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Abstract
Lemass rejected Whitaker's recommendations that direct taxes be reduced and public investment shifted from social to productive areas. This was arguably done for political reasons and because Lemass believed that it might be possible to establish a social partnership deal of the type that Eichengreen has argued to have played a crucial role in post-war European convergence on US living standards. Such a bargain could not be reached under Ireland's industrial-relations system however. The present paper contrasts the two systems and shows the adverse employment, investment and growth effects that such attempts would have had in Ireland.

Introduction

Seán Lemass is regarded by many as the finest Taoiseach in the history of the state. All politicians are constrained however by the need to retain the support of the electorate and of a time-varying combination of sectional interests and swing voters. Though Whitaker had argued in *Economic Development* (1958) for a reduction in direct taxation and a shift in public investment from social to productive areas, and these proposals were endorsed in the *First Programme for Economic Expansion* (1958), neither was actually implemented by Lemass.[1]

The *First Programme for Economic Expansion* specifically proposed reducing capital spending on local authority housing and hospitals and implementing significant income tax reductions. It was suggested furthermore, as Leddin and Walsh (2003, page 87) note, that the rate of increase in wages and salaries in Ireland should lag behind that in Britain. The actual outcomes in these areas over Lemass' tenure as Taoiseach (1959-66) are charted in Table 1. The reductions in capital spending were very short lived; income taxes increased significantly, and Irish nominal wages expanded far more rapidly than in the UK.

I am grateful to Niamh Hardiman for drawing my attention to Roche (2009), with which the present paper shares some common themes, and to Jim O'Leary, who unearthed the strike data. The comments of participants at the 2009 Irish Economic Association Annual Conference, where an earlier version of the paper was presented, are gratefully acknowledged.

[1] Martin O'Donoghue has suggested to me that Lemass may have seen these documents as too grounded in the traditional orthodoxy of the Department of Finance.

Table 1: Historical Outcomes, 1959-66

	1959	1960	1961	1962	1963	1964	1965	1966
Government capital expenditure: investment in housing, € million	4.00	3.34	3.65	4.39	5.47	8.09	12.11	14.09
Public Authority Gross Physical Capital Formation, Health, € million	0.85	0.77	0.71	0.62	0.73	1.07	1.09	1.90
Average rate of income tax (%)	n.a.	n.a.	5	5	5	6	6	7
Average rate of personal taxation including employee social insurance	n.a.	n.a.	7	8	8	8	9	10
Nominal compensation per employee (1960=100), Ireland	n.a.	100	108.3	117.5	123.6	140.6	148	160.6
Nominal compensation per employee (1960=100), UK	n.a.	100	106.8	111.8	117.4	125.7	134.3	142.9

Sources: European Economy, statistical annex, for wage data; ESRI databank for the remainder

The substantial increase in social investment – with its concomitant financing requirements – can be understood as a reaction to the losses in urban areas suffered by Fianna Fáil in the narrow election outcomes of the 1950s and early 1960s (Bew and Patterson, 1982) and perhaps also by the need to retain the loyalty of workers in protectionist-era industries as protectionism was dismantled. This argument is illustrated by the comparison in Table 2 of Fianna Fáil's fluctuating support in Dublin (which in 1961 accounted for 47 percent of manufacturing employment compared to just over a quarter of the state's population) relative to nationwide trends.[2]

Table 2: Fianna Fáil share of general election first preference votes

	Dublin	Ireland
1944	51.8	48.9
1948*	38.9	41.9
1951	46.4	46.3
1954*	39.3	43.4
1957	46.8	48.3
1961	44.6	43.8
1965	48.2	47.7

Source: Sinnott (1995), Appendix 2; * represents Fianna Fáil general election defeats

The strength of Lemass' relations with the trade union movement have been well documented, and indeed triggered the 1964 resignation of his Minister for Agriculture (Horgan, 1999, 204). Girvin (1994), for example, notes that shortly after becoming

[2] Horgan (1999, 201) notes that in the 1961 election Fianna Fáil representation in Cork city fell from three seats to two while the party failed to gain even one of the additional four seats added in Dublin. The 1965 election, by contrast, saw the Fianna Fáil vote in Dublin return to levels not seen since 1944 and the party's share in Cork city rise by over 5 percent. Roche (2009) concurs with the political interpretation offered here, noting that "union and working-class support was copper-fastened by Fianna Fail's 'leftward shift' during the mid 1960s… Here Lemass departed for political reasons from Whitaker's more austere and orthodox insistence on prioritizing so-called productive investment in public spending programmes".

