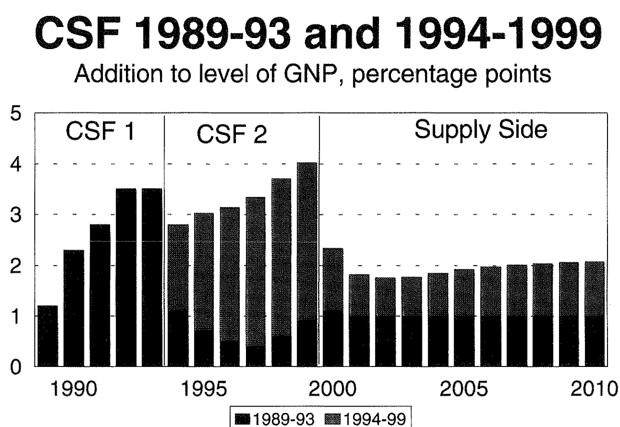
Since the late 1950s Irish industrial policy has been strongly oriented toward attracting foreign investment through the use of both fiscal and financial incentives. This policy has remained consistent through successive governments. A benefit of this prolonged and consistent policy is that it has helped in the process of establishing a modern, favourably balanced internationally competitive industrial base in Ireland.

EU Membership and Structural Funds Investment

The EU has been a feature of economic life in Ireland for nearly 25 years. Membership, which copper-fastened the increasing openness of the Irish economy and most importantly gave access to the single

market, has benefited long-term competitiveness and developed the physical infrastructure. The growth in EU transfers from the structural funds during the late 1980s made a significant direct contribution to growth at an important time of economic change.

Figure 1.3:

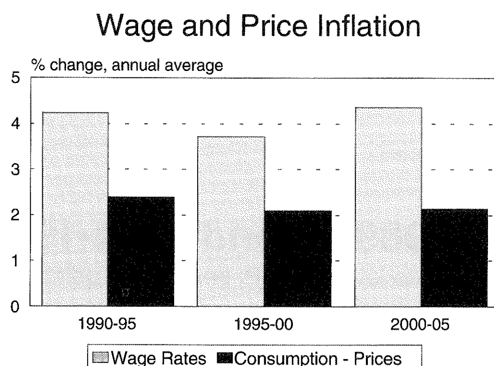


Source: Duffy, Fitz Gerald, Kearney and Shortall (1997).

Consensus Economic Strategy

The necessity to tackle the serious economic situation of the 1980s resulted in a consensus approach to economic strategy. This strategy, which has been maintained under a series of agreements has resulted in moderate pay increases, low inflation and has facilitated good industrial relations and improved competitiveness.

Figure 1.4:



Source: Duffy, Fitz Gerald, Kearney and Shortall (1997).

1.4 Short Term Outlook

International Environment

An important factor determining the course for a small open economy such as Ireland is the outlook for the world economy. This is currently more important than usual. It is difficult to assess what the various financial crises will mean for the world economy. Although the ultimate impact is still not entirely clear it is safe to say that the international environment will be less favourable in 1999 than in recent years. The Asian crisis has become more deep-rooted and has had an adverse impact on the Japanese economy. This, combined with the Russian crisis, means that we anticipate growth in output and world trade will slow although this will be offset to some extent by a decline in interest rates internationally. How the balance between these factors evolves will determine the course of the world economy.

The IMF have recently revised down their forecast for world economic growth to 2 per cent in 1998, down a full percentage point from the May *World Economic Outlook*. Growth is projected to increase in 1999 to 2½ per cent, down from the May forecast of 3.7 per cent. The IMF report states that "For the future euro area, it is expected that the momentum of recovery will be reasonably well sustained, and for the

United States, it is projected that the economy slows markedly in a 'soft landing', without falling into recession". Admittedly this is their baseline scenario and it is acknowledged that there are significant downside risks.

Regardless of the recent performance of the economy Ireland cannot consider itself immune from any international slowdown. However, provided the international environment does not deteriorate into recession then a slowdown may in fact prove to be a positive development. The international slowdown could help the Irish economy to return to a sustainable growth rate, from the unsustainable pace of recent years.

The international slowdown would have serious implications for the Irish economy if it became so severe as to have a significant impact on FDI flows. Ireland has benefited from the presence of a large multinational sector. If FDI inflows were to display a marked fall or indeed if existing foreign companies were to publicly scale back their current investments this would have an adverse effect on confidence domestically as well as affecting export levels in the new millenium. However, a small reduction in FDI flows could help reduce congestion and capacity constraints in the short-term and allow for investment and measures to deal with the problems.

The Domestic Economy

While budgetary policy must be part of a longer term plan it cannot ignore the short-term needs of the economy. The short-term outlook for the Irish economy, based on the *Quarterly Economic Commentary*, is also positive, albeit subject to a higher degree of uncertainty and risk.

The growth factors outlined in Section 1.3 have continued to operate strongly during 1998 against a background of European recovery. It now seems likely that real GNP growth for the year will be in the region of 8½ per cent. The growth factors will continue to operate during 1999 ensuring that the Irish economy enjoys a good relative performance.

The absolute level will ultimately depend on the world economy. As has already been said, no one at this stage knows the outcome for the international environment. Comparisons have been made with the

1929/30 crash but in fact the differences from this scenario vastly outweigh the similarities. In recent decades stock market losses have had little impact on real growth in the advanced economies.

The key for Ireland in the short term is the performance of the continental European economies. At present most European authorities remain sanguine about the impact of the crises. On the basis of what has emerged so far we anticipate that 1999 will see slightly slower growth in Europe, significantly slower growth in the USA and near stagnation elsewhere, including the UK.

Given our international outlook our expectation is for slower Irish export growth. However, we anticipate only a slight reduction in the volume growth of fixed investment, consumption and imports. As a result of this and intensifying capacity constraints we anticipate that growth in real GNP will decline to about 5½ per cent in 1999. The reduction in GNP will mean a considerable slowdown in the increase in employment in 1999.

Substantial increases in the twelve-monthly figures for the consumer price index have focused much attention on inflation. Based on our view that the recent rise in the consumer price index is due to the lagged effects of earlier movements in the effective exchange rate, consumer price inflation is likely to decline over the course of 1999. Sterling is likely to depreciate further against the euro currencies. The twelve-monthly increases in the Consumer Price Index appear to have already peaked at little over 3 per cent and a gradual fall in 1999 to an annual average of about 2.6 per cent is now projected.

The issue of house prices is topical and one that has received much coverage. However, there is some evidence that the rate of house price growth may be slowing. It would be beneficial if the housing market were to stabilise on the basis of measures already introduced as a result of the Bacon report rather than requiring further intervention. We would hope that the rate of new house building must be reaching a point where it will at least match the underlying rate of demand, once speculative and precautionary purchasing abates. This may well happen if the expectation of continuous price increases were removed. We expect that increases in house prices will slow and average a small percentage increase during 1999, compared to recent years.

Medium-term Outlook for Ireland

The ESRI's *Medium-Term Review:1997-2003* provides a picture of what the economy could achieve over the next five years. Irish growth has been faster than was predicted for the early part of the period. This higher than expected growth means that we expect some slowdown in growth during the later years. This will depend largely on the rate of foreign direct investment. For the entire period growth is not expected to be less than the annual average forecast, but probably will not be very much more. Current thinking is that the average growth rate for GNP will lie around 6 per cent for the period 1995-2000. Annual average growth will slow to around 5 per cent a year in the following five years with some further deceleration thereafter.

The return to rapid growth in the mid 1990s has resulted in a strong increase in employment levels. Current ESRI forecasts anticipate a further sustained increase in employment in the period to 2005. For the second half of the 1990s employment growth is forecast to average 3.3 per cent a year falling to 2 per cent a year in the first half of the next decade and to around 1.5 per cent a year for the following five years. It is expected that the growth in employment will be strong enough to absorb all labour market entrants and thus unemployment is forecast to fall from a rate of 10.3 per cent of the labour force in 1997 to 6.7 per cent in 2005.

In the *Medium-Term Review* we forecast that government finances would move into surplus in the next decade, sometime around 2005. However, the buoyancy of the economy saw this occur last year. The continuation of growth should allow a surplus to exist on the public accounts into the next decade, even assuming a significant reduction in EU structural fund and CAP payments. As outlined above, low economic dependency rates will not last indefinitely and some time between 2020 and 2030 the levels of dependency will begin to put increasing pressure on domestic resources. Furthermore, Ireland is moving steadily towards the position where it will become a net contributor to the EU. Under these circumstances it is appropriate that the surplus in the public finances is maintained, and the absolute level of the National Debt reduced, over the next decade.

1.6 Implications for Budget 1999

As an outline of the macro-economic perspective it is not the function of this paper to set out detailed requirements for the Budget. However, it is necessary to say what the short- and medium-term outlook mean for Budget 1999.

Budget 1999 is being delivered at a unique time in Irish economic history. At the end of this year Ireland will become one of the first wave of economic and monetary union member countries. In common with ten other EMU members the euro will become our national currency. Monetary and exchange rate policy will be determined by the European Central Bank. Budget 1999 will be the last budget before EMU but the policies which come into effect next April will need to recognise the changed environment.

At the same time that the dilemma between a slow external and a strong domestic environment exists, EMU membership will require a substantial cut in Irish interest rates. By the time Budget measures come into effect at the beginning of April, official Irish interest rates will have fallen by about 3 percentage points over the preceding year. Ironically, these interest rate cuts, which for much of 1998 would have been damaging for the Irish economy, could now serve to offset the effects of the international slowdown.

The strength of growth in the early part of the period (coupled with improved collection) meant that the public finances are much stronger than the *Medium-Term Review* had forecast for 1998. This benefit will persist as the national debt falls. It remains necessary to take full advantage of the rapid growth to reduce the debt. Within the environment of an international slowdown the government should aim for as large a general government surplus in 1999 as in 1998. Within this constraint it should be possible to implement further tax cuts in the spirit of *Partnership 2000.*

On the basis of the above what stance should the budget take? It will be faced with a multitude of requests for resources at a time when there is much economic uncertainty. The international downturn suggests the need for prudence – building up resources until the full depth of the situation becomes clear. The medium-term demographic outlook points to the need to save now for a time when the dependency

ratio begins to move against the economy again, sometime around 2010. This is offset by the need to address existing and emerging supply side constraints. Budgetary policy must balance these conflicting needs within the requirement that a surplus in the public finances is maintained over the next decade.

Measures contained in Budget 1999 should be aimed at ensuring that the medium term potential of the economy is realised by removing, or at least reducing, short-term constraints. From this perspective Budget 1999 will need to address the fact that some of the resources needed to fuel growth in the future are being used up in the current boom and consequently the average growth rate between 1999 and 2002 may be lower than forecast in the *Medium-Term Review*. Constraints have emerged in the labour market, both skilled and unskilled. Within this context it is important to remember that the *Medium-Term Review* forecasts an unemployment rate of 6.7 per cent in 2005. There appears to be a shortage of rental accommodation for potential returning emigrants, who may also be deterred by the level of house prices as well as reduced amounts of serviced land available for development, either industrial or residential. Budget policy should take steps to reduce such bottlenecks in the economy, within the fiscal stance set out above.

At a time when the economy is growing substantially the opportunity could be taken to address inequalities that exist in society. In my opinion this ties in with the need to ensure that *Partnership 2000* remains intact as part of the strain on the agreement result from the perception that the benefits of the agreements are not reaching all sectors of society. The partnership approach to a series of national agreements is identified in the *Medium-Term Review* as one of the factors that has contributed to Ireland's recent success. The agreements contributed substantially to our competitiveness through moderate increases in nominal pay and had the beneficial side-effect of a sharp fall in days lost to industrial action. A number of recent *Quarterly Economic Commentarys* have stressed the need to protect the partnership approach to pay determination (see QEC July 1998 as example). The commitments under *Partnership 2000* have already been met and interest rate cuts should provide a boost to the economy. There remains a continuing need to address problems within the Irish tax system and Budget 1999 must contain tax measures to encourage labour market

participation. In keeping with overall macro considerations, any tax measures must take account of the need to maintain a surplus in the public finances.

The budget must allow for the fact that the nature of Ireland's financial relationship with the EU will change. This places a requirement on the direction of public finances. Rapid growth in economic activity is putting pressure on the existing physical infrastructure. In the MTR we argued that the decline in structural funds post-1999 would "coincide with a period when economic growth will require increased investment in infrastructure rather than a reduction". The stronger than anticipated growth between 1996 and 1998 means that this day has already arrived.

The *Medium Term Review* identified a number of factors as important to ensure that the positive Central Forecast is realised. According to the *Medium-Term Review* (page ix)...."Key factors in 'making it happen' are:

- Sustaining and reinforcing the partnership approach to income determination so that it survives the pressures from rising expectations;
- Adequate investment must be undertaken to provide the infrastructure essential to future growth;
- The pressures on the environment will have to be controlled by an appropriate use of fiscal instruments such as taxes and charges;
- Prudent management of the public finances to move into surplus in the next decade. (MTR, page ix)."

The majority of these factors are still relevant and in some cases have assumed critical importance. What they also set out is a set of medium term goals that any budgetary policy, be it short- or medium-term, must recognise.

Table 1.1: *Recent Performance and Medium-Term Forecasts*

	1985-90	*1990-95*	*1995-00*	*2000-05*	
	Average Annual Growth Rates				
GNP	3.6	4.5	6.0	4.9	
Investment	3.8	1.3	10.9	4.6	
Employment (April)	1.0	1.8	3.2	2.0	
Average Industrial Earnings	4.8	3.1	4.6	4.1	
Consumption deflator	3.3	2.4	1.9	2.1	
	1985	*1990*	*1995*	*2000*	*2005*
Unemployment Rate [1]	17.0	12.8	12.1	8.6	6.7
Balance of Payments [2]	-4.1	-1.6	3.1	0.8	2.7
EBR[2]	12.1	1.9	1.9	-0.8	-1.8

Notes: 1. ILO basis.
2. Per cent of GNP.

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Chapter 2

INCOME TAX AND SOCIAL WELFARE POLICIES[1]

Tim Callan, Brian Nolan and John Walsh

2.1 Introduction

There has been considerable debate over the "fairness" of recent Budgets. Much of it has focused on how tax cuts have been structured – the extent to which cuts have been delivered through rate and band adjustments as against increases in allowances. We will argue that:

1. Recent budgets have, indeed, favoured high earners.
2. Tax cuts targeted on the low paid would not fully redress this imbalance.
3. Social welfare rates must also rise in line with growth in other incomes if the benefits of economic growth are to be spread more widely across the community.
4. It is possible to achieve reductions in poverty, but not if budgetary policy maintains its present balance between tax cuts and welfare increases.

