Ireland - Stability Programme

December 2003 Update

Foreword

This document updates Ireland's Stability Programme and includes macroeconomic projections to 2006. It also takes account of the measures adopted in Budget 2004.

This Update has been prepared in conjunction with Budget 2004 and is being presented to Dáil Éireann on Budget Day, 3 December 2003. As such it also provides an economic background to Budget 2004.

It has been prepared in accordance with Council Regulation (EC) No. 1466/97 which sets out the rules covering the content of Stability Programmes, and conforms with the revised Opinion on the content and format of Stability and Convergence Programmes agreed by the EU Economic and Financial Committee in June 2001.

Contents

Chapter 1 - Overall Policy Framework and Objectives

Government Objectives

The Government's economic and budgetary strategy is based on the objective of fostering economic growth and attaining full employment as the basis of continued prosperity all round. The key policies that underpin this overall strategy can be summarised as follows:

- maintaining the public finances in a sound and sustainable state, as the necessary basis to allow the economy to regain competitiveness;
- fostering employment and growth;
- improving the quality of public services and delivering further real improvements to those on low incomes;
- continuing to address the infrastructural deficit in a structured and achievable way so as to facilitate further economic growth; and
- strengthening regional development to deliver more balanced and sustainable economic growth.

The framing of medium term budgetary policy in accordance with the requirements of the Stability and Growth Pact facilitates confidence, investment and growth, and thereby supports the Government objectives for jobs, prosperity and balanced economic development. In particular, the growth of public expenditure must continue to be kept in line with revenue growth, consolidating the achievements of recent years, and ensuring budgetary sustainability going forward. The Government is determined that Ireland's public finances will be well-placed to address additional fiscal pressures over the longer term, including the budgetary consequences of an ageing population.

Economic Outlook

Ireland's economy is open and outward looking and its prospects are therefore closely linked to global economic conditions. While the anticipated return to stronger economic growth was delayed in 2003, it is now increasingly likely that an international recovery will gather pace in 2004.

Irish GDP is now forecast to increase at 3.3% in 2004 and at an annual average rate of 4.4% over the three years 2004-2006. GNP growth, a more accurate reflection of national income in Ireland, is anticipated to grow by 3.0% in 2004 and to average 3.8% over the forecast period.

Employment is expected to grow by 1.3% in 2004 and by more than 1.4% a year on average over 2004-2006, compared with a 1.8% average over the last three years. However, the labour force is expected to grow at a faster rate, and the unemployment rate may therefore rise to 5.0% in 2004 and moderate somewhat to 4.8% by 2006. Consumer price inflation (as measured by the Consumer Price Index) for 2004 as a whole should decrease to 2.5%, and will continue to fall closer to the EU average, reaching 2.4% by 2006.

Budgetary Stance

The projected budgetary position over the period 2004-06 (summarised in Table 1 below) is for a "headline" General Government budget deficit of -1.1% of GDP in 2004 followed by deficits of -1.4% in 2005 and -1.1% in 2006. The underlying (structural) budget balance, moving from a deficit of -0.8% of GDP in 2003 to a deficit of -0.1% in 2006, respects the terms of the Stability and Growth Pact. The debt-to-GDP ratio will be maintained at the second lowest in the EU – below 34% for the forecast period – in line with the Government's long-term priorities outlined above.

Table 1 - General Government Balance and Prospective Debt Ratio (% of GDP)

% of GDP	2003	2004	2005	2006
General Government Balance	-0.4	-1.1	-1.4	-1.1
Cyclically-adjusted Balance	-0.8	-0.5	-0.4	-0.1
Debt Ratio (year end)	33.1	33.3	33.5	33.3

Source: Department of Finance

Chapter 2 - Economic Outlook

2.1 Summary[1]

The international recovery which had been expected to begin earlier in 2003 has been slow to materialise, and, while there are signs that a modest recovery is underway, we do not expect it to take firm hold until 2004. Against this background growth for 2003 is now estimated to be 2.2% in GDP and 2.5% in GNP terms.