Taoiseach, he invited the newly established Irish Congress of Trade Unions to meet him

> "to discuss the question of development and how cooperation might be generated between the various economic interests. Lemass' speeches in 1959 often paralleled the position adopted in previous years by Congress. These included the need for planning, for state involvement in development and the expansion of the state sector… At this stage, the government was pursuing a cautious fiscal policy, maintaining spending at existing levels but shifting investment from social to capital spending. The argument forwarded by Congress was that while capital investment was important and welcome, it would not suffice to expand the economy. Social spending should not be seen as non-productive, as it often injected money into the economy which had a knock-on effect elsewhere. Within a year of Lemass becoming Taoiseach he had abandoned the cautious economic policy, and budgets began to expand with increased investment in those areas identified by Congress both in policy documents and in its private research".[3]

Lemass seems clearly to have had in mind the construction of a European-style social partnership agreement of the type that Eichengreen (1996) suggests facilitated post-war Continental European convergence on US income levels.[4] In 1963 he prepared a note for meetings with employers and unions that urged that "wages and salaries should, in each alternate year, be adjusted upward at an average rate slightly less than the realised growth of national production" – the differential being to provide a margin "for social insurance benefits or other desirable social objects" (Horgan, 1999, 229).

Shortly thereafter, in a budget speech, he stated his belief "that the time has come when national policy should take a shift to the left… By which I mean more positive measures to ensure the effective translation of the benefits of economic progress into the improvement of social conditions and specifically an equitable wage structure, wider educational opportunities, the extension of the health services and of our systems of protection against the hazards of old age, illness and unemployment" (Horgan, 232).

Instead, in Horgan's (1999, 190) interpretation, his wooing of the unions gave them "and the public sector unions in particular, a new sense of their industrial strength, which was to usher in unparalleled unrest in 1964 and 1965 and wage settlements that ran quickly out of control".

We have seen in Table 1 above the evidence on Irish wage settlements over this period. For reference, Ireland's comparative unemployment experience and troubled industrial relations environment are charted in Figures 1 and 2.

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[3] For more on the relationship between Lemass and the unions see Murphy (1999).
[4] Roche (2009) provides evidence from contemporary records showing that wage policies and industrial relations institutions in The Netherlands and Sweden were seen as having relevance for Ireland.

Figure 1: Unemployment rates in Ireland, the UK and Germany

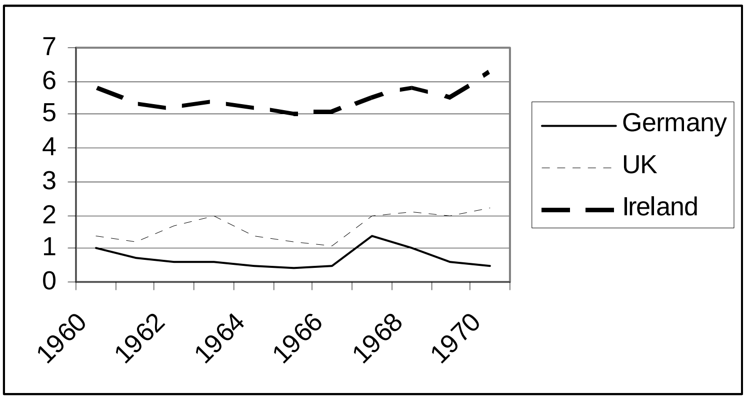
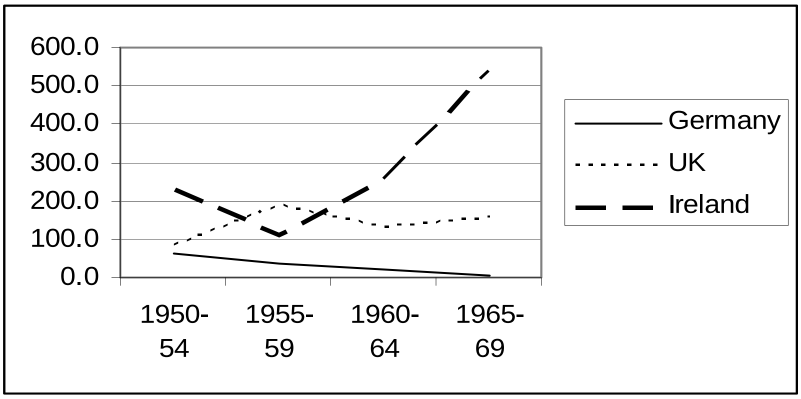