The key issue identified and examined by this paper is the balance between social welfare increases and tax cuts, rather than the size of the overall tax/welfare package. In our analysis we explore alternative future policies within the overall framework for tax and government expenditure set out in the multi-annual projections accompanying last year's Budget.

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[1] This study draws on the 1994 Wave of the *Living in Ireland Survey,* the Irish element of the European Community Household Panel. Brendan Whelan and James Williams of the ESRI's Survey Unit were responsible for the survey design, data collection and database creation.

2.2 What is a "Fair" Budget?

While all would agree that the Budget should be "fair" in its distributional impact, this tends to mean different things to different people. We therefore need a benchmark against which to assess the budgetary measures the Minister actually announces. What is the best way to construct this benchmark?

A useful starting point in analysing fairness is a benchmark which ensures that major population groups share equally in the benefits of economic growth. A budget which ensured this outcome could be regarded as "distributionally neutral": growth in disposable income would be the same for all major population groups, and shares of income for different groups in the population would remain the same after the budget as in the year before. While some would argue that the government should undertake more redistribution, and others that it should do less, the "distributionally neutral" benchmark at least provides a yardstick against which changes can reasonably be measured.[2]

A number of choices arise in implementing such a benchmark. The approach implemented here involves indexing tax and social welfare to the growth in wage income, the predominant element in national income.[3] In effect, then, the benchmark represents a budget which is neutral in terms of the share of wages going in tax, and in terms of the relationship between wages and the incomes of social welfare recipients. For wage earners, this is achieved by increasing tax-free allowances and the standard rate band in line with the growth in gross wages. For those depending on social welfare payments for their income, an increase in welfare rates equal to the rate of increase in pre-tax wages would, in general, ensure that they shared equally in the growth in income. In what follows, we compare the actual budgetary outturns with this benchmark constructed by indexing tax and welfare policies to the growth in wages.

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[2] A similar benchmark is among those used by Redmond, Sutherland and Wilson (1998).

[3] Incomes from self-employment are more variable from year to year than wages, so indexing taxes and social welfare to wage growth provides a more stable benchmark.

The Conventional Approach

The usual analysis undertaken in documents which accompany the budget is quite different. The convention there is to analyse the impact of the budget as if the alternative to budget day changes was to leave tax and social welfare policy unchanged in nominal terms. This is both unrealistic (since we know social welfare rates will almost invariably change) and also potentially misleading, as will be demonstrated here. If policy were actually frozen in nominal terms, the average tax rate would rise because of the progressivity of the income tax system – there would be “fiscal drag” due to both inflation and real growth in incomes. Furthermore, the incomes of welfare recipients would fall in real terms.

A slightly different convention is now used in preparing the multi-annual projections which accompany the budget documentation. The “no policy change” scenario in this case allows for indexation of welfare parameters in line with price inflation, though tax policy parameters are still frozen in nominal terms. No policy change then means constant real levels of expenditure (“service”). But if policy followed this path, average tax rates would still rise, and the incomes of welfare recipients would fall behind in relative terms. The fact that price inflation has fallen to relatively low levels may make indexation to the CPI seem less urgent, but rapid real growth in incomes means that adjustment of welfare rates and taxes over time are still issues of primary importance in setting a stable policy path for the future.

Much of the commentary on budget tax and welfare changes looks at the effects on a small number of supposedly "typical" families. While this approach can help to understand the nature of a policy change, it can also be highly misleading. The most commonly analysed "typical" family at budget time is a one-earner couple, with 2 children, taxed under PAYE. Less than 1 family in 20 actually falls into this category, and those who do differ widely in terms of income, housing tenure and other characteristics relevant to their social welfare entitlements and income tax liabilities. Concentration on the effects of a policy change on a small number of hypothetical households cannot provide an overall picture of the gains and losses associated with reform packages; and by concentrating on a small number of supposedly "typical" families may lead to the neglect of effects which are important for significant groups.

SWITCH: the ESRI Tax-benefit Model

Tax-benefit models are needed to assess the complex and far-reaching effects of changes to tax and social welfare policy. *SWITCH,* the ESRI tax-benefit model (the acronym stands for *S*imulating *W*elfare and *I*ncome *T*ax *CH*anges) is now a well-established tool for such analysis. It is based on the *Living in Ireland Survey,* a large-scale nationally representative survey of households undertaken by the ESRI in 1994. The model database has been adjusted in ways which ensure that it adequately reflects changes in incomes, employment, unemployment and population since then - and draws on projections of such changes as far ahead as 2001 to provide a framework for medium-term analysis of budgetary issues.

The model uses detailed information on individual and family circumstances (including information on wages and hours of work for those in paid employment, and on labour force status and receipt of social welfare benefits for those not in paid employment) to assess the social welfare entitlements and tax liabilities of each family in the database. The model can therefore simulate for each family the disposable income they would receive under actual policy, or under alternative policies of interest.

Using these detailed calculations it is possible to summarise the impact of policy changes in many different ways. Here we focus in particular on how the average gain or loss varies depending on the income of the family. Family units are ranked by income, adjusting for differences in family size and composition using a simple scale: 1 for the first adult in the family, 0.66 for a second adult and 0.33 for children.

One underlying technical assumption is that labour market behaviour and wage rates are the same under each policy; but the model can shed light on how such behaviour may change by identifying the impact of policy changes on financial incentives to work

Microsimulation models, based on large-scale surveys of actual households, have been developed and used in many countries to overcome these shortcomings. Tax-benefit models based on a large-scale

representative sample of the population automatically take account of the wide diversity of circumstances in the population; can help to identify the overall pattern of gains and losses; and can help to assess the impact of policy changes on financial incentives to work. In this paper, we use SWITCH, the ESRI tax-benefit model (see box) to analyse the impact of budgetary changes in tax and welfare policy.

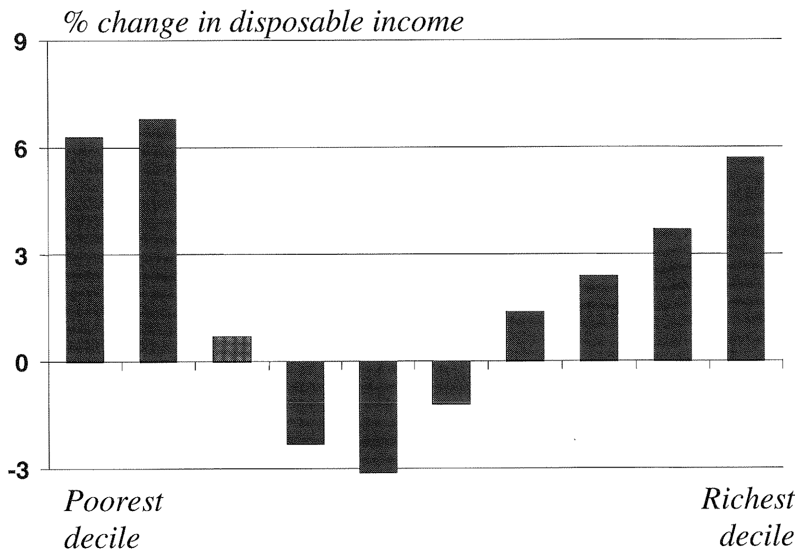
2.3 Who Has Gained in the Past?

Before considering the impact of recent budgets, it is worth examining how tax and welfare policy over the 1987 to 1994 period performed against the "distributionally neutral" benchmark.[4] During this period, the recommendations of the Commission on Social Welfare were one of the main influences on the development of social welfare policy. These recommendations involved a move away from a highly differentiated system of payments towards one with fewer rates of payment. A high priority recommendation was that the lowest social welfare payment rates should be increased to bring them within reach of the recommended targets for all social welfare rates. Thus, rates for Unemployment Assistance and Supplementary Welfare Allowance were increased much more rapidly than most rates, with the highest rates (Old Age and related pensions) being increased by more than prices, but by less than the growth in average incomes over the period. On the income tax side, the structure of the system was simplified, with the number of tax rates reduced from three to two; and there were substantial reductions in the standard and top rates of tax (from 35% to 27% for the standard rate, and from 58% to 48% for the top rate).

The net distributive effect of these changes, as measured against the benchmark of simply indexing tax and welfare policies in line with earnings growth, can be seen in Figure 2.1. This shows considerable gains on average for the poorest 20 per cent of families, reflecting the

[4] Here we draw on a more detailed analysis of tax and welfare policy changes (Callan and Nolan, forthcoming 1998).

Figure 2.1: *Distributive Effects of 1987 to 1994 Changes Against Policy Indexed to Earnings*



increase in the lowest rates of welfare payment. There were losses relative to the indexation benchmark for many low and middle income earners, and for those welfare recipients (including many pensioners) whose payments did not increase as fast as earnings. The tax cuts also gave rise to substantial gains for higher earners. These gains were greatest for the top income earners

Over the 1994 to 1998 period the pattern of policy change has been somewhat different. In general, welfare rates have risen by a little more than prices, but not as fast as other incomes. There were, however, special increases for pensioners in the most recent budget, and these are, of course, included in our analysis. There have been some further cuts in tax rates, along with widening of the standard rate band and increases in personal allowances. There has also been restructuring of the PRSI system, with an allowance structure being put in place.

Figure 2.2: *Distributive Effects of 1994 to 1998 Changes Against "Conventional" Benchmark*

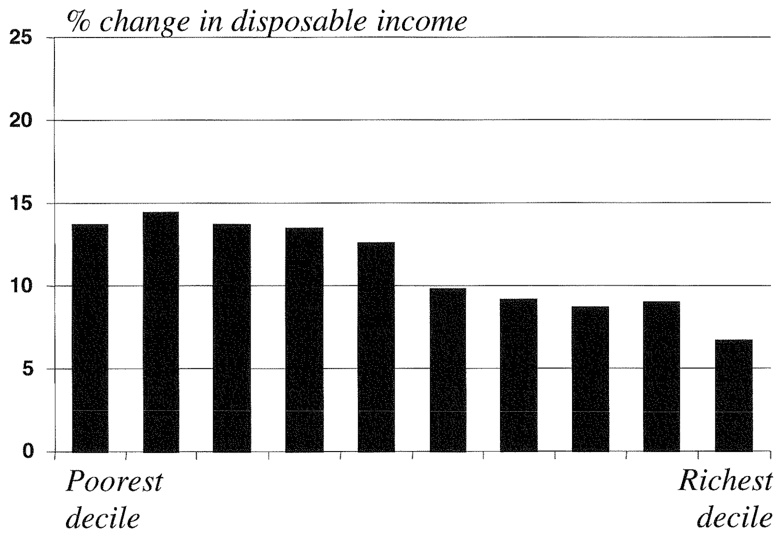


Figure 2.3: *Distributive Effects of 1994 to 1998 Changes Against Policy Indexed to Earnings*

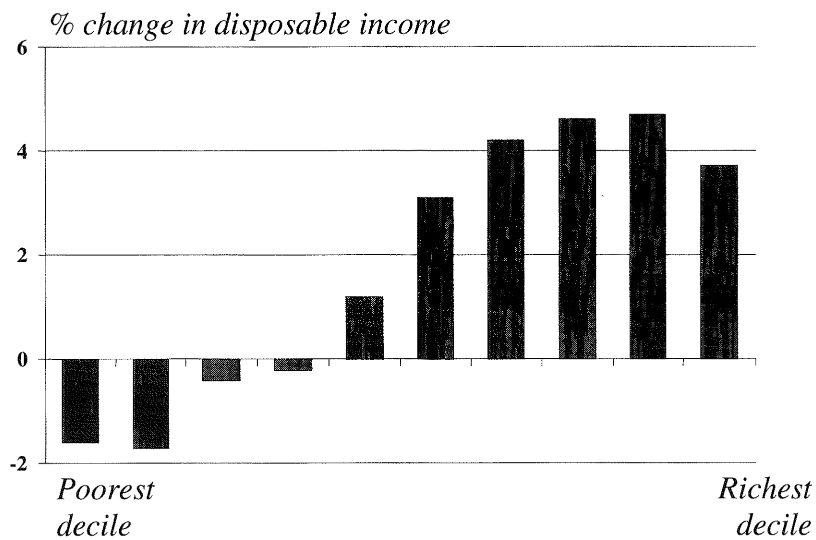


Figure 2.2 shows how the gains from these budgetary policy changes would look under the conventional framework, which assumes that the alternative was that 1998 tax and welfare policies would be identical, in nominal terms, with the 1994 policies. This suggests that all income groups have gained, on average, from the changes, and that the gains have been greatest at the bottom of the income distribution, with lesser gains at the top. But this is a misleading conclusion: the incomes of those at the top of the distribution have increased more rapidly than those at the bottom.

Figure 2.3 shows how the distributive effect is assessed against the more realistic and appropriate benchmark of indexing policy to earnings growth. Here it is clear that budgetary policy has, in general, allowed the incomes of welfare recipients to fall further behind average incomes, and has, through tax cuts, particularly favoured top income earners. The richest 10 per cent of families gained about 4 per cent from Budget day changes, over and above what they would have gained from the simple indexation rule. But the poorest 30 per cent of the population gained 2 per cent less from the more complex and costly Budget day changes actually introduced than from indexation. They would have fared better if successive Ministers for Finance had simply indexed social welfare and taxes to average income growth.

2.4 Who Will Gain in the Future?

We now move on to consider how future budgetary policy might influence the distribution of the fruits of economic growth. We clarify first of all the potential impact of alternative methods of cutting income taxes – including the introduction of tax credits – on these distributive outcomes. We then project forward a possible future path for tax and welfare policy, in line with past policy and stated government commitments. The outcomes in terms of the poverty targets set out in the *National Anti-Poverty Strategy* are then explored, and we examine whether an alternative mix of tax and welfare policies might perform better in this context.

How to Structure Tax Cuts

The issue of how to structure tax cuts – the balance between cuts in rates, band widening and increased personal allowances – has attracted a great deal of attention. Most recently, the idea of replacing personal allowances with tax credits has been advanced as a means of focusing tax relief on the low paid. We examine the issue of tax credits first of all, and then address the question of the balance between different elements of tax-cutting packages.