Assuming an improvement in global economic activity in 2004, Ireland's GDP is forecast to grow by 3.3% in 2004, with GNP expanding by 3.0%. The short-term outlook for the economy is subject to some uncertainty and therefore the risks to the 2004 forecasts are on the downside. If the global recovery does not develop at the expected pace, or if there is a further appreciation in the euro, this would impact negatively on Irish growth. By 2006, it is expected at this point in time that economic growth will return to around trend levels of 5.2% in GDP terms and 4.4% in GNP terms.

The labour market has been relatively resilient despite lower economic growth and the outlook for employment in 2004 is for an increase of approximately 1.3%. Unemployment is expected to rise marginally to 5.0% in 2004 as the labour force continues to expand. Inflation as measured by the CPI is forecast to decrease to 2.5% in 2004, while the HICP measure of inflation is projected to decline by about 1.7% to 2.3%.

Table 2 - Economic and Budgetary Indicators: 1997-2003

	1997	1998	1999	2000	2001	2002	2003
% volume change (except where otherwise stated)							
GNP	9.7	7.9	8.9	10.2	3.8	0.1	2.5
GDP	11.1	8.6	11.3	10.1	6.2	6.9	2.2
Personal consumption	7.2	7.3	9.6	8.5	5.5	2.7	2.4
Public consumption	5.1	5.5	7.7	7.5	11.1	9.4	4.2
Fixed investment (including stocks)	21.4	16.9	7.5	9.3	-1.8	-0.6	-0.4
Exports of goods and services	17.4	21.0	15.2	20.6	8.3	6.2	-4.0
Imports of goods and services	16.8	25.5	12.1	21.3	6.5	2.3	-6.0
Consumer Price Index (CPI) (% change)	1.5	2.4	1.6	5.6	4.9	4.6	3.5
GDP deflator (% change)	4.1	6.4	3.9	4.3	5.1	5.4	2.2
Unemployment (% of labour force)	10.3	7.6	5.6	4.3	3.9	4.4	4.8
Employment (% change)	3.9	8.3	6.3	4.7	2.9	1.4	1.0
Employment change ('000)	51.4	114.6	95.2	76.7	49.1	23.7	17.0
General Gov. Balance (% GDP) *	1.1	2.4	2.4	4.4	0.9	-0.2	-0.4
General Gov. Debt (% GDP)	65.0	54.9	48.6	38.4	36.1	32.4	33.1

* Deficit (-) / Surplus (+).
Labour market data for 1997-98 refer to April. For later years, full-year data are used.
Source: CSO and Department of Finance

[1] The analysis here is based on data available up to end-November 2003, and on the European Commission's assumptions regarding the external environment that are set out in Appendix 1.

2.2 The Economy in 2003

This year the expected recovery in domestic activity was delayed due to the international recovery being slow to materialise. Quarterly National Accounts have shown that annual GNP rose by just 1.0% in the first quarter of 2003, although this improved in the second quarter to 3.1%. While domestic demand has been relatively subdued, it has been supported by steady consumption and record output in the housing sector.

As one of the most open economies in the world our ability to supply goods and services to the global economy is vital to our economic wellbeing. Recent losses in competitiveness, due partly to the appreciation of the euro and inadequate competition in certain sectors, must be regained if we are to secure our economic prosperity into the medium term.

External Developments

2003 was a disappointing year for the world economy, with unsteady growth in all the major economies. In the US, economic conditions have improved gradually, after the war in Iraq, with accommodating monetary policy and expansionary fiscal policy. For the year as a whole, the Commission estimates GDP growth of 2.8% in the US economy. A sustained recovery has yet to take hold in the EU economy, with estimated growth of 0.4% in 2003 in the euro area. In the UK, a major trade partner with the Irish indigenous sector, GDP growth was stronger than in the euro area, expanding by an estimated 2% in 2003.

Weak international demand due to the prolonged global downturn has impacted negatively on Ireland's export growth. This has been exacerbated by the appreciation of the euro and price inflation. For the year as a whole, exports of goods and services are forecast to decline by 4%. A significant element in the decline in exports has been attributed by the CSO to the ending of a fraudulent import/export scheme in electrical machinery with the UK. While this greatly influenced the gross trade flows, the net position is not affected.

Domestic Demand

Personal consumption growth has remained relatively steady. Employment has held up well so far this year and this, combined with moderating inflation, has supported consumption. We would expect personal consumption to increase by 2.4% in 2003 compared with 2.7% in 2002.