Figure 2: Strike Days Lost Per Thousand Employees



Source: Edwards and Hyman (1994)

The "social wage" (i.e. the personal wage plus welfare-state provisions) plays a pivotal role in Eichengreen's analysis. The present paper argues however that the highly fragmented state of Irish industrial relations at the time prevented any such agreement being struck.[5] The personal wage took precedence over the social wage under prevailing Irish (and UK) labour-market structures. In this case, the paper argues, the type of fiscal policies adopted by Lemass would have had detrimental growth effects, which can explain in part the country's poor convergence performance over this period (Figure 3).

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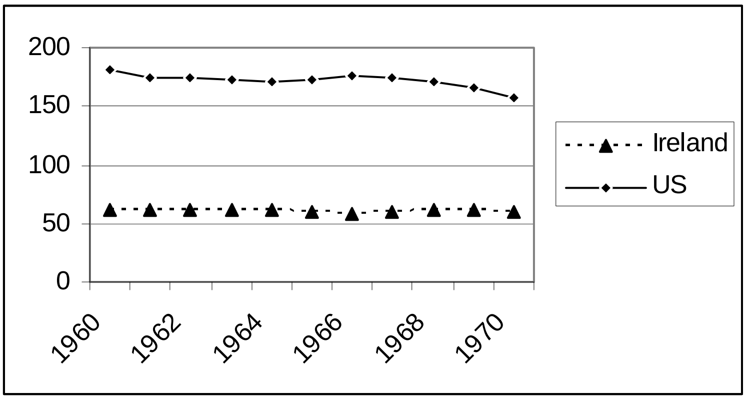
[5] Roche (2009) agrees, arguing that "Lemass had seriously underestimated the challenge of transforming the Irish industrial relations system… In effect, the various corporatist institutions created in the ferment of institutional innovation from the late 1950s to the mid 1960s had been bolted on to a system of pay bargaining and industrial relations in which the centre of gravity continued to be defined by unions' faith in sectional free collective bargaining and most employers' willingness to accommodate such a posture."

Figure 3: GDP per capita (PPS); EU15=100



Source: European Economy, statistical annex

2. The Eichengreen Hypothesis and Irish Labour-Market Structures

Eichengreen (1996) discusses the general time inconsistency of agreements between unions and employers in which both agree to defer returns in exchange for future gains; i.e. where workers moderate their wage claims in order to make profits available for investment, and employers restrain dividend payments in order to reinvest. This dynamic inconsistency can be overcome however if institutions are developed to monitor employer compliance, and unemployment benefits and health and retirement programmes – the institutions of the welfare state – serve as bonds that will be jeopardised if labour reneges.

He describes how these social pacts operated in the Netherlands, Germany, Belgium, Norway and Austria, but notes that in a number of other countries – including Ireland and the UK, as well as France and Italy – attempts to reach such a bargain failed. In these countries excessive wage pressure limited the availability of domestic investment finance, reducing investment ratios and economic growth rates.