Tax Credits

A tax credit system would work as follows. Income taxes would first be calculated on the basis of total income (with no deductions or allowances), with the first slice being taxed at the standard rate, and the remainder at the top rate. Tax credits would then be deducted from this calculated amount to give the actual tax bill. An increased tax credit would therefore be of equal value to all taxpayers – it would reduce all tax bills by the same amount (subject only to the proviso that tax bills could not be negative).[5] By contrast, an increase in tax free allowances is of greatest cash value to those with the highest marginal rate of tax.

This comparison is often taken to mean that a system of tax credits would provide a better mechanism for focusing tax relief on the low paid than the current system, and that a move to tax credits would necessarily assist the low paid more than changes under the current system. But this is not the case. The truth is that:

- a system of tax credits contains no more potential for targeting the lower paid than the present tax-free allowance system.
- a move to tax credits does not guarantee that tax cuts will be targeted on the low paid.

[5] There is a case for considering what are called "refundable" tax credits, where the tax authorities could make a refund or payment to the individual, but this does not seem to be what is actively under consideration in the immediate budgetary context. A system of "refundable" tax credits would bear some resemblance to a basic income scheme, which is the subject of separate investigation by a Working Group under Partnership 2000.

In order to demonstrate the truth of the first proposition, let us first consider how the present system could deliver the same result as a move to tax credits. It is true that an increase in tax free allowances, other things being equal, is of greater cash value to a top rate taxpayer than a standard rate taxpayer. But it is possible under the current system to achieve the same result as an increase in tax credits – a reduction in each taxpayer's tax bill of the same amount. The "trick" is simply to increase tax free allowances, but offset this increase with a reduction in the width of the standard rate band. In this way, the income threshold at which the top rate of tax becomes payable (the "top rate threshold") is held constant. As a result, the gains of top rate taxpayers are restricted to be the value of the increased allowance at the standard rate. In a dynamic context, this need not involve a nominal reduction in the width of the standard rate band: it might simply require that the band be frozen, rather than indexed in line with earnings, while the top rate tax threshold would increase *pari passu* with the increase in allowances.

As regards the second proposition, we note that some recent discussions of tax credits have focused on potential losses of top rate taxpayers. Compensation for such losses through cuts in the top rate of tax have also been discussed. But this is either unnecessary, or undermines the case for the introduction of tax credits. If personal allowances were replaced by tax credits (equal to the value of the allowances at the standard rate), it would be possible to "compensate" top rate taxpayers precisely by widening the standard rate band so that the top rate tax threshold remains unchanged. There is no need to cut the top rate of tax to compensate top rate taxpayers – the widening of the standard rate band achieves precisely the necessary compensation for the fact that they no longer have a tax free allowance valued at their marginal rate. A cut in the top rate of tax could not achieve this precise compensation – the very rich would gain most, while other top rate taxpayers could lose out.

Further confusion over the impact of a move to tax credits arises when we come to consider special allowances such as the PAYE allowance, widowed and lone parent's allowances. Some would see a move to tax credits as an opportunity to target these reliefs towards low and middle income earners, and accept that this means less relief for top

rate taxpayers. If this is the intention, standard-rating the reliefs – in the same way as mortgage interest relief – would do the job just as easily. Others see the potential losses for top rate taxpayers from converting these reliefs to tax credits as a problem, and look for a means of compensating them. There is no exact compensation mechanism for these potential losses. But if this is the major concern, it is not clear why a move to tax credits is being contemplated at all.

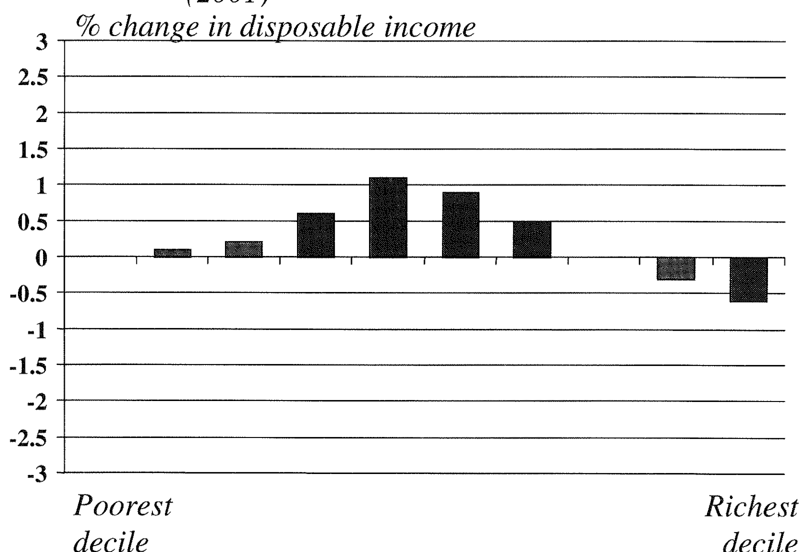
Increased Allowances vs Rate Cuts

It is widely agreed that any cuts in income tax should now be targeted towards the lower paid. This would improve the financial incentive to work facing the unemployed, help to ease the labour supply constraints on growth, and help to share the fruits of growth more equitably than the pattern of tax cuts in recent years. How could this be done under the present system (which, as we have shown, has the same potential for focusing relief on the low paid as a tax credit system)?

The pattern of past policy has been a mixture of cuts in the standard and top rates of tax, widening of the standard rate band, and increases in personal allowances. The multi-annual projections accompanying last year's Budget indicate a "prudent provision" for tax relief of the order of £250m per annum over the years 1999 and 2000. Here we consider how a package of measures with a cost of a similar overall magnitude (approximately £270m per year) could be structured. We have constructed a tax-cutting package which follows the pattern in recent budgets and the indications given in the *Action Programme for a New Millennium.* This involves a cut in the standard tax rate from 24% to 22%, a cut of one percentage point in the top tax rate (to 45%), a widening of the standard rate band from £10,000 to £10,300 and an increase in personal allowances of £150. An alternative package, focusing all reliefs on an increased personal allowance would instead see personal allowances rise by £450 to £3,600. Figure 2.4 shows how the allowance-based tax cut would differ from the usual type of package. The differences would be slight in the lower reaches of the income distribution, where there are few taxpayers. Low and middle-income taxpayers would benefit by more from a package focused exclusively on increasing personal allowances. Those at the top of the income

distribution would benefit more from the mixed tax cut package, including cuts in the standard and top rates of tax.

Figure 2.4: *Distributive Effects of Tax Cuts Exclusively Through Allowances vs Mixed Tax Cut Package (2001)*



We noted earlier that an increased tax credit was equivalent to an increased personal allowance together with a narrowing of the standard rate band. In a dynamic context, simply freezing the standard rate band may be sufficient. The allowance increase considered, in conjunction with a constant standard rate band, keeps the top rate threshold roughly indexed in line with wage growth. This would be roughly equivalent to a tax credit increase with indexation of the standard rate band to earnings growth.

Social Welfare Policy

In order to project forward a possible scenario for social welfare policy we take account of some specific government commitments. The government's *Action Programme for a New Millennium* states that key priorities for the elderly will include substantial social welfare increases including an increase in the Old Age Pension to £100 per week over a

five year period. Last year's budget took an initial step in this direction, with an increase of £5 per week in the personal rate of certain pensions (Old Age Contributory and Non-Contributory Pensions, Widows Contributory and Non-Contributory Pensions for those aged over 66, and Invalidity Pension for those aged over 65). Our benchmark scenario includes an increase of £4.25 in each of these rates over the next 3 years (leading to an Old Age Contributory Pension of £100 in 2002). We also take account of the Partnership 2000 commitment to raise certain rates to the (CPI-adjusted) standards set by the Commission on Social Welfare.

We also need to take a view on the possible evolution of other social welfare rates. Here we are again guided by the multi-annual projections and by past policy. The multi-annual projections indicate possible provision for extra expenditure of £120m per annum on a full year basis. Historically, much of such expenditure has been on social welfare increases. Empirically, this amount would allow for the special increases noted above, with remaining resources allowing a general increase in welfare rates somewhat higher than inflation, but lower than the growth in average incomes. This is the sort of pattern which has been observed in the past five years or so.

Combining this social welfare scenario with either of the tax scenarios outlined earlier (mixed tax rate cuts or an exclusive focus on allowances) we can estimate the likely impact on relative poverty (the reasons for using a purely relative line are discussed in the box). The measure of poverty used here is the proportion of persons in households falling below 40%, 50% and 60% of average income. This measure is not identical with that in the targets set in the *National Anti-Poverty Strategy,* but it is closely related to it. In particular, we can expect that changes in the measure we examine will be very closely mirrored by changes in the measures targeted by the government's *National Anti-Poverty Strategy.*

Poverty Measures: Why Use a Relative Income Poverty Line?

It could be argued that a purely relative definition of poverty is not the appropriate one, given the scale of the increase in real incomes which has occurred throughout the income distribution in recent years and is projected to continue to 2001. In such a situation the contrast between a relative income line and one which is held fixed in real terms over time is of course pronounced. This may be illustrated by the Irish experience over the 1987-1994 period, when the numbers below relative income lines were broadly stable but the numbers below a line held constant in real terms fell by about half. Much depends here on the time horizon adopted in assessing such trends.

The central argument for a relative concept of poverty is that standards of adequacy reflect the broader living standards of the society, and thus the poverty standard moves up as general living standards rise. It may indeed be the case that perceptions of what is adequate lag behind average incomes when the latter are growing as rapidly as they have been here since 1994. However, a strong argument can be made that, over time, increases in general living standards will come to be fully reflected in expectations about what is sufficient to participate fully in society. This means that real income growth can have an impact in the short term, but over the long haul the only way to reduce poverty is to bring people closer to average living standards. This is represented crudely in a purely relative income poverty line, but in essence is also at the core of the measure of poverty combining income and non-monetary indicators of deprivation incorporated into the National Anti-Poverty Strategy.

Table 2.1 shows that a continuation of past policy trends would see a rise in the numbers falling below half average income, or the lower poverty cut-off of 40% of average income. The proportion below 60% of average income would be roughly constant. Altering the tax element of the strategy to focus on the low paid would make a small difference. But the key underlying feature is that the incomes of people relying on social welfare (including many pensioners, widows, lone parents and those who

are ill or disabled, as well as the unemployed) would fall relative to average income under the scenario outlined. The projection to 2001 takes account of the likely fall in unemployment and rise in employment. It also takes account of the special increases for pensioners described above.

Table 2.1 : *Proportion of Population Below Relative Income Poverty Lines, Estimates for 1994 and Projections for 2001 Under Alternative Policy Scenarios*

% of persons below	*1994*	*2001, mixed tax cuts*	*2001, tax cuts exclusively through allowances*
40% of average income	5.8	11.5	11.4
50% of average income	18.7	21.6	21.1
60% of average income	31.9	31.8	31.3

Notes: All figures are based on *simulated* tax and social welfare entitlements: this accounts for differences from results for 1994 shown in Callan *et al.* (1996), which are based on actual tax and welfare receipts. These differences are relatively minor and would not be expected to affect the analysis of changes over time.

An Alternative Scenario

What would happen if, instead of continuing with the pattern of recent budgets, the next three budgets took a different approach to the allocation of resources between social welfare increases and tax cuts? We examine this question strictly within the context of the "budgetary envelope" outlined above, which allows for tax cuts costing £750m over the three year period and welfare increases costing £250m over and above inflation. What is at issue is the possible impact on rates of poverty from an alternative tax/welfare package with the same total resources. For example, the tax system could be given sufficient resources to index the structure (which would cost about £500m), but some restructuring undertaken by giving all tax relief in the form of increased allowances. The overall envelope would then permit social welfare increases costing approximately £500m rather than the £250m assumed under a

continuation of present policies. This could translate, for example, into a general rate of social welfare increase of just under 19 per cent - which, incidentally, would see rates for the elderly rise above the special increases envisaged in the "continuation of present policy".

Such a shift would have a significant impact on the rates of relative poverty shown in Table 2.1. The proportion of individuals falling below 40% of average income is set to rise to over 11 per cent under a continuation of present policies, but could be held to under 8 per cent, if greater priority were given to welfare increases than tax cuts, as described above. Similarly, while close to 22 per cent are set to fall below half of average income under a continuation of present policies, this proportion could be held below 20 per cent under the alternative policy giving greater priority to social welfare increases.[6]

While relative poverty rates would still rise under this alternative scenario, some of this rise may in fact have taken place already. This analysis shows that, on a static basis, shifts between tax cuts and welfare increases can have an impact on rates of relative poverty. The extent of the impact depends, of course, on the extent of the shift. But the eventual outcome depends also on dynamic considerations, to which we now turn.

Tax, Welfare and Partnership

The results we have presented here are from a purely static analysis – they do not take into account behavioural responses to alternative tax or welfare indexation policies. The best way to reduce poverty is to get people from welfare into work at an adequate wage, so the work (and other) incentive effects of alternative strategies are of course highly relevant. However, the gap between welfare rates for the unemployed and average gross earnings has been widening during the years of rapid economic growth, and this is more pronounced when one focuses on after-tax earnings. Much remains to be done to minimise disincentive effects: reducing the tax burden on the low paid as discussed above, and the introduction of a National Minimum Wage (at an appropriate level) will contribute. We have discussed complementary

[6] A smaller impact is evident at the highest 60% poverty line, where the alternative policy would see 30.6% of individuals falling below the relative poverty standard.

policies to promote incentives, including reforms in child income support, in detail elsewhere. Allowing welfare rates to lag further behind earnings will inevitably leave an increasing proportion of those who continue to rely on that income below relative income poverty lines, making the attainment of the National Anti-Poverty Strategy's poverty reduction target unattainable.

Another dynamic effect of alternative tax/welfare strategies is potentially on the continuation of social partnership agreements. Tax reductions have played a key role in the wage bargains incorporated in those agreements, and tax policy – in particular towards the low paid – over the next budgets may have an important influence on the climate for renegotiation. Social inclusion has featured increasingly in the partnership process, but so far as social welfare rates are concerned the focus has been on reaching the levels (in real terms) recommended by the Commission on Social Welfare back in 1986. If these are reached in 1999, the broader issue of the appropriate relationship between welfare rates and earnings over time will come to the fore.[7] (It is also worth noting that indexation of welfare rates to gross earnings rather than prices is the technical assumption underlying the forecasts in the ESRI's Medium-Term Review, and in that analysis were consistent with sustained high levels of economic growth.)