The slowdown in the rate of employment growth evident in recent years, continued in 2003 with a year-on-year rate of growth of just 1.6% to March-May 2003 compared with close to 2% in the corresponding period in 2002. For the year as a whole, employment growth is likely to average around 1.0%. Slower employment growth has led to a small year-on-year rise in the unemployment rate to 4.4% in March-May 2003. The unemployment rate is estimated to average 4.8% this year, compared to 4.4% on average in 2002.

Earnings growth in the period 2001/2002 averaged 6.8%. In 2003 earnings growth has shown a continuation of the more moderate trend that emerged in 2002 – non-agricultural earnings rose by 6.8% in 2002 compared with 12.9% in 2001. Earnings growth in 2003 has eased further, assisted by the new *Sustaining Progress* social partnership agreement which has lower earnings increases than previous agreements. Distribution and business services earnings rose by 5.2% in the year to June 2003, while data for March 2003 showed a 3.1% year-on-year increase in average earnings for the public sector and a 1.6% decrease for the financial sector. Construction sector earnings increased by 3.9% in the year to June 2003. By contrast, industrial earnings rose by 9.2% in the year to June 2003. However, this average figure may have been influenced somewhat by the aforementioned reduction in employment.

The prolonged downturn in the global economy has impacted adversely on investment. Quarterly National Accounts show that Gross Domestic Fixed Capital Formation was 5.7% weaker in the second quarter of 2003 as compared with the same period last year. Building and construction investment continued to expand, reflecting continued implementation of the National Development

Plan. The housing market is set to achieve another year of record output. We expect housing output to increase by around 11% year-on-year in 2003, reaching an all-time high of 64,000 units. For the year as a whole we expect total real investment to decline by 0.4%.

Final Demand and Imports

Final demand is projected to increase by almost 2.0% in 2003, compared to 3.5% in 2002. For the year as a whole, imports of goods and services are projected to decrease by 6% compared with an increase of 2.3% in 2002. As noted above in the case of exports, the ending of the fraudulent trade scheme has been partly responsible for the large decline in imports.

The current account of the Balance of Payments for the first half of 2003 shows a deficit of €1,428 million, compared to a deficit of €426 million in the first half of 2002. The merchandise trade surplus in the first half of the year was nearly €3 billion below the same period last year, while the invisibles deficit was almost €2 billion lower. For the year as a whole, a current account deficit of the order of 1.9% of GNP is projected.

Gross Domestic Product and Gross National Product

GDP is estimated to expand by about 2.2% in 2003, with GNP estimated to increase by 2.5%. Accrued profits of multinationals are largely responsible for the gap between the two measures. One-off factors which influenced the inflows of profits of multinationals in 2002 are not expected to be repeated to the same extent in 2003.

Table 3 – Economic Indicators 2003: Budget Forecast and Estimated Outturn

	2003 Forecast (December 2002)	2003 Estimate (December 2003)
GNP (% volume change)	2.2	2.5
GDP (% volume change)	3.5	2.2
Consumer prices (% change)	4.8	3.5
Unemployment rate (% labour force)	5.3	4.8
Employment growth (‘000)	11	17
Employment growth (%)	0.6	1.0

Source: Department of Finance

2.3 Macroeconomic Projections: 2004 - 2006

After the recent period of weakness in the international economy we expect our economy to move to a growth path which will return it to trend by the end of the forecast period. The projections for Ireland in this Stability Programme Update are based on a relatively benign scenario in which the domestic economy benefits from a sustained international pick up. The forecasts also incorporate technical assumptions about interest and exchange rates as per the EU Commission external assumptions, and the expectation that Ireland, by remaining focused on its international competitiveness, is positioned to take advantage of the recovery in global economic activity. Regaining competitiveness is a key objective of economic policy.

External Outlook

The international economic outlook is positive according to the latest EU Commission forecasts. While uncertainty remains over the strength and pace of the global recovery, the Commission believes that activity will pick up during 2004 and 2005. The Commission’s forecasts for GDP growth in key economies are set out in Table 4 below. The Commission projects that demand in Ireland’s export markets will grow by 5.8% next year, compared to an estimated 2.8% this year. In these circumstances, Irish exports of goods and services are forecast to rise by 6.0% next year.