The difference in the industrial relations regimes prevailing in these two sets of countries can be characterised in terms of the analysis of Calmfors and Driffill (1988). The highly encompassing nature of the centralised systems of Northern Europe meant that all stakeholder interests were represented in the bargain and hence, according to Calmfors and Driffill, these bargains are associated with generally beneficial macro outcomes. In line with the analysis of Olson (1982) however, the poorest macroeconomic outcomes result when organised interests (i) are strong enough to cause major disruptions but (ii) are not sufficiently encompassing to bear a significant fraction of the societal costs associated with pressing their claims. An illustration of the latter in the Irish case is supplied by Hardiman (1994) who quotes a trade union official to the effect that "if there are 16 percent out of work, there are still 84 percent in work who are not too put out by the plight of the unemployed and who want their wage increase".

She describes the industrial relations system prevailing in Ireland and the UK at this time in the following terms:

> "Divisions within the trade union movement contributed to the extent of wage inflation and the scale of industrial conflict. Sectional differences between skilled workers and the rest increased the potential for leap-

> frogging wage claims. Moreover, economic growth and the greater security of employment had made the membership of the trade unions stronger and more independent…. The authority of Congress, newly reunited after some fifteen years of schism, was still not fully established, and a number of unions remained outside it. On the employers' side, many of the largest employers of craft labour conducted their bargaining outside the context of FUE (Federated Union of Employers) advice and support altogether." [6]

Her description of the process is worth quoting in some detail.

> "Bargaining groups in the strongest bargaining position assumed a role of wage leadership; that is, they established the norm for the pay round which later entrants sought to emulate. The wage leaders were generally craft groups, but clerical staff in large public sector employments, particularly the ESB, also played an important role. As differentials and relativities between occupational groups became more visible, the effect was to inject a new restlessness into the activities of bargaining groups, which was particularly evident in the emergence of additional catch-up pay claims in between the main rounds of bargaining activity. And finally, in contrast with the pre-war years, increased expectations meant that a 'conventional wisdom' grew in union circles that the cash value of the pay increase negotiated in one round should always exceed that of the preceding round".

Amongst the key differences between the Irish industrial relations system of that time and that prevailing today were the much larger numbers of competing unions, the intense competition between Irish and UK-based unions, and the much lower share of Congress membership accounted for by white-collar unions.[7]

In language reminiscent of Olson, Hardiman notes that "no single bargaining group believed it had to pay any attention to the impact of its activities on the overall state of economic performance. Yet the cumulative consequences of everyone's bargaining practices were proving more and more harmful to overall economic performance."

3. The Model

The aim of the paper is to contrast the effects of tax-financed government social spending under the different labour-market structures of Continental Europe and Ireland.

The monopoly union model is employed to illustrate the Irish case in which, à la Olson, organised interests are not sufficiently encompassing to bear a significant fraction of the associated costs to society. This model yields a Pareto-inefficient

[6] McCarthy's (1973) detailed history of the major Irish strikes of the 1960s confirms this account.

[7] There were 115 unions operating in 1955 and 123 in 1960. By 1995, the number had fallen to 56. White-collar unions in 1995 made up more than 40 percent of Congress membership while in the Lemass era the proportion was around 20 percent, with UK-based unions comprising some 14 percent of the total (Murphy and Roche, 1997; Wallace, Gunnigle and McMahon, 2004).

outcome (in that the equilibrium is not on the union-firm contract curve) in which a proportion of the workforce is involuntarily unemployed.[8]

The Nash bargaining model, on the other hand, yields an efficient outcome that shares the available rents between workers and employers. Oswald (1985) suggests that "this is an obvious characteristic to impose when one large union confronts one large employer"; i.e. when both groups are highly encompassing. This model is employed to illustrate the type of equilibria achieved under the Northern European system.[9]

3.1 *Tax-Financed Government Social Spending in the Continental System*

The Nash bargaining solution maximises the product of the gains made by both parties over and above the outcomes that would have emerged for each party had no contract been agreed upon.

The operation of the model is illustrated first in the absence of government spending and taxation. The firm's profit, if a bargain is reached, is R(L)-wL, while the total income of union members is wL+[N-L]b, where R(L) is the production function, L is employment, N is total union membership and b is the rate of unemployment benefit.[10] All goods are tradable, with exogenous prices set at unity by the small open economy assumption. If no bargain is struck, firm profits (ignoring fixed costs) are zero and union income is Nb.