In conclusion it is worth highlighting the even broader questions about the overall direction of taxation and public expenditure which will also have to be faced as we move into the new century. As Ireland's average income per capita converges towards those of our more prosperous EU partners, do we want our tax and public expenditure to GDP ratios to remain relatively low – what one might see as the US/UK model – or to increase towards the levels seen in for example Denmark, Belgium or the Netherlands? This is a central strategic and societal choice, going far beyond budgetary policy from year to year but setting the framework within which those budgets will operate. Like most choices, it is made under uncertainty about the nature of the constraints we face and the dynamic feedback effects of setting off down one route rather than another: but it is a choice which must be made.

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[7] See Callan, Nolan and Whelan (1996).

2.5 Conclusions

We have seen that policy in recent budgets has favoured higher earners, with welfare recipients faring less well than under simple indexation of tax and welfare policy to wage growth. Giving more attention to increased allowances or the introduction of tax credits could equalise the gains of low and high income taxpayers. But this would still leave the incomes of many social welfare recipients lagging behind the growth in average family income. A continuation of past policy trends – with social welfare rates increasing more slowly than average incomes – will see a rise in poverty in coming years. If the benefits of growth are to be distributed in a way which will, at a minimum, prevent a rise in relative poverty, then social welfare rates must rise in line with growth in other incomes. Anti-poverty strategy cannot rely wholly on growth in employment, or wholly on increased welfare rates: it must combine each of these with broader measures to reach the targeted reductions in relative poverty.

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Chapter 3

SPENDING PRIORITIES IN LABOUR MARKET PROGRAMMES FOR THE UNEMPLOYED

Philip O'Connell

3.1 The Nature of the Problem

Strong economic growth leading to rapid employment creation has led to a fall in unemployment in recent years. Long-term unemployment has also fallen somewhat. This is encouraging, but there is a strong probability that the remaining long-term unemployed, with a heavy concentration of low educational qualifications and poor employment experience, will encounter severe difficulties finding work. The National Anti-Poverty Strategy sets a target of reducing long-term unemployment to 3.5 per cent of the labour force. This paper questions whether this target is likely to be achieved on the basis of current trends in unemployment and current priorities in labour market policies.

The paper examines trends in unemployment as well as the evolution of active labour market programmes during the 1990s. It argues that further substantial reductions in long-term unemployment can only be achieved through a coherent strategy that delivers effective well-targeted programmes on a sufficient scale to tackle our long-term unemployment problem. It calls for a refocusing of interventions on the long-term unemployed, and argues that provision of effective and well-targeted programmes to those most disadvantaged in the labour market could serve both equity and efficiency goals: yielding the highest return to public expenditures while reducing poverty.

3.2 Unemployment in the 1990s

Total employment increased by an average of over 4 per cent *per annum* between 1993-1997 and significant growth is likely to continue over the medium term. Table 3.1 shows trends in unemployment and long-term unemployment during the 1990s. Unemployment has fallen substantially from almost 16 per cent in 1993 to just over 10 per cent in 1997, and most recent estimates suggest that it is currently about 9 per cent.[1] The decline in unemployment has not matched the dramatic increase in employment because of strong growth in the labour force due to the continued influx of young entrants from the educational system, rising labour force participation and net immigration. While total unemployment has fallen, long-term unemployment remains unacceptably high. Currently well over half of the unemployed have been so for more than one year, with the result that 5.6 per cent of the labour force are presently long-term unemployed – thus Ireland continues to suffer from one the highest rates of long-term unemployment in Europe.

Table 3.1 : *Trends in Unemployment and Long-term Unemployment, 1990-1997, ILO Basis*

	Total Unemployment (1,000s)	*Long-term Unemployment (1,000s)*	*Share of LTU in Total %*	*Total Unemployment Rate %*	*Long-term Unemployment Rate %*
1990	174.5	109.4	62.7	13.1	8.2
1991	197.8	117.9	59.6	14.6	8.7
1992	206.7	116.5	56.4	15.1	8.5
1993	220.0	125.4	57.0	15.7	8.9
1994	211.1	128.3	60.8	14.7	9.0
1995	177.5	103.3	58.2	12.2	7.1
1996	178.9	103.3	57.7	11.9	6.9
1997	159.1	86.3	54.2	10.3	5.6

Source: Central Statistics Office. Annual series of *Labour Force Surveys.*

[1] All unemployment data reported is this paper use the International Labour Office (ILO) definition, which relates to those who, in the week before the survey, were without work, were available for work, and had taken specific steps to find work in the preceding four weeks.

Long-term unemployment increased markedly during the recessionary period of the early 1990s and peaked at 128,000 in 1994, at which point it accounted for over 60 per cent of total unemployment and represented 9 per cent of the labour force. Since then, long-term unemployment has fallen substantially to 86,000 in 1997, or 5.6 per cent of the labour force. The recent decline in long-term unemployment has been somewhat erratic, with a decline of 25,000 between 1994-95, virtually no movement in 1995-96, followed by another fall of 17,000 between 1996-97.

The recent decline in long-term unemployment coincides with the recent dramatic improvement in labour market conditions. This might suggest that long-term unemployment is more responsive to cyclical conditions that has heretofore been believed, but it is worth considering other potential factors. The first decline between April 1994 and April 1995 coincided with the dramatic expansion of the Community Employment Scheme from about 20,000 participants in early 1994 to about 40,000 in early 1995. At that time, the vast majority of participants in Community Employment had been recruited from among the long-term unemployed, and while the reduction in the number of long-term unemployed between 1994-95 (25,000) is larger than the expansion in Community Employment, it is likely that a very substantial proportion of the decline in measured long-term unemployment was due to the expansion of Community Employment rather than to a sudden improvement in job prospects for the long-term unemployed.

Rapid employment growth may have played a larger role in the second fall between 1996-97, although here again, at least some of the decline may have been due to labour market policy interventions, broadly defined, rather than market forces. The first likely candidate here is the Back to Work Allowance Scheme, which allows long-term recipients of unemployment payments to take up work while retaining a proportion of their social welfare incomes. This scheme expanded from about 10,000 participants at the end of 1995 to a throughput of over 21,000 in 1997 (WRC Social and Economic Consultants, 1997; Murphy, Deloitte and Touche, 1998). To the extent that the Back to Work allowance scheme resulted in a decline in long-term unemployment, this must be counted as a success of active labour market policy.

However, analysis of trends in the Live Register of unemployment suggests that over the 1996-98 period a substantial part of the reduction in long-term unemployment, as measured by that source, occurred among those who had been unemployed for a very long period of time – i.e. up to three years or more (Fitz Gerald, forthcoming). This is surprising since we would expect that those better-equipped to compete on the labour market – with shorter unemployment duration – would tend to be absorbed first into a booming labour market. This suggests the need to search for other explanations for the decline in very-long-term unemployment. A second contributing factor may have been the more rigorous application of eligibility conditions relating to receipt of long-term unemployment compensation following the report of the CSO study of discrepancies between Live Register and Labour Force Survey based estimates of unemployment published in September 1996. These administrative changes appear to have led to a fall in claimant numbers on the Live Register, and thus to have reduced the discrepancy between Live Register and Labour Force Survey based estimates of unemployment, but they may also have led to a reduction in the latter estimates by increasing either job search or labour force withdrawal on the part of those with weak claims to unemployment compensation.

Future Prospects

What then of future trends in long-term unemployment? Can we anticipate a further substantial reduction in the numbers of long-term unemployed, comparable to that achieved between 1994-1997? If we accept that at least some of the reduction in long-term unemployment should be attributed to labour market policy interventions, broadly conceived, we must also accept that these represent "once-off" gains. Thus for example, the reductions achieved by the expansion of the Community Employment Scheme are unlikely to occur again without a further substantial expansion in the programme. Increased stringency in the application of rules for unemployment compensation might result in some further reduction in the number of claimants on the Live Register. However, this would be unlikely to substantially reduce the number counted by the ILO measure to be long-term unemployed, since this requires an active search for work.

A rather different set of considerations applies to the decline in long-term unemployment resulting from market forces – i.e. increased recruitment of long-term unemployed individuals into jobs. Here, the principle that those best equipped to compete on the labour market are the first to be hired applies. One of the main impediments to effective labour market participation by the long-term unemployed is their generally poor educational qualifications. In 1994, 37 per cent of those long-term unemployed had no qualifications, compared with only 18 per cent of those at work, and while 58 per cent of those at work had completed the Leaving Certificate, only one-quarter of the long-term unemployed had achieved this level of education (Tansey, 1998). Thus, there is a strong probability that the labour market will "cream-off" those with the highest educational and skill levels and those with the most work experience, leaving behind a residual group with low educational qualifications and poor labour market experience. Thus, over time the employability of those remaining long-term unemployed – their stock of education, skills and work competencies – deteriorates. Both sets of considerations suggest that a further substantial reduction in long-term unemployment is unlikely to be achieved without the aid of strenuous state-sponsored interventions that are effective, appropriately targeted, and of sufficient scale to tackle the problem.

3.3 Active Labour Market Programmes

Ireland is a comparatively big spender on active labour market policy. In 1996 about 1.75 per cent of Gross Domestic Product was devoted to employment and training programmes, mainly directed at the unemployed, well ahead of the OECD average of about 1 per cent of GDP. Recent years have seen considerable innovation in programmes for the unemployed and a marked expansion in the number of participants.

Table 3.2 presents a summary of provision by programme type for the years 1990, 1994 and 1997. The total number of participants increased from 57,000 in 1990 to 88,000 in 1994 and to 111,000 in 1997. In 1990 the number of participants was equivalent to over 4 per cent of the entire labour force and almost 33 per cent of the number unemployed. By 1997, the ratio of programme participants to the labour

force had grown to over 7 per cent and that of participants to total unemployment had grown to almost 70 per cent.[2]

Table 3.2: *Participants in Active Labour Market Programmes, 1990-1997*

	1990		*1994*		*1997*	
	Number	*%*	*Number*	*%*	*Number*	*%*
General Training	22,980	40.3	18,802	21.3	14,126	12.7
Skills Training	14,706	25.8	14,880	16.9	14,724	13.3
Direct Employment Schemes	14,598	25.6	37,038	42.0	56,090	50.5
Employment Subsidies	4,792	8.4	17,420	19.8	26,115	23.5
Total Provision	57,076	100.0	88,140	100.0	111,055	100.0
Ratio of Total Provision to Labour Force		4.3		6.2		7.2
Ratio of Total Provision to Unemployment		32.7		41.8		69.8

Sources: 1990: O'Connell and McGinnity, 1997.
1994 and 1997: Murphy, Deloitte and Touche, 1998.

This dramatic expansion has given rise to marked shifts in the balance between programme types. The number in training have fallen over time, with the result that the proportion of participants in training programmes fell from 65 per cent of the total in 1990 to one-quarter in 1997. All of the growth in numbers has taken place in temporary employment schemes. The most dramatic expansion has taken place in Direct Employment Schemes. By 1997, the number of participants in Community Employment, which by then was the only direct employment scheme in operation, amounted to 56,000 people, accounting for half of all participants in active labour market programmes, and equivalent to 3.5 per cent of the labour force and 35 per cent of total unemployment. Community Employment is a direct

[2] These ratios are simply indicative of the scale of provision and some care should be exercised in their interpretation. First, a substantial proportion of participants in active labour market programmes are drawn from those not participating in the labour force – including young labour market entrants, and women re-entrants. Second, the data on participants mainly refer to throughputs (i.e. those completing programmes within a period) while the labour force and unemployment denominators refer to stocks measured at a particular point in time.

employment creation scheme proving temporary part-time employment with a minimal level of training, typically amounting to 20 days, to long-term unemployed and other socially disadvantaged participants.

Effectiveness of Programmes

Active labour market programmes in Ireland represent a significant investment of resources on a very substantial scale and it is important to assess the effectiveness of the interventions. The international literature on active labour market policy suggests that the impact of such policies in creating additional employment is limited, with the exception of direct job creation measures (OECD, 1993). The research on the impact of such policies on the employment prospects of their participants shows a great deal of confusion, with empirical results often appearing to contradict each other (O'Connell and McGinnity, 1997a; Fay, 1996). Training policies may generate additional employment under conditions of skills shortages. In fact, there are good reasons to believe that training may have such positive effects in the Irish context, both because of the relatively low level of in-company training in Irish firms (Sexton and O'Connell, 1996), and also because of the emergence of skills shortages in the booming economy. Macro-level effects notwithstanding, effective and well-targeted measures may, however, serve to redistribute employment opportunities to less advantaged labour market participants.

In assessing the effectiveness of labour market programmes it is essential to stress the importance of the distinction between the gross and net impact of programmes. *Gross* effects of programmes, typically measured by job-placement rates, are poor indicators of programme effectiveness. Crude placement rates take no account of the characteristics of programme participants which may have a bearing on subsequent labour market outcomes. Furthermore, placement rates tell us nothing about what would have happened in the absence of a programme. Assessing the *net* effects of programmes entails both taking account of relevant individual characteristics of participants (such as age, gender, education and previous labour market experience), as well as comparing outcomes for programme participants with an appropriate comparison group of non-participants. While job-placement rates are frequently collected by programme administrators, these gross impact measures are of limited value and may provide incorrect signals about the effectiveness of programmes. For

example, a programme which recruits participants suffering severe labour market disadvantages may achieve lower gross job-placement rates than a programme which recruits participants who are already well-equipped to compete on the labour programmes, but the *net effectiveness* of the former may nevertheless be greater than the latter. A strong case can be made for the use of net rather than gross job-placement rates in guiding developments in labour market policy.

Empirical assessment of the net impact of active labour market programmes in Ireland shows that programmes with strong linkages to the labour market – training in specific employable skills and temporary employment subsidies for real jobs in the market place – do enhance the labour market prospects of their participants. (O'Connell and McGinnity, 1997). That assessment is based on a comprehensive follow-up survey of programme participants matched with a comparison group of young people who had not participated in active labour market programmes but who had been unemployed at the time participants left their programmes. The analysis demonstrates that participants in market oriented programmes are more likely to find work in both the short and long term, they spend a greater proportion of time post-programme in employment. Furthermore, they earn significantly more than participants in programmes with weak market linkages and than the comparison group of non-participants. The analysis shows, moreover, that the superiority of market oriented programmes is maintained even when account is taken of relevant individual characteristics such as age; gender; education and duration of unemployment prior to programme participation. In contrast, programmes with weak market linkages, including general training programmes as well as direct employment schemes in the public or voluntary sectors, are much less effective in improving participants' job prospects.