Table 4 – Real GDP Growth in Ireland's Main Trading Partners

	2003	2004	2005
Germany	0.0	1.6	1.8
France	0.1	1.7	2.3
Italy	0.3	1.5	1.9
Euro area	0.4	1.8	2.3
UK	2.0	2.8	2.9
EU15	0.8	2.0	2.4
US	2.8	3.8	3.3
Japan	2.6	1.7	1.5

Source: European Commission 2003 Autumn forecasts

Domestic Demand

Due to the improvement in the economic outlook, investment is set for a return to positive growth after the slight contraction in 2003. The increase is driven largely by public investment in infrastructural development through the National Development Plan, although this is offset to some extent by a moderation in investment growth in the building and construction sector. Investment in machinery and equipment is forecast to make a relatively strong recovery from the downward trend prevalent over the last two years. Consequently, total investment is projected to grow by 1.3% in 2004.

Real growth in public consumption is projected to slow further from 4.2% in 2003 to 2.1% in 2004. Growth in personal consumption is expected to strengthen to 3.6% in 2004 following the beneficial impact on domestic sentiment of the upturn in the international economy, and a consequent moderation in the savings rate. Employment growth in 2004 is forecast to increase marginally to 1.3%. However, the labour force is expected to expand by more than can be absorbed by this growth and accordingly the unemployment rate is expected to rise to 5.0% in 2004. This relatively less favourable labour market outlook should contribute to a further moderation in wage growth next year.

Final Demand and Imports

Final demand is projected to increase by 2.7% in 2004. In line with the above developments, import growth is set to be 3.6%. With the pick up in the international economy the 2004 current account deficit on the balance of payments is expected to remain at 1.9%.

GDP, GNP and Risks

GDP is expected to grow by about 3.3% in 2004. We expect net factor flows to increase as exports pick up. Therefore real GNP growth is forecast to grow by about 3.0% over 2004. There will be moderate growth in the first half of the year, with increasing momentum as the year progresses.

Going forward, the economy is expected to return to trend growth rates towards the end of the forecast period. This is based on the assumption that the pick up in the international economy develops and impacts favourably on the domestic economy. In the period 2004-2006 it is projected that GDP growth will average about 4.4% per annum, while GNP will grow by an average of 3.8% per annum.

However, significant downside risks should be assigned to this benign scenario of a smooth return to trend growth. For example, while it seems that the global upturn has begun, there are risks surrounding its pace and strength. In view of Ireland's openness and small size, a setback in the international economy would have significant implications for the growth profile which is outlined here. The ten new member states joining the EU in 2004 may also prove a challenge to Irish exports and to inward foreign investment.

Table 5 – Growth and Associated Factors

	2003	2004	2005	2006
GNP growth at constant market prices	2.5	3.0	3.9	4.4
GNP level at current market prices	109,800	117,700	126,000	134,900
GDP growth at constant market prices	2.2	3.3	4.7	5.2
GDP level at current market prices	135,200	144,800	156,000	168,000
GDP deflator	2.2	3.6	2.9	2.4
HICP change	4.0	2.3	2.0	2.0
CPI change	3.5	2.5	2.5	2.4
Employment growth	1.0	1.3	1.5	1.3
Unemployment rate	4.8	5.0	4.9	4.8
Labour productivity growth	1.6	1.8	2.5	3.2
	% Volume Change			
Private consumption expenditure	2.4	3.6	4.1	4.8
Government consumption expenditure	4.2	2.1	2.3	2.5
Gross fixed capital formation	-0.4	1.3	1.9	2.2
Exports of goods and services	-4.0	3.9	6.8	7.1
Imports of goods and services	-6.0	3.6	5.8	6.1
	Contributions to GDP growth			
Final domestic demand	1.6	2.3	2.7	3.1
Change in stocks	0.2	0.2	0.2	0.2
External balance of goods and services	0.4	0.8	1.8	1.9

Source: Department of Finance

2.4 Inflation

Developments in 2003

Inflation, as measured by annual changes in the Consumer Price Index (CPI), eased significantly in 2003 due to falling mortgage interest rates, a decrease in oil prices, falling import prices and a considerable moderation in services sector inflation. For the year as a whole, CPI inflation is estimated to average 3.5%. As measured on the EU harmonised basis at 4.0% this year, inflation in Ireland remains in excess of the euro area average. However, the gap between Irish and euro area inflation has narrowed somewhat over the course of 2003.