The Nash solution to the bargaining problem is the wage and employment level that maximises:

(1) $$\Omega = [R(L) - wL]\,[(w-b)L]$$

The first-order conditions are:

(2) $$R_L = b$$

and

(3) $$w = [R(L)/L \quad + \quad R_L] / 2$$

These are the well-known Nash-bargaining results.[11] The wage struck is the arithmetic mean of the average and marginal products of labour, and the outcome is efficient since the employment level sets the marginal product of labour equal to its opportunity cost, which is the rate of unemployment benefit.

Now consider how tax-financed government spending enters the equation. The neo-classical approach to fiscal policy allows government spending, G, to add to private

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[8] The Coase theorem states that interested parties – in the absence of transactions costs – should be able to bargain privately to correct this type of market failure. The underlying presumption then is that such costs prevented the business sector from organising to secure such an outcome.

[9] This model is relevant only to the historical period under discussion. As Eichengreen (1996) notes, the period of rapid catch-up following World War II was ideal for sustaining cooperative behaviour as rapid growth increased the willingness of workers and capitalists to defer current compensation in return for future gains. As the scope for catch-up diminished, the incentive to renege on cooperative agreements was heightened, wage pressures intensified and investment slumped.

[10] In some formulations the utility of the wage bill is employed rather than the wage bill itself. This introduces complications that are uninteresting for present purposes.

[11] Hall and Lilien (1979) show that many frequently-encountered contractual arrangements that make the wage bill a function of employment can achieve the type of efficiency assumed here whilst allowing the firm full control over employment levels.

utility via the function $\gamma(G)$, with $\gamma_G > 0$. We assume this government spending adds directly to workers' utility, as in the discussion of Eichengreen. We assume furthermore that lump-sum taxation is unavailable; financing is by means of income tax alone, and unemployment benefits remain untaxed.

The Nash solution now maximises:

(4) $$\Omega = [R(L) - wL]\,[w(1-t)L + \gamma(G) - Lb]$$

from which the following first-order conditions emerge:

(5) $$R_L = b/(1-t)$$

and

(6) $$w = [R(L)/L + R_L] / 2 - [\gamma(G) / 2L(1-t)]$$

Comparing equations (3) and (6) reveals that government social spending induces wage moderation, as in the Eichengreen analysis, and hence increases investable profits, while comparison of (2) and (5) shows that an increase in income tax reduces employment, since it changes the trade-off between employment and leisure that workers face.

The impact of an income tax increase on employment can easily be found to be:

(7) $$dL/dt = b / R_{LL}(1-t)^2 < 0$$

Equivalently, the impact on profits, π, is:

(8) $$d\pi/dt = [\gamma(G) / (1-t)^2 - L\ R_{LL}\ dL/dt\,] / 2 = [\gamma(G) - Lb]/2(1-t)^2$$

It might seem surprising at first glance that the effect on increased income taxes on profits should be ambiguous. As McDonald and Solow (1981) explain however, since the bargained wage exceeds the marginal revenue product of labour the firm is being induced, by the all-or-nothing offer, to employ more workers than it would like to at this wage. Since an increase in tax reduces the level of employment, this yields an added element of benefit to the firm.

3.2 *Tax-Financed Government Social Spending in the Irish System*

Recall our characterisation of the Irish industrial-relations system as fragmented and substantially less encompassing than the Continental system.[12] One implication of this, as noted by Calmfors and Driffill (1988) and evidenced by the earlier quote from Hardiman (1994), is that the parties to the bargain will not take macroeconomic outcomes into account. This suggests that they will also free ride on government social spending. While it enters the utility function of the electorate, it will not appear in the union's objective function.

The union's objective function is:

(9) $$\Omega_{union} = w(1-t)L + b(N-L)$$

while that of the electorate, on the assumption that the median voter is a worker, can be written as:

(10) $$\Omega_{voter} = w(1-t)L + b(N-L) + \gamma(G)$$

[12] Hardiman (1994) quotes the then (Labour Party) Minister for Enterprise and Employment, speaking in 1992, to the effect that "the trade union commitment in relation to the social dialogue … must be and is driven by the demands of their own members, very largely members who are at work and have strong political clout. On the other hand, politicians…have an obligation to the entire labour force, including those out of work".