These findings should not, however, be interpreted to suggest that programmes with weak market linkages are of no value and should be discontinued. For many of the disadvantaged unemployed their educational qualifications or skills may be so inadequate that participation in general or foundation level training, or in temporary work experience, offers the only hope of eventual re-integration into the labour market. The findings do suggest, however, that general training or direct employment schemes are of themselves unlikely to significantly improve the job prospects of participants unless they are followed by

progression to more advanced schemes which have better linkages with the open labour market. This suggests the need for reintegration paths designed to allow the long-term unemployed and socially excluded to progress through a series of programmes tailored to their particular needs with the ultimate objective of securing sustainable employment.

The recent report on the impact of Community Employment (Murphy, Deloitte and Touche, 1998) suggests that job placement rates of participants in Community Employment have improved in recent years. The findings of that report also suggest, however, that market oriented training programmes, such as Specific Skills and Job Training are a great deal more effective in terms of job placement than Community Employment.

The available evidence strongly suggests that the type of programme which has expanded most rapidly in recent years – direct employment schemes with weak linkages to the market – is less effective in enhancing participants' employment prospects. This is hardly surprising in respect of Community Employment – while the work experience gained on the programme may be of some value to participants, the minimal training content, typically amounting to 20 days, can hardly be regarded as sufficient to counteract the educational disadvantages of most participants. The other major programme which has undergone marked expansion in recent years, the Back to Work Allowance Scheme, is an employment subsidy with strong market linkages which O'Connell and McGinnity's work suggests should have positive effects on participants' subsequent labour market prospects. However, the net labour market impact of the Back to Work Allowance Scheme has yet to be assessed.[3] On the other hand, skills training programmes directly linked to labour market needs, which do enhance their participants' labour market prospects, and which could, moreover, be expected to carry the additional advantage of alleviating emerging

[3] WRC's (1997) evaluation of the Back to Work Allowance Scheme suggests that while the scheme has been successful in activating the long-term unemployed, it is less effective in achieving their reintegration into employment and self employment, and that the scheme is characterised by high drop out rates as social welfare support is progressively reduced. The evaluation was unable, however, to rigorously compare outcomes of scheme participants with a comparison group of non-participants, with the result that we lack an adequate assessment of the net impact of the programme.

skill shortages in the booming labour market, have remained virtually static over the 1990s.

Targeting of Programmes

The impact of active labour market programmes in combating unemployment depends not only on their effectiveness, but also on whether they reach the right people. In Ireland, as in many other countries, those most disadvantaged in the labour market – including the long-term unemployed, young early school leavers, and women seeking to return to work after career interruptions – are more likely to participate in basic level general training or direct job creation measures than in market linked skills training programmes or in measures which subsidise employment or self-employment in the private sector. Relatively low job placement rates from such programmes are partly due to low educational qualifications or the poor or intermittent nature of previous work experience of their participants, but they also reflect the nature and quality of the programmes and, where provided, the level of training. This is particularly clear in relation to the long-term unemployed. In recent years, the long-term unemployed, who comprise over half the total unemployed, accounted for about 95 per cent of participants on Community Employment but only 11 per cent of participants on mainstream FÁS training programmes. The allocation of individuals across active labour market programmes seems to be perverse: those most in need of assistance are concentrated in the less effective programmes.

Part of the explanation for the concentration of those most difficult to place in the less effective programmes may lie in their relatively low endowment of skills, qualification and experience, Programme administrators seeking to maximise gross job-placement rates may be inclined to select the best equipped candidates for apparently effective programmes while consigning those with particularly severe barriers to employment to programmes with low placement rates. However, such a "creaming off" selection process is likely to incur high deadweight losses by providing assistance to those who already enjoy relatively good job prospects. A more coherent strategy to counter labour market disadvantage would ensure progression from less effective programmes to those characterised by strong market

linkages and high job-placement rates. In practice, however, programmes targeted on marginalised groups suffer from a general weakness in not facilitating progression to further education and training or work experience – despite the fact that most participants in such programmes are in greater need of such progression opportunities than any other group of labour market participants. Recent reforms in certification systems have led to some improvement in progression options at foundation level training, although there remain strong elements of segregation between the training and educational system – rendering it difficult, for example, for an early school leaver who has completed a training course to access further education, rather than further training. Ultimately, however, removing barriers to progression requires a degree of co-ordination between the relevant authorities which has not heretofore been apparent. In fact, with the expansion of programmes has come proliferation of implementing agencies. At present, responsibility for labour market services for the unemployed is dispersed across numerous independent agencies, including the Department of Enterprise; Trade and Employment; the Department of Education and Science; and the Department of Social, Community and Family Affairs; as well as FÁS, CERT and the NRB – to name just the principal players. Institutional coherence would be more likely if a single agency were given overall responsibility for combating unemployment with the capacity to promote greater co-ordination between relevant agencies. I argue below that consideration should be given to charging an expanded Employment Service with this role.

Consideration of targeting also entails the issue of the wider impact of programmes and of the returns to public expenditures. All labour market programmes entail an element of deadweight whereby a proportion of those participating in a programme would obtain a job even in the absence of the programme. Given scarce resources, programmes which incur high deadweight costs are unacceptable. Programmes which are strongly linked to the labour market with high job-placement rates may be particularly prone to high deadweight – as better equipped candidates may find it easier to access such programmes. For example, the *Mid-Term Evaluation of the Human Resources Development Operational Programme 1994-1999* (Goodbody Economic Consultants, 1997) argued that Specific Skills Training programmes tend to incur high deadweight costs because many participants are already well qualified and a substantial proportion would

have found jobs without participating in the training. They recommended, appropriately, that the proportion of participants on the programme suffering specific labour market disadvantages should be increased. Current labour market conditions would suggest that this recommendation should have general application. It may now be appropriate to give first preference to the long-term unemployed and others suffering specific severe disadvantages in the labour market, such as young early school leavers with low educational qualifications and women seeking to re-enter the workforce, while allowing short-term unemployed individuals with better labour market prospects to rely on market forces to a greater extent.

Recent changes in active labour market policies have entailed a substantial increase in activity on active programmes to combat unemployment. However, most of the additional resources appear to have been used to achieve an expansion in the quantity of provision rather than an improvement in the quality of programmes. The evidence on the effectiveness of programmes suggests that there is a need to improve the quality of programmes, particularly those targeted at the most disadvantaged, as well as to ensure progression to effective programmes in the final phase of reintegration paths which have the ultimate objective of securing sustainable employment. This strategy of developing reintegration paths consisting of a series of programmes that are appropriate to the needs of the client and that ultimately result in job-placement has recently been advocated by the OECD. Such an approach would, of course, require the allocation of substantially greater resources targeted specifically at those most disadvantaged in the labour market, but at least part of this could be recouped through a reduction in the level of service to relatively short-term unemployed individuals confronting less severe barriers to employment.

Recent Policy Shifts

In April 1998 the Irish Government published its *Employment Action Plan,* which outlined its policy approach to implementing the EU Employment Policy Guidelines agreed at the 1998 Luxembourg Summit. The EU guidelines stipulate: (1) That young people under the age of 25 should be offered employment, training, work experience or some other employability measure before reaching an unemployment duration of six months; (2) That unemployed adults should be offered similar opportunities to those at (1) above before crossing a threshold of twelve

months unemployment; and (3) That these interventions should be combined with measures to reintegrate those already long-term unemployed. These guidelines, which call for preventative measures to minimise the inflow to long-term unemployment, rather than to provide interventions to assist the stock of long-term unemployed, represent a reversal of existing priorities. In Ireland according priority to the long-term unemployed in active labour market provision is a long- and well-established axiom of practice, even if, as we have argued above, that has been achieved through the expansion of less effective programmes with weak market linkages targeted at the long-term unemployed.

There are two problems with the new approach. First, the Irish government has committed itself to implementing the first element of the EU guidelines – targeting young entrants to unemployment – within the first twelve months of the planning period. It undertakes to phase in the second preventative component – targeted at adults *before* they cross the twelve month threshold into long-term unemployment – over the next five years, as resources permit. Given the lack of substantial additional expenditure commitments in the *Employment Action Plan,* it appears that the Irish authorities intend to replace the existing commitment to the long-term unemployed, a commitment which was renewed under the national Partnership 2000 Agreement in 1997, with an alternative commitment to the new preventative strategies (O'Riordan, 1998). In the absence of additional institutional and financial resources, this refocusing of interventions represents a shift in the balance of resources and interventions towards the young and relatively short-term unemployed and, therefore, away from the long-term unemployed, particularly the older long-term unemployed. This threatens to push the most disadvantaged to the back of the queue for access to programmes.

Second, it is important to question whether following a European-wide strategy is appropriate to current Irish conditions. Following a preventative approach may make strategic sense in other European countries, particularly those with sluggish employment growth and relatively low rates of long-term unemployment, but a similar policy prescription may be inappropriate in the Irish case. Ireland differs sharply from its European partners: its rate of economic growth is among the fastest in the developed world, it is experiencing an unprecedented employment boom, unemployment is falling, and it has a history of

excessively high and persistent long-term unemployment. In the face of sluggish growth in output and employment the European strategy is designed to prevent the emergence of long-term unemployment through early interventions. In the Irish case, however, the booming labour market, with emerging labour shortages, is sufficiently strong to reduce short-time unemployment, by minimising the inflow and increasing the outflow from short-term unemployment. The long-term unemployed, on the other hand, face severe barriers to reintegration, and the past scale and persistence of the problem in Ireland exacerbates the difficulty of reducing long-term unemployment – with a core of individuals with a very long history of unemployment who are difficult to place. The comparatively high incidence of long-term unemployment provides a clear indication of where resources are most needed in Ireland. Abandoning well-established priorities to conform with EU-wide policy initiatives that are designed for very different labour market conditions suggests the absence of a strategic approach to tackling specifically Irish problems.

3.4 What Is To Be Done?

Rather than adopting EU-wide solutions, I believe that a strong case can be made for developing an Irish solution to the Irish problem – which is now much more a problem of long-term unemployment than one of high unemployment. The dramatic improvement in labour market conditions represents a new opportunity to solve our long-term unemployment problem, but this calls for new strategic thinking about priorities. The most effective and efficient way forward is to increase expenditures on highly effective programmes targeted exclusively and intensively on the long-term unemployed, while allowing market forces to absorb younger relatively short-term unemployed. Such a prioritisation of the long-term unemployed could serve both efficiency and equity goals – representing a better investment of public resources while combating social exclusion.

Refocusing policies on the long term unemployed, if they are to be effective, would require several changes to current policy:

(1) *Develop reintegration paths for the long-term unemployed leading to programmes characterised by strong labour market linkages and high job placement rates.* Given the educational and skills

disadvantages from which many of the long-term unemployed suffer, this would entail some restructuring of programme provision, including the development of intermediate-level skills training programmes to facilitate progression to more advanced training in employable skills.

(2) *Increase opportunities for long-term unemployed people to participate in effective programmes.* This would entail some expansion of programmes with strong market linkages, but would also entail a reduction in the numbers participating in Community Employment. Community Employment would continue to comprise two streams, with a reintegration stream which would function as the first step in a reintegration path and a longer-term direct employment creation scheme for a minority of participants whose re-employment prospects are particularly poor. The current practice of allowing recycling of participants in the reintegration stream though successive Community Employment Schemes would be discontinued, as recommended by the Murphy, Deloitte and Touche (1998) report.

(3) *Implement a form of affirmative action in recruitment to programmes that favour the long- rather than short-term unemployed.* This would entail a substitution of disadvantaged clients in place of those better equipped to compete on market-linked programmes with high placement rates. Successful development of reintegration paths would also result in some expansion in market linked training and employment programmes, a part of the cost of which could be achieved through the reduction in the number of relatively well-endowed participants and reductions in participation in Community Employment. Evaluation of the impact of programmes on the basis of net rather than gross placement rates would facilitate this reorientation, since it would reduce the inclination of programme administrators to recruit the best equipped candidates in pursuit of high gross job-placement rates.

(4) *Expand the capacity and role of the Public Employment Service.* I have argued above that consideration should be given to charging the Public Employment Service with a central role in co-ordinating services to the unemployed. This suggestion echoes the thrust of the recommendations of the National Economic and Social Forum (1994) report on combating long-term unemployment. An important element of the proposed enlarged role for the PES would include screening of the relatively short-term unemployed to identify those most

at risk of long-term unemployment to steer them towards appropriate training and employment opportunities. This preventative role would be consistent with current EU employment policy guidelines. The PES would also, however, adopt a curative role, providing a brokerage service to ensure the provision of effective reintegration paths for the most disadvantaged in the labour market, primarily the long-term unemployed, as well as co-ordinating the efforts of the various responsible agencies.

These changes would entail an increase in both financial and institutional resources to be allocated to active labour market programmes targeted on the most disadvantaged in the labour market and primarily on the long-term unemployed. I have argued above that targeting the long-term unemployed and ensuring that they have privileged access to effective labour market programmes can serve both equity and efficiency goals. Consideration of overall trends in the labour market suggest that this virtuous combination can also be realised at the macro-level. Forecasts of employment trends suggest that total unemployment can be expected to continue to decline, assuming a continuation of substantial economic growth rates. The *Employment Action Plan* envisages a fall in total unemployment to 7 per cent by the year 2000. If long-term unemployment is not also reduced substantially, then short-term "frictional" unemployment would fall to such a low level as to generate intensified wage pressures, which could be sufficient in themselves to undermine the virtuous conjuncture of conditions underpinning Ireland's current success. A successful coherent strategy to reintegrate the long-term unemployed thus carries with it the advantage of increasing the effective supply of labour and easing the skill shortages and labour bottlenecks which are already beginning to emerge.

We should regard the present circumstances of a rapidly growing economy, a booming labour market, and fiscal surpluses as an opportunity to solve our long-term unemployment problem and to ease labour supply problems. Economic logic and historical experience should tell us that such fortuitous conditions are unlikely to last. If we act now in a coherent manner to tackle our long-term unemployment problem we have the opportunity to substantially reduce the excessive scale of long-term unemployment and solve a persistent and divisive social problem. The resource costs of successfully tackling the problem,

moreover, will decline with the success of the strategy. However, if we do not tackle our long-term unemployment problem now, as a matter of urgency, the opportunity may pass to allow a large segment of society to become more productive and independent and both contribute to, and reap the benefits of, economic and social progress.