Anti-Inflation Initiative

Bringing inflation down further towards the euro area average remains a key priority of economic policy because of its importance in regaining competitiveness. Under *Sustaining Progress* it was agreed that an Anti-Inflation Initiative would be developed to tackle the sources of domestic inflationary pressure. The Anti-Inflation Initiative Group, comprising key participants in the partnership process, was established to drive the process forward and has examined issues such as pay, competition, excessive pricing and insurance costs. All of the social partners are continuing to work together to drive inflation down further.

Prospects for 2004 and beyond

The outlook is for consumer price index inflation to moderate further in 2004, and to average 2.5% for the year as a whole. Import prices are likely to benefit somewhat from the sustained strength of the euro against both the dollar and sterling. On the domestic front, services sector inflation is expected to moderate further, reflecting still loosening labour market conditions and easing demand, although it will remain in excess of the headline figure.

The Government is committed to supporting and maintaining competitiveness and to enhancing the conditions for economic growth through further structural reform of product, capital and labour markets, details of which are set out in the 2002 Progress Report on Reforming Product and Capital Markets[2] and the 2002 National Employment Action Plan[3].

Range of Forecasts

The following table compares the Department of Finance forecasts with those of other organisations. In some instances the assumptions underpinning the forecasts may be different, and this must be borne in mind when making comparisons.

Table 6 – Comparison of Macroeconomic Forecasts for Ireland in 2004

Annual % change	GDP	GNP	CPI	Employment
Department of Finance (Budget 2004)	3.3	3.0	2.5	1.3
European Commission (Autumn 2003)	3.7	--	3.0*	1.0
OECD (November 2003)	3.6	2.2	2.8*	1.3
Central Bank of Ireland (Autumn 2003)	3½	2¾	3	0.7
ESRI (October 2003)	3.2	3.1	2.6	1.1

*HICP

[2] Available at http://www.finance.gov.ie
[3] Available at http://www.entemp.ie

Chapter 3 - General Government Balance and Debt

3.1 Summary

The Government's budgetary strategy is based on the objective of continued budgetary sustainability into the medium term. The public finance position is sound.

As regards underlying medium-term budgetary sustainability, the debt/GDP ratio is projected to remain below 34% to end-2006, far below the present EU average debt level of around 64% of GDP, and the second-lowest in the EU. The outlook is for a "headline" General Government budget deficit of -1.1% GDP in 2004 followed by deficits of -1.4% in 2005 and -1.1% in 2006. If infrastructural investment were halved to the EU average, the General Government finances in 2004 would be in surplus. The underlying (structural) budget balance respects the terms of the Stability and Growth Pact.

3.2 Policy Strategy

The Government Programme states that the Stability and Growth Pact "provides the overall framework" for budgetary policy.

The five key objectives of the Government with regard to budgetary and economic policy are:

- maintaining the sound position of the public finances in a healthy state while pursuing a budgetary policy stance that allows the economy to regain competitiveness;
- fostering employment and growth;
- improving the quality of public services and delivering further real improvements to those on low incomes;
- continuing to address the infrastructural deficit in a structured and achievable way so as to facilitate further economic growth; and
- strengthening regional development to deliver more balanced and sustainable economic growth.

The framing of medium term budgetary policy in accordance with the requirements of the Stability and Growth Pact facilitates confidence, investment and growth, and thereby supports the Government objectives for jobs, prosperity and balanced economic development. In particular, the growth of public expenditure must continue to be kept in line with revenue growth, consolidating the achievements of recent years, and ensuring budgetary sustainability going forward. The Government is determined that Ireland's public finances will be well-placed to address additional fiscal pressures over the longer term, including the budgetary consequences of an ageing population.