The monopoly union chooses a wage w to maximise its objective function Ω_{union}, taking into account the impact of wages on labour demand. The resulting wage is

(11) $w = b/[(1-\alpha)(1-t)]$

where α comes from the elasticity of labour demand ($\varepsilon_{LD} = -1/\alpha$) associated with a Cobb-Douglas production function, $Y = AK^{\alpha}L^{1-\alpha}$. The associated level of employment, which comes from the firm's profit-maximisation decision, is

(12) $R_L = w$

This union-determined wage is greater than the opportunity cost of labour b, as was the case also under the Continental system. Unlike the latter however – even in the absence of income tax – we now have inefficient unemployment, as measured by N-L. The impact on wages of a change in the tax rate is given by

(13) $dw/dt = w / (1-t) > 0$

An increase in the tax rate raises wage demands, leading to a reduction in employment and a corresponding increase in unemployment. The impact on employment is given by:

(14) $dL/dt = b / R_{LL}(1-\alpha)(1-t)^2 < 0$

while the impact on profits, π, in the present case is:

(15) $d\pi /dt = - L \ R_{LL} \ dL/dt < 0$

3.3 *Comparison of Tax-Financed Government Social Spending under the Two Regimes*

The following stark contrasts emerge between the two regimes:

1. Government social spending, for a given tax rate, induces wage moderation under the Continental but not the Irish system, with consequent beneficial investment effects under the former.

2. Tax financing reduces employment in both regimes, but more so in the Irish case, as can be seen by comparing equations (7) and (12).

3. For a given level of social spending, an increase in tax has a greater negative effect on profits under the Irish than under the Continental system, as can be seen by comparing equations (8) and (15).[13]

4. Though optimal levels of government social spending are not worked out here, the more adverse effects of tax increases in the Irish system means that the optimal level of spending will be lower than under the Continental system.

5. It follows from point 3 above that an equivalent increase in taxation under the two regimes will have more damaging growth consequences in the Irish case, when capital accumulation/decumulation is allowed for.[14]

6. Notwithstanding these adverse growth effects, the consequences of government social spending for the electorate will still be beneficial as long as it does not exceed the optimal level (as determined when tax effects are taken into account),

[13] Recall that dL/dt attains a larger negative value under the Irish than under the Continental system.

[14] Daveri and Tabellini (2000) present some similar results in the context of an overlapping-generations growth model.

as will be clear from equation (10). This supports the suggestion offered earlier that political considerations may have led Lemass to reject the Whitaker/White Paper proposals.

Conclusions

The paper has contrasted the Irish and Continental European industrial relations systems of the 1960s. The latter, as in Eichengreen's analysis, traded social spending by government for wage moderation on the part of unions. Lemass appeared to have desired such a form of social partnership but the present analysis suggests that such a deal could not be struck under Irish conditions.

Had the Ireland of the 1960s been characterised by the "social wage" motivation that Eichengreen identified in the Continental European case, Lemass' rejection of Whitaker's recommendations for a reduction in direct taxation and a shift of public investment from social to productive areas could have had more benign effects. In the Irish case as modelled here however, social spending could not purchase wage moderation, while tax financing would have had more adverse effects on employment, investment and growth than under the Continental system.

The general thrust of the present paper fits in with the analysis of Barry (2003) which compares the convergence performance of the cohesion countries – Greece, Spain, Portugal and Ireland – over this period. Each of the other three countries converged strongly on Western Europe. Of the factors that growth theory typically focuses upon, only the operation of the labour market appears to distinguish Ireland from the rest. Notwithstanding high unemployment and a productivity growth rate well below that of the other cohesion countries, Irish real wages rose far more rapidly than elsewhere, though the restrictions on wage growth in these other cases reflected the authoritarian nature of the prevailing regimes, of course, rather than the implementation of any form of social partnership.

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