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Chapter 4

REDIRECTING TRANSPORT TAXES

Sue Scott and Bernard Feeney

4.1 Introduction

Because of the peripheral nature of the Irish economy, transport has always been seen as an important determinant of economic growth. This view has been reinforced of late by the realisation that lack of adequate transport infrastructure and inefficient use of the available infrastructure may be a significant factor in bringing the economic boom to a halt.

Strong growth in the demand for transport is giving rise to severe congestion problems and many other adverse environmental effects. These include local air pollution, global warming, accidents, degradation of infrastructure, noise, visual intrusion, barrier and fragmentation effects, and also soil and water pollution. Some of these effects – for example, road accidents – occur on a widespread basis, while others – such as traffic congestion in urban areas – are more localised. Local effects can be particularly severe for some groups, while others are free from the consequences. Noisy traffic, for example, is likely to affect poor people, who more often live beside it.

A key feature here is that the damage or costs imposed by increased transport activity are not borne directly by transport users. Taxes on transport, like many other taxes, have a role not only in raising revenue, but in correcting for costs not otherwise included in the price – such as damage to the environment and congestion. We argue that transport taxes must be restructured to give more accurate signals to transport users regarding these costs. It is not enough to simply fund improved transport infrastructure without restructuring transport taxes. Such a strategy would see problems of congestion and environmental

damage increase to even more serious proportions. Projections into the future have added a sense of urgency to the search for solutions.

On current trends, road vehicle kilometres are projected to grow some 75 per cent by 2010 compared to 1996 levels and projected growth in air passenger movements is not far behind. While we do not have detailed projections for all the problems which are associated with transport, we can describe the expected growth in air emissions.

Emissions of the main global warming gases rise in line with fuel use because there are no feasible means of screening out these emissions. While Ireland has committed itself to limiting emissions of greenhouse gases to 13 per cent above their 1990 level by 2008-2012, strong growth in economic activity could make this target difficult to attain. On present trends it is forecast that greenhouse gases from the transport sector could easily double. If the targeted overall reduction is to be achieved, action will be needed to curb emissions from transport and other sources. Again, a restructuring of transport taxes can help to achieve this outcome in an efficient and equitable manner.

The prospect in regard to many local pollutants is rather better. Such measures as the mandatory introduction of catalytic converters for new passenger cars will help to stabilise or reduce emissions of carbon monoxide, nitrogen oxides, volatile organic compounds and particulate matter (CO, NOx, VOC and PM, respectively. However, concentration is what matters in the case of local pollution. In Dublin, for example, concentrations of many such pollutants are above guide levels and will continue to remain so at heavily trafficked roadside locations.[1] Harmful side effects include an increased incidence of heart and lung problems, and some cancers. Thus, there is still a role for policy to play in attempting to reduce the levels of such harmful emissions.

4.2 Policy Context

It is our contention that good management requires a mix of policy instruments, owing to the complexities of transport. However, the tax system in particular has been largely neglected as a policy instrument. A growing body of analysis describes how policy on transport needs

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[1] Forecasts from Oscar Faber, Ecotec, Goodbody, ESRI (1998, forthcoming). Emissions in relation to guide levels from McManus (1998).

redirecting[2] so that the link between transport use and damage is clearer. The cost of damage has been estimated[3] for many of the harmful side effects enumerated above, and there are strong arguments for charging these costs to transport users through the tax system.

Some modes do more damage than others and these modes need to be targeted, especially if their use is expected to grow rapidly. They include heavy goods vehicles in particular, air transport, shipping and motorcycles, for example. Remembering that concentrations, rather than emissions, are often what matters, some modes of transport do damage in congested urban environments rather than in the countryside. Charging for damage and for congestion itself would then need to be location specific.

Reform along these lines needs to take the following into account:

1. There are moves at EU level to harmonise charges.

The present diverse tax treatments of transport across the EU distorts competition and limits the incentives to cut environmental costs. Gradual and progressive harmonisation is evidently needed, across modes and between member states. The EU Commission's recent White Paper on fair payment for infrastructure use proposes that the charging system be based on the "user pays" principle, that is

> all users of transport infrastructure should pay for the costs, including environmental and other external impacts.

The idea behind getting people to pay is that wants are generally insatiable and a policy response which increases free supply encourages excess demand. In order to be an incentive to good environmental behaviour, charges need to be targeted at the actual decision or action that entails use of infrastructure or puts pressure on the environment. On this the Commission advises that users pay for the costs they impose, "at, or as close as possible to the point of use", adding that member states can obviously continue to support the provision of public services in the general interest. Apart from being obviously fair, such an approach is also supportive of other policies such as the operation of standards and

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[2] Commission of the European Communities (1995), European Conference of Ministers of Transport (1998), Jansen and Denis (1998), Lawlor, (1997), McCarthy, (1997).
[3] European Conference of Ministers of Transfers (1998).

regulations, rendering them more effective and reducing the need for enforcement.

2. The UK, our neighbour, is using the tax system to encourage environmentally friendly transport.

The UK government is committed to raising road fuel duties by at least 6 per cent a year above inflation. This weakens arguments made to the effect that fiscal reform would harm our competitiveness. Such arguments are tenuous in national terms[4] but hold for some sections of society, the polluting ones in fact.

The UK now has the highest rate of excise tax on diesel in the EU. Ireland's rate on the other hand is below the midpoint of the range in EU excise tax rates. Interestingly this has not led to Ireland's price at the pump being correspondingly low. Rather, the result of low tax and perhaps the policy on Whitegate is that Ireland has the second highest price at the pump after the UK, and the highest pre-tax price in the EU.[5] The oil sector, not purchasers of diesel, benefits from Ireland's relatively low rate of excise, it seems.

3. Getting the user to pay is efficient.

It is efficient to get users to pay because they are then discouraged from using that which they do not value. It restrains use that is not giving satisfaction commensurate with cost, thus ensuring that overall benefits enjoyed are not outweighed by costs. Getting the user to pay is also a means of achieving environmental objectives which, paradoxically, does not lead to a rise in taxation overall. Charges or taxes, while removing a distortion (under-priced use of infrastructure and the environment), yield revenues which can in turn be used to remove distortionary taxes. They amount to a tax shift in the end. Taxes associated with employment can

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[4] For example, by Fitz Gerald, J. and D. McCoy, (1992). Studies by the Dutch Central Planning Bureau (1996), Bleijenberg *et al.* (1990) indicate that a result of internalising transport damage costs is to increase employment marginally. Of studies by nine other researchers or organisations into the effects of switching taxes from labour to pollution, seven show unambiguous employment gains. Results of these studies are summarised in OECD (1997).

[5] Commission of the European Communities, (1997). Recent figures show Ireland's pre-tax price of diesel in second place, after Sweden.

then be reduced, and transport, a relatively labour-intensive activity, would enjoy reduced labour costs. Alternatively the revenue could be used to lower VAT, if one wants to take pressure off inflation. Alternative policies to help the environment, the most commonly advocated being subsidies for technological alterations and grants to provide infrastructure, called for by people who want to avoid using taxes and charges, in fact do entail a rise in taxation overall. Furthermore they do not give an incentive to good environmental behaviour.

4.3 Strategic Issues for Budgetary Policy

In this section we discuss how budgetary policy could move to apply the general principles outlined earlier to some specific issues. While there are links between some of these topics, we consider road transport, public transport, urban transport, heavy goods vehicles and air transport in turn.

Road Transport

Differentiate registration tax and circulation tax more closely according to environmental damage and raise excise tax on diesel.

There are many points at which transport behaviour can be influenced by taxes and charges. There is taxation related to the actual *ongoing use* of transport, including fuel taxes mentioned above, emissions taxes based on some measure or estimate, and real-time road pricing. There are taxes related to access to *infrastructure*, or circulation taxes, such as the annual road tax and parking charges, and there are taxes associated with *acquisition* or registration of vehicles. It is worth describing some of the issues which need to be considered when selecting the mix of taxes.

It is sometimes stated that charges for external damage and use of infrastructure should all be loaded onto ongoing use through taxation of fuels, as a means of targeting emissions. One way would be to raise the excise duty to cover all the costs and then reduce the other registration and annual taxes. The European Conference of Transport Ministers has estimated the level of excise taxes that would be sufficient to internalise road costs in rural areas, after realisation of currently foreseen improvements in vehicle technology. The costs covered include the costs

of infrastructure, accidents, climate change, air pollution and nuisance from noise. Congestion is not included. The excise tax in ECU per litre would need to be at the levels summarised in the table below (figures relate to 1996). The rates of excise in the bottom line are for Ireland and these indicate that to cover these external costs we should at least double our rates, and more than triple them in the case of some diesel.

Table 4.1: *Excise Taxes Per Litre: Required Charges to Cover Costs and Actual Charges*

	Petrol	*Diesel*
		ECU per litre
Required charge	0.83	0.74 to 1.04
Average EU excise	0.48	0.32
Ireland	0.35	0.30

Notes: These would be the required charges to cover infrastructure, accidents, climate change, air pollution and noise, in conditions pertaining in mainland EU countries.

Obviously this would not be feasible in the near future. Over 80 per cent of vehicle kilometres occur in rural areas where there is no alternative to the private car. In addition our rural costs would not be so high as in mainland Europe. Second, in theory it is marginal cost that should be charged for on each journey. Also important perhaps is the fact that people have but a vague idea of the costs that they themselves are incurring on their journeys. This has recently been backed up by a TCD study which showed that motorists underestimate their own financial costs of trips.[6] If some means could be found to communicate ongoing costs the effect might be stronger.

In any event it is clear that we need to influence other stages where users make transport choices, namely choice of vehicle, choice of usage (as between commuting and leisure), driver habits and so on. There is a case therefore for not departing radically from the present multi-stage taxation, but with two refinements. One relates to the rural/urban split, alluded to above, which is discussed more fully in the section on urban transport below. The other relates to the fact that the decision as to type of vehicle can be influenced by purchase and circulation taxes. These

[6] O'Mahony, M. (1999, forthcoming).

should be more fine-tuned than they are at present, where tax is *ad valorem*, differentiated by size of engine. This needs to be changed so that fuel usage and other environmental criteria are used.

Another area for scrutiny is the relative taxation of cleaner fuels. The table above suggested that diesel imposed more costs than petrol. Petrol in turn imposes more costs than LPG, but there is no single fuel which is superior on all counts as the following table of emissions in grammes per kWh of various fuels shows.

Table 4.2 : *Emissions of Harmful Gases for Petrol, Diesel and LPG*

(grammes per kWh)	*Carbon dioxide*	*Nitrogen oxides*	*Hydro-carbons*	*Carbon monoxide*	*Particulate matter*
Petrol with catalytic converter	950	3.5	0.6	4.5	0.05
Diesel	650	6.5 to 7.1	0.2 to 0.5	0.5 to 1.0	0.10 to 0.20
LPG	650	6.0	0.2	0.6	0.07

Source: Volvo, Sweden. Figures are approximate and vary depending on operating conditions.

Not shown is the potentially harmful substance called benzene, a carcinogen, which is emitted by petrol engines. The particulates or PMs are now considered to be a serious cause for concern in urban areas and as can be seen these are emitted by use of diesel. LPG is broadly superior to diesel and petrol on most environmental counts except on NOx emissions. The LPG infrastructure has contracted in recent years. It was probably not helped by the fact that household LPG is penalised *vis-à-vis* natural gas because natural gas is not subject to excise. Taking account of considerations mentioned earlier and the information given here, an increase in tax on diesel may be warranted in order to encourage the use of LPG. This issue arises again in the discussion of public transport below.

Public Transport

Replace the rebate on diesel by explicit subsidies based on passenger kilometres and impose VAT at a low rate.

The fiscal treatment of scheduled public road transport is somewhat perverse. Owing to its being exempt VAT, new technology in the form of new buses, for example, is subject to full non-deductible

VAT at 21 per cent. Meanwhile there is a large rebate on diesel. Rebates and subsidies tend to encourage extra use. It is not fuel use that should be encouraged and furthermore diesel may not be the fuel one wants to encourage. For licensed scheduled road passenger transport, the rate of excise on LPG is over three times the rate on diesel. The argument that the technology and infrastructure for LPG are not sufficiently advanced is possibly well-founded, but such fiscal treatment will help to prolong just that. Long-term effects of the fiscal setup are stronger than the short-term effects.

At the same time the subsidy to public road transport, to Dublin Bus for example, is very low by the standards of major cities in the world. In a comparison shown in *Jane's Urban Transport Systems 1992-93* of some 250 cities around the world, grants to the bus system in Dublin come bottom of the list, at 1.2 per cent of operating costs. The "true" subsidy is of course larger, and hidden in the excise rebate on diesel. One estimate of the worth of the rebate to Dublin Bus (by reference to the rate imposed on private purchase of diesel) is £7 million. Add this to the explicit subsidy gives a total of some £11 million which is still a relatively low subsidy. The main point is that subsidies should be targeted on some desirable objectives, such as passenger kilometres, so that the company is rewarded according as these are achieved.

As mentioned domestic public passenger transport is also exempt from VAT. This too is a mixed blessing because the transport companies cannot reclaim VAT, currently at 21 per cent, on their inputs such as equipment and buses. The effect is to raise the cost of inputs relative to the price of the service. Calculations undertaken by Revenue show that if a rate of VAT of 8 per cent were raised on domestic public passenger transport, the same amount of revenue would still be forthcoming. Taxing at 12.5 per cent might raise fares by about 3.7 per cent which could be avoided through direct subsidies for provision of transport services. In any event the current exemption will have to be removed in accordance with EU VAT rules.

Urban Transport

Parking at place of work should be charged to the car commuter on a daily basis, through the Rates.

The problems of urban congestion do not need to be described. While a modern system of public transport will offer opportunities for improvements, the potential will not be achieved if car commuters do not make the switch and use the new system. Urban road pricing, through electronic tolls for example, could be a good method for encouraging the switch but the technology is still in the early stages of application and results will tend to be mixed for a while. Pending the advent of such ideal methods, another method to discourage excessive urban driving is available, namely correct parking charges. In particular this means removing the zero-charge on parking which is enjoyed by many people driving to their place of work.

A significant share of urban congestion is caused by business persons in commuting hours. However, as non-peak traffic and through-traffic increase, road pricing is likely to be required eventually. We know from studies of use of travel modes inside and outside the DART corridor, that the availability of a modern system is an important determinant of usage of public transport.[7] Nevertheless, when people have a free car parking space at work they tend to use it. A study of Los Angeles commuters found that employer-paid parking significantly increases the probability that an employee will drive to work, and furthermore will drive alone.[8] The study predicts that between 25 and 34 per cent fewer cars are driven to work, when workers have to pay to park, as compared to when their parking is free.