3.3 Actual Balances and Implications of Forthcoming Budget

A deficit of -0.4% of GDP on the general government finances is currently projected in 2003, compared with a deficit of -0.2% in 2002 and a planned deficit of -0.7% for 2003 at the time of last year's Budget. The somewhat lower deficit is mainly due to stronger than expected revenue growth in the latter part of 2003.

A "headline" General Government deficit of -1.1% of GDP is planned for 2004, followed by deficits of -1.4% in 2005 and -1.1% in 2006. Necessary infrastructural investment is having a significant impact on the General Government Balance. Ireland's investment in infrastructure is currently running at about twice the EU average. If this investment were cut to the average of the EU, then the General Government Balance position would be more favourable by over 1.5% of GDP. It would not make economic sense however to achieve such an outcome in this way.

Ireland is expected to continue to have the second-lowest debt-to-GDP ratio in the EU-15 with a ratio of 33.3% in 2004.

In response to the infrastructural needs of the economy, capital expenditure will average 5% of GNP over the period 2004-2006, in line with the National Development Plan. The provisions for day-to-day spending will, at the same time, underpin substantial progress across the broad range of social and other objectives. More detailed information in relation to Government expenditure and revenue issues is set out in Chapter 5.

Not less than 1% of GNP will continue to be set aside annually for the pre-funding of pension liabilities, building up assets to help address costs associated with ageing in future decades. This pre-funding does not affect the General Government Balance.

Table 7 - General Government Budgetary Developments in % of GDP

	2002	2003	2004	2005	2006
General government balance	-0.2	-0.4	-1.1	-1.4	-1.1
Central government	0.1	-0.4	-1.1	-1.5	-1.3
Local government	-0.1	-0.2	-0.1	-0.1	-0.1
Social security funds	-0.2	0.2	0.1	0.2	0.3
Total receipts	33.1	34.1	33.5	32.9	32.5
Total expenditures	33.3	34.6	34.6	34.2	33.6
Budget balance	-0.2	-0.4	-1.1	-1.4	-1.1
Net interest payments	0.2	0.2	0.4	0.4	0.4
Primary balance	1.2	1.0	0.3	0.1	0.3
		Components of Revenue:			
Taxes	23.7	24.5	24.4	24.1	24.0
Social contributions	5.7	5.8	5.7	5.7	5.5
Interest income	1.2	1.3	1.1	1.0	1.0
Other	2.5	2.5	2.3	2.1	2.0
Total receipts	33.1	34.1	33.5	32.9	32.5
		Components of Expenditure:			
Collective consumption	5.5	5.8	5.9	5.8	5.7
Individual consumption	9.5	10.0	10.2	10.0	9.9
Social transfers other than in kind	8.3	9.1	9.2	9.1	8.9
Interest payments	1.4	1.5	1.4	1.4	1.4
Subsidies	0.8	0.6	0.6	0.6	0.6
Gross fixed capital formation	4.4	3.9	3.8	3.9	3.8
Other*	3.2	3.6	3.6	3.4	3.3
Total expenditures	33.3	34.6	34.6	34.2	33.6

Source: Department of Finance; preliminary ESA95 basis; rounding may affect totals.
*2002 total includes -0.2% in respect of UMTS licence receipts.

3.4 Structural Balance and Fiscal Stance

The Cyclically-Adjusted Budget Balance (CABB) is calculated by subtracting the estimated cyclically induced variation in the Budget from the observed budget balance. Comparing CABBs from year to year can give an indication of the discretionary changes in the Governments fiscal position.

In previous updates, the Irish authorities have expressed reservations about the precision and relevance of CABB in estimating the overall fiscal stance. These are discussed below. Among these concerns is the extent to which estimates of the output gap for Ireland have been volatile and varied widely over time.

CABB estimates are surrounded by uncertainty. The actual figures for General Government Debt and General Government Balance are likely to convey more relevant information and insight into the nature of fiscal policy going forward.

Estimating the Output Gap

There is a widespread international consensus that estimates of Ireland's potential output and output gap present real difficulties.

- The ***Council's*** opinion on the 2002 update stated that the "*estimate of the output gap presents unusual margins of uncertainty due to the special features of the Irish economy*".
- The ***Commission*** (*Public Finances in EMU*, 2003) stated that "*calculations of the output gap are subject to a particularly large margin of error in Ireland