Parking spaces have a value and free provision does amount to a transfer from the employer to the employee – something which is not enjoyed by those who commute by public transport. In contrast, an employer-paid bus pass is subject to tax as a benefit-in-kind. The playing field could be levelled, so to speak, by subjecting car parking spaces to the same benefit-in-kind tax treatment, but this could be a perverse incentive to use the space. Being a tax paid upfront, once a year, there

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[7] Killen (forthcoming 1998).
[8] Wilson (1992).

would be no daily incentive to use public transport, indeed the reverse could be the case.

A daily charge for spaces could be implemented relatively easily and it is suggested that the local business Rates be the means used. That part of the business premises that is the parking area should be separately assessed for Rates. The level of Rates charged on the parking area should reflect the cost of parking infrastructure generally and, pending road use charging, should cover the external costs imposed by peak time driving. In order to encourage businesses to introduce daily charging for use of parking spaces (by such means as electronic swipe cards which automatically deduct the charge from pay), they could be granted, say, a few years' derogation from the rise in Rates on their parking area. In this way drivers would not pay on the days when they did not bring in their cars. Flexibility and individual choice are preserved. If people reduced their car commuting by two days per week only, there would be a 40 per cent reduction in private car commuting to work.

Such a valuation of commercial and industrial premises as proposed here is not precluded in the consolidated rateable valuation code. In order to restrict their Rates bill, owners of business properties will be interested to keep down the number of car parking spaces on their premises. If they decide to reduce the number of parking spaces, they can seek to have their premises revalued on request, for a fee which currently amounts to £100.

By law at present only one Rate in the Pound is payable whereas the proposal outlined above would require a higher Rate, or a surcharge, to be payable for the parking area of business premises. While a change in the law might be required to allow this, there are no insuperable problems to be expected, judging from preliminary enquiries to the Department of the Environment.

The implications of this for the Budget are that, with more income available to local authorities from higher Rates levied on car parking spaces, the grant from central government could be reduced.

Heavy Goods Vehicles

Heavy goods vehicles are not paying their way: restructure taxes on them to reflect the damage they do.

Even without consideration of congestion costs, heavy goods vehicles (HGVs) are not paying their way. The most significant cost, which HGVs impose, is damage to the road system. Contrary to popular opinion, it is not simply a matter that the heavier the vehicle the greater the damage - the weight on the axle is a more important determinant. This means that a five-axle vehicle may cause less damage than a four-axle vehicle of lower overall weight.

Vehicles with high axle loads are particularly damaging in the Irish context as the bulk of travel takes place on non-national roads which were mostly paved over forty years ago and were not designed to carry heavy axle loads. If more vehicles with lower axle loads were introduced into the road vehicle fleet, then road maintenance costs would be reduced. One means of encouraging this would be to alter the structure of the road tax as it applies to HGVs. At present, HGVs are taxed on the basis of unladen weight. If, instead, taxes were calculated on the basis of gross vehicle weight and number of axles, tax rates could be structured so that the amount of tax paid would reflect the costs imposed by vehicles of each tax class. Vehicle purchasers would have a significant incentive to purchase vehicles that are less damaging.

This is not a new proposal. The European Union has been seeking to have such a system introduced for many years. It is time perhaps for the Irish government, like the UK to take unilateral action in this regard and make the change.

Air Transport

Support moves at international level to make international air travel subject to VAT and to air emissions charges.

Although aviation contributes but a small share of pollution at present, global emissions are expected to treble over the period 1990 to 2015. Emissions from air transport include ozone depleting substances, greenhouse gases and acidifying emissions and local air pollutants. Odours and noise are also caused by air transport. Some emissions relate to the quantity of fuel used, some to landings and take-offs, and some to engine characteristics.

There is discussion at international level and studies have been undertaken on the subject of making air transport, and other international transport modes, eligible for VAT. Air transport is effectively zero-rated for VAT, being able to reclaim VAT on inputs, which gives it an advantage for which there is little justification. This is current EU policy. However DGXXI commissioned a report which investigates, among other things, the feasibility of imposing harmonised VAT on all intra-EU passenger transport at 8 per cent,[9] taxing on the basis of the place of departure. This could only be adopted on an EU-wide basis and, if it were, the Foreign Travel Tax could be removed.

In addition to discussions on VAT, there are several studies on charging for damage caused by air emissions.[10] While the Chicago Convention and the so-called bilateral Air Service Agreements present obstacles for common action, it appears that they do not preclude *en route* emission-based charges in European airspace, though legal provisions may be needed to extend airspace for taxation purposes above seas beyond the 12-mile zone. A charge raised at a level that would cover the external costs, and therefore having strong rationale, would be expected roughly to halve the predicted growth in emissions from 1992 to 2025. The proposed tax would be equivalent to raising aviation fuel prices, currently 0.16 $/l, by 0.20 $/l in a gradual phased approach. The reason why the environmental impact is high is that such a tax would have a pervasive effect. It would generate incentives relating to aircraft technology, design, size, load factor and indeed volume growth. Modest improvements in each link in the chain, when combined, add up to a substantial reduction in air pollution.

Ireland is not in a position to take unilateral action on taxation of international air transport. However it is in Ireland's interests to encourage such moves at international level in order to avert an increase in global pollution, and the long-term budgetary implications would be significant.

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[9] DGXXI of the Commission of the European Communities (1997).

[10] Bleijenberg and Wit, (1998), Michaelis, (1997).

4.4 Conclusion

Transport taxes should be viewed as a means of contributing to the successful development of an efficient and environmentally friendly transport system. At present some taxes are tending to discourage such development. The sooner the directions in taxation advised above are announced, the better. It is important to inform choices during a period of strong investment. Moreover, changes in transport taxation need not raise the level of taxation in the economy generally, as transport tax revenues can be used to reduce other taxes. People can reduce their tax bill or charges significantly by altering their behaviour in relation to transport, which is the purpose of the exercise.

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Chapter 5

CHILDCARE POLICY OPTIONS

Tony Fahey

5.1 The Context

The Momentum for Action is Growing

Few issues have seen more talk and less action over the past twenty-five years than the question of childcare services. The first major policy study on the issue was the report of the Taskforce on ChildCare Services which was initiated by Brendan Corish (then Minister for Health) in 1974. There has been a steady trickle of reports wholly or partly focused on the same issue in the intervening years. But little by way of substantial policy development has occurred, even though some local initiatives have been taken under an anti-poverty heading in recent years.

Now it appears that the matter may be about to come to a head. Partnership 2000 made a commitment to devise a National Framework for the Development of the Childcare Sector. An Expert Working Group on Childcare was set up to move that commitment forward, and it is due to make its recommendations shortly. At the same time, it appears that a momentum has built up to include major provisions for childcare in the forthcoming budget.

But the Underlying Direction is Unclear

However, despite the current momentum, policy development on child care still lacks a clear sense of direction. This is so for a number of reasons:

- There is much fundamental conflict about what state intervention in child care should try to achieve.

- If state intervention is to go beyond gestures and achieve substantial impact, the cost to the exchequer is likely to be large.
- Even if the objectives were clear and the money made available, there is an enormous range of possible delivery mechanisms, some of which have uncertain knock-on effects in other areas.
- The question of delivery is made more complicated by the large number of government departments which have a stake in the child care question (Education, Health, Justice, Equality and Law Reform, Enterprise and Employment, Social Community and Family Affairs, to name but the most prominent).
- In the background, there are many economists who would query whether it makes economic sense for the state to get involved in this area at all, on the basis that if paid childcare were a good thing from an economic point of view, the laws of supply and demand would come into play to ensure that it was delivered.

In the run-up to the forthcoming budget, there seems to be a growing head of steam behind the view that tax allowances should be used as the main avenue of support for both paid childcare and stay-at-home parents. However, other groups see major drawbacks with that approach and advocate quite different measures, for a range of different reasons. In short, while many people demand that something should be done, there is little agreement on what that something should be – or really whether extensive state action in this area is truly warranted.

5.2 Conflict of Objectives

Slowness to act on the issue of child-care can be put down in the first instance to a lack of agreement on what state support for childcare should be for. The perspective on this question of "the mother in the labour force", which is rooted in a gender equity agenda, is now in the ascendant, but its ascendancy is challenged on one side by the perspective of the mother at home, on another side by the anti-poverty perspective, and on yet another side by various arguments based on the economic efficiency perspective.

The Gender Equity/Working Mother Perspective

From the "mothers in the labour force" point of view, state intervention in child care should be designed to relieve the burden of paid child care on the working mother and thus to support mothers' participation in the labour force. The precise nature of the burden on working mothers varies. It is not always simply a matter of the cost of paid childcare, though cost is a common problem. It can equally be a matter of availability (finding childcare), quality (worrying about how good the available childcare is) or flexibility (matching the available childcare hours to the parents' working hours).

Though the burden varies, the underlying problem (according to this perspective) is the same – lack of funding. Working parents' wages and salaries (particularly after income tax and insurance levies are taken out) are such that they can often barely afford childcare, to the extent that childcare providers are often forced to cut their prices to the bone to accommodate their clients. That in turn constrains supply and impairs both quality and flexibility. Data on the usage of paid childcare in Ireland indicate that the dominant form of childcare provision is the childminder based either in the childminder's home or the child's home, rather than the formally organised creche or kindergarten (Table 5.1). Such home-based paid childminding is likely to be more flexible and less costly to parents, partly because much of it is carried out in the black economy. But it is also less subject to regulation and of more uncertain quality, so that its prevalence in the Irish system of childcare provision is a matter of some concern from a number of points of view.

Table 5.1: *Usage of Child Care by Mother's Employment Status (%)*

Type of paid child care used in reference week	*Mother's Economic Status* *Home duties*	*Full-time job*	*Part-time job*	*Un-employed/ Other*	*All*
		Mothers with youngest child aged 0-4			
Did not use paid child care	82	22	47	75	62
Creche/nursery/ kindergarten/other pre-school	16* 17**	14* 24**	21* 29**	25	17* 21**
Minder in minder's home	1.0	45	18	-	14
Minder in child's home	-	11	9	-	4
Paid relative	-	8	5	-	3
Column total	100	100	100	100	100
(Row per cent)	(57)	(23)	(16)	(4)	(100)
N	*376*	*155*	*106*	*26*	*663*
		Mothers with youngest child aged 5-9			
Did not use paid child care	99	68	84	94	91
Creche/nursery/ kindergarten/other pre-school	-	-	1	-	-
Minder in minder's home	-	10	8	-	3
Minder in child's home	1	19	3		5
Paid relative	-	3	4	6	1
Column total	100	100	100	100	100
(Row per cent)	(63)	(18)	(17)	(2)	(100)
N	*309*	*89*	*82*	*13*	*495*

* Used creche, nursery, kindergarten only (used in calculation of column totals).

** Used creche, nursery, kindergarten plus other form of child care

Source: 1997 Survey of Child-care Arrangements (ESRI) (See also Williams and Collins 1998).

The general nature of the policy solution which is being demanded is simple – state support for paid childcare, designed either to reduce the cost to the parents or increase supply, improve quality or enhance flexibility (or usually some combination of all these things). Such state support might take any of a number of forms – subsidies to parents (e.g. childcare vouchers, income tax allowances for childcare costs), subsidies to private providers (e.g. capital grants for buildings and facilities, recurrent grants per child minded) or direct provision by the state itself in the form of public creches or kindergartens.

The Mothers in the Home Perspective

The "mothers in the home" perspective on childcare rejects the view that state subvention for childcare should be aimed solely at parents in the labour force and argues instead that mothers (or fathers) who wish to stay at home to look after their children themselves are equally deserving of recognition and support from the state. Some who advance this view would cite a quality-of-care justification – that parents are the best possible carers for the child, generally superior to even good quality paid care. Others would feel that, on the average, there is little to choose in quality terms between good paid care and good parental care (or perhaps even that a mix of the two is the ideal). In any event, the policy implication which is drawn focuses on the notion of *choice*: state support should subvent childcare in a manner which is neutral on the choice facing parents between paying for childcare while working outside the home versus staying at home to provide that care.

The Anti-Poverty Perspective

The "anti-poverty" perspective starts from the position that Ireland has a particularly high rate of child poverty compared with other EU members. Its central principle is that state subvention that touches in any way on children should aim most of all to alleviate child poverty. In this view, a focus on childcare solely as a dimension of women's labour force participation is far too narrow. Childcare, rather, should be seen as merely one component (and possibly not the most important one) of a broader attack on child poverty and a more comprehensive concern for the welfare of deprived children. Childcare supports for poor families, therefore, should be wrapped up in a broader package of measures

designed to raise poor children's standard of living, enhance their educational chances and promote their overall well-being – it should be a dimension of child welfare policy more than of labour force policy (though the two are not mutually exclusive). The priority, in this approach, would simply be to increase the incomes of poor families with children, irrespective of the labour force status of their parents, and to back this up with a range of family support and educational services (some of which might come under a childcare heading) aimed at the most deprived or dysfunctional families and designed to support them in the effective nurture of their children.

The Economic Efficiency Perspective – The Short-term Dimension

The "economic efficiency" view of state subvention or provision of paid childcare has a short-term and a long-term dimension – the short-term focusing on its impact on women's labour force participation and immediate economic growth, the long-term on child welfare and human capital development. We need to look at each of these dimensions separately.

In the strict economic view, the fact that large numbers of mothers stay at home to mind their children is not necessarily an indication of economic inefficiency (whatever it may mean for gender equity). Child rearing is an economically useful function, someone has to do it and it could be as economically efficient to have a parent do it as anyone else could. To push the argument further, parents' flexibility and capacity for multi-tasking in the home may give them a substantial efficiency advantage over single-function, formally timetabled paid childminding.

Paid childminding organised on a group basis at first sight appears to have an economies-of-scale advantage – it would appear to be more efficient, for example, to have one childminder look after five small children from different families than to spread that job over the parents in the families concerned. However, these economies-of-scale advantages may be illusory, again because of the multi-tasking associated with child-minding by parents. A parent looking after a child usually does many other things as well, such as house cleaning, caring for clothes, grocery shopping, etc. – things the childminder working in a group setting does not do and that the parent in a paid job has to do after

getting home from work or at the weekends. The apparent efficiency gain of the group childminder, therefore, may be an artefact of the jobs the childminder does not do and that get thrown back on the parents to do as a "second shift" after the days paid work is done.

Possibilities for real improvement in economic efficiency do, of course, exist. They arise mainly where full-time child-minding by parents (usually mothers) causes the parents in question to be underemployed, that is, to make less than optimum economic use of their skills and productive potential. Income tax disincentives to paid work and the use of paid childcare (which are considered further below) could cause such underemployment to occur: it could cause mothers in the home not to move into economic activities which would marginally improve their economic output simply because the tax take on their wages (and on the wages of the paid substitute childminder) would wipe out the benefit of the extra return which those mothers would thereby enjoy. To the extent that those tax disincentives apply particularly to paid childminding (e.g. where the paid childminder is taxed as well as the working mother), there thus may be a case for policy intervention to minimise the obstacles involved.

However, the possibility of such underemployment, and consequently for intervention, arises only in connection with a limited range of mothers – mainly those in the middle band of earnings potential, rather than those at the top or the bottom. High earners and those with low earnings potential would experience little or no underemployment effect – the high earners because they are already at work, making more or less full use of their productive potential, the low potential earners because their paid work would have no higher economic value than their unpaid childminding work and thus the economic rationale for substituting paid for unpaid childcare is not there in the first place. The category which is most strongly affected, therefore, is the band in the middle – and without further investigation we do not know how broad that middle band is. These are the mothers with modest earnings ability for whom the benefits of taking up paid jobs and purchasing childcare may be marginal and may therefore be easily wiped out by the tax take. Even if the *number* of mothers in this middle band were large (and we do not know at present how large that number is), the aggregate net loss of real economic output which would

result from them staying at home might be rather small, since the value of their output as childminders at home would be nearly as great as the value of their output in a paid job.

In consequence, the use of state supports to bring about large-scale movement of mothers in this middle band out of the home into paid work may yield little real economic gain (though again, it may have large beneficial consequences for the economic independence of women and thus for gender equity). Someone still has to mind the children, and while commercialising that function through paid childcare for women with moderate earnings ability will increase *measured* economic output, most of the increase will arise from the transfer of an existing activity into the market economy rather than from real output gains. The situation is quite different for mothers with higher productivity and earnings potential: as they move from work at home into the paid labour force, a real gain in output is likely to occur. But that movement is not conditional on extensive support from the state. As the Irish experience of recent years demonstrates, large-scale movement of higher-skilled women into the labour market can occur without state support for childcare, since the logic of such movement is largely dictated by market forces.

Something similar could be said about the labour supply impact: the movement of mothers into paid work may increase the overall labour supply, but since that requires a counter-balancing movement of other women into paid childminding, the net increase of workers for *non-childminding* functions may be rather small. Again, the labour market becomes busier, but only because the childminding function is tacked onto it rather than because of increased labour supply to other areas of economic activity.

For mothers with moderate earnings potential, therefore, there may be a very strong case for state subvention or provision of paid childcare on gender equity grounds (on the assumption that greater take-up of paid work enhances gender equity). The same gender equity case might also be made in relation to mothers with low earnings potential. However, according to the economic efficiency perspective, we should not fool ourselves into believing that, in addition to the gender equity benefits of state subvention of paid childcare, there would also be real economic benefits in the shape of increased labour supply and growth in

real economic output. In this view, the hard economic fact is that, where a parent has to rely on state subvention of paid childcare to make entry into a paid job financially feasible, it would probably be as beneficial in strict economic terms if the state subvention were dispensed with (or given directly to the parent), the parent stayed in the home and the employer hired the childminder instead.

The Economic Efficiency Perspective – The Long-term Dimension

A *long-term economic efficiency* perspective has affinities with the anti-poverty perspective outlined earlier, on the basis that child poverty inhibits human capital development and thus leads to partial or total waste of many children's life-time economic potential. State intervention to support the adequate care and support of poor children, and thus the maximisation of their long-run economic potential, might thus be justified as both equitable and economically efficient. As with the anti-poverty perspective, this perspective is only incidentally concerned with state provision or subsidisation of paid childcare in the narrow sense, viewed as a corollary of mothers' labour force participation. It is more concerned with the broad range of child welfare measures which might raise poor children's living standards and enhance their overall personal and educational development.

5.3 What is the Present Policy Situation?

Before considering possible new policy developments, we need to be aware of the main elements in the present policy regime as far as childcare is concerned. The present policy regime exerts major influences on childcare provision, so that the starting question is not "should the state intervene?" but "are present interventions the right ones?" – or alternatively, "should present interventions be eliminated?"

Income Tax Treatment of Married Couples

One of the most important elements in the present policy regime as far as childcare is concerned is the income tax treatment of married couples. In the present income tax system, among couples where only one spouse is earning a taxable income, the tax-free allowances and tax bands of the non-earning spouse are transferable to the earning spouse, thus greatly reducing the tax liability of the earning spouse. At the

aggregate level, the cost of this tax expenditure to the Exchequer was estimated at £350 million in 1991 (Callan and Farrell, 1991). While that sum may have declined since then (because of overall tax cuts and a reduced incidence of stay-at-home wives) it is still likely to be substantial. At the level of the couple, the incentive effect on the non-earning spouse is to discourage the taking up of paid employment (except where the earning spouse's income is well below the tax threshold), since in most cases, all the additional income would be liable for income tax, quite often at the top rather than the standard rate.

At its introduction, this policy was justified as a "subvention to childcare", on the assumption that the majority of stay-at-home spouses stayed out of the labour force to look after their children. However, the tax benefits involved are not tied to the presence of children but depend solely on the non-earner being married to the earner. An estimate based on 1995 Labour Force Survey data concluded that about "one-third of the spouses who might have benefited from this arrangement carried out no childcare, as they either had no children or their children were grown up, while mothers with children of pre-school age, who might be thought of as the prime candidates for favourable income tax treatment, accounted for only a quarter of those actually receiving the benefit and a little over half of all mothers of young children" (Fahey, 1998).

In short, while the present income tax treatment of married couples could be counted as a subvention for unpaid childcare in the home, it is poorly directed to that end. While it hits the right target in many cases, in many others it does not, in that many who receive the subvention are not engaged in childcare and many who have a heavy childcare burden do not receive the subvention.

The tax treatment of married couples has a further negative feature from a paid childcare point of view: many of the women who are affected by its disincentives to paid employment are precisely the women who otherwise might work as providers of paid childcare (older married women whose families are reared or nearly reared are particularly relevant in this context). The effect of those disincentives is thus not only to reduce the demand for paid childcare on the parents side (by encouraging them to stay at home to do it themselves) but also to reduce the supply of paid childcare workers on the provider side.

The Tax Treatment of Paid Versus Unpaid Childcare

A further major state influence on childcare provision arises from the fact that, as already noted, unpaid child care provided by parents is untaxed whereas paid childminding is taxed, as is the paid work which a parent must carry out to pay for it. In this, of course, paid childcare is no different from any other market service or final consumption good, all of which are typically produced subject to labour taxes and purchased by consumers out of post-tax income.

In the case of childcare, however, the relationship between the market and non-market varieties is distinctive in that the non-market variety (as provided by parents in the home) has traditionally been dominant (and still remains so in many respects). The movement towards the market variety is tentative and price sensitive, so that the tax wedge on paid childcare has a substantial restraining influence on that movement. All of this might be of little moment for public policy were it not for the gendered nature of the childcare role: it is mainly women who are encouraged to stay in the home by the tax wedge on paid childcare. Thus on *gender equity* grounds, there is a case for treating the tax wedge on paid childcare as having a special significance, over and above that which applies to other market services. Tax allowances for paid childcare are one means of responding to such a case, though as is suggested further below, direct subsidies for childcare, delivered either to the consumer or the provider of childcare, would be a more effective means of targeting women whose labour market behaviour is most affected by the tax wedge.

5.4 Scope of the Task

No matter what policy measure is adopted to respond to the current debate about childcare, the scope of what is required to make a serious impact is likely to be large. This is so in part because the starting point is so low. The only major universal state provision for children at present (outside of schooling) is Child Benefit. The average value of that benefit now stands at about £8.50 per week – a very small amount in the light of what it costs to rear a child. Increases of any real substance on that basic amount, whatever the delivery mechanism used, soon add up to very large sums. Thus, for example, to take only what would be regarded as the population of main interest from a childcare point of

view – children aged 0-4 – there are about 250,000 individuals in that category. If they were to receive added state benefits valued at £20 per child (a not excessively generous amount), the exchequer cost would be of the order of £250 million in a single year.

The large scope of the task is also revealed by the present costs associated with paid childcare. While firm data on such costs are lacking, it would appear that they generally fall in the range of £60-£90 per child for a full week's care. This is on the basis of low wages for childcare workers (wages of £2-£3 per hour are often mentioned) and quality standards which are often questionable. Yet it appears that many parents find it difficult to meet these costs. At the same time, it seems almost certain that costs will rise substantially in the future. The introduction of a general economy-wide minimum wage of over £4 per hour, for example, (as is currently intended) would have a large upward effect on childcare costs. So too would the widespread enforcement of quality standards (regarding buildings, safety regulations, insurance, staff-child ratios, staff qualifications, etc.). A similar effect would arise from income tax enforcement, assuming that such enforcement were to be effective in promoting tax compliance in the informal childcare sector. All of these forces would lead to substantial hikes in the price of childcare, all of which might tend to absorb newly introduced state funding without reducing costs to parents or providing extra places. There are, however, some counterbalancing factors to which we now turn.

The Fiscal Context

While the scope of the task is large from a state expenditure point of view, there are some compensating fiscal factors. In general, the commercialisation of childcare associated with movement of mothers into paid employment has a positive fiscal effect, since it brings a formerly non-taxable activity within the income tax net. Even if the real *economic* gain from such a movement may be less than is often supposed (as argued earlier), the *exchequer* gain from increased income taxes may be quite large. We lack empirical estimates of the size of the exchequer gain, but it should be kept in mind in talking about costs. It means, for example, that subsidies for paid childcare, while amounting to an exchequer cost in one way, could elicit some compensating returns in

other ways, for example, by drawing more mothers into paid employment, by increasing the number of taxable childminders and perhaps also by increasing the number of existing childminders who become tax compliant. This is not to suggest that state subventions for childcare would be self-financing but that the net cost to the state, taking exchequer gains as well as losses into account, might be smaller than would be evident from looking at the headline expenditure figures alone.

5.5 What To Do?

The considerations so far set out do not lead to clear comprehensive conclusions on what should be done about state intervention in childcare. Certain individual pointers do emerge, however.

The first and most unambiguous is that the present income tax treatment of married couples, by which tax-free allowances and tax bands are transferable between spouses, should be phased out. That element of tax policy satisfies almost none of the perspectives set out earlier: it inhibits gender equity, since it discourages many married women from taking up paid jobs; it is economically inefficient for the same reason; it does nothing for poverty, and in fact is regressive in effect. It does give some comfort to the mother in the home, since her household may be a beneficiary of the tax expenditure involved. But it is badly targeted from that point of view since many of the wives who get the benefit are not mothers (or are mothers who no longer have dependent children). In short, it is a tax provision with no known policy justification and should be withdrawn, particularly in view of the large tax expenditures it entails.

If such phasing out were introduced, it would be important that the revenue increases which would arise would be channelled back to families with children. Various policy perspectives would be in contention as guides to how that channelling back should be structured – the gender equity perspective, the mother in the home perspective and the anti-poverty perspective. These tend to pull in opposing directions, though some compromise between them seems possible.

From a certain gender equity perspective, supports narrowly targeted on paid childcare would have much attraction, since such supports would counter-balance the present bias towards stay-at-home

motherhood in the income tax system. Income tax allowances would form one version of such supports, but direct subsidies to childcare might be more effective since they would be of greater relative benefit to middle-income than to high earners and thus would particularly benefit a key marginal group as far as participation in the labour force is concerned. From the mother in the home perspective, supports for *children* rather than for *paid childcare* would be more appealing, since they would not be conditional on the mother going out to work or availing of paid childcare. A focus on children would also have justification as a *quid pro quo* for the elimination of joint tax treatment of married couples suggested above.

For the anti-poverty perspective, it is a cardinal principle that a tax-based approach be avoided – irrespective of whether such a tax-based approach were directed solely at paid childcare or spread more widely to include children of stay-at-home mothers. The whole tax-based approach suffers from its regressive nature and its limited relevance for those who are low on the wage scale or outside the wage system altogether. In short, it offers little or nothing to the anti-poverty perspective – in fact, it tends to take away from what that perspective requires.

A balanced solution, therefore, would require an approach which would meet anti-poverty concerns while not ignoring either the gender equality or "mother in the home" points of view. The approach most likely to achieve that mix would be a mix of cash and services benefits for children distributed through social welfare and social services mechanisms, and designed in such a way that they would have a beneficial effect for all mothers with children but with a loading towards the poor.

From a narrow poverty point of view, the preference might be for highly targeted social welfare mechanisms – supports which are delivered only to the poor. However, since these imply means-testing and means thresholds, they remove the incentive for the poor to raise themselves above the relevant thresholds, thus creating poverty traps. From a broader gender point of view, they also have the drawback that they bring no benefit to mothers who are not in poverty but may have a genuine claim to better treatment, either on gender equity grounds or because they want to stay in the home to mind children.

The other extreme is represented by universal flat-rate benefits which go to everybody, irrespective of their income status. Though very expensive from the exchequer point of view, they have the attraction from the poverty perspective that (a) as flat-rate benefits, their *relative* impact is greater for the poor than the non-poor, and (b) they create no poverty traps. They also bring benefits to the working mother and the mother in the home, irrespective of income level. Such universal benefits could amount to a basic income for children. Child Benefit as presently constituted provides the core of such as basic income for children, except that the size of the benefit is too small to amount even to a "basic" income.

In highly deprived or dysfunctional families, income supports may not be enough, particularly where children are concerned. Such families by their nature may lack the capacity to convert income into consumption or developmental benefits for their children. This points to a requirement for development-oriented services to be provided directly to such families or their children. It is in this context that an emphasis is often placed on the need for quality childcare and pre-school education for children in deprived families, not as a services which parents purchase as a pre-requisite to labour force participation but as a provider-initiated intervention which families are encouraged to avail of, irrespective of their labour force orientation. This would point towards the need for widely available creche-cum-kindergarten services with a clear early-education focus, provided either directly by the state or with strong state support, and concentrated initially in areas with a high incidence of deprived families. Services of this types have already emerged in some deprived areas under the heading of anti-poverty or local development programmes, and these may provide a model for what might be provided on a more widespread basis.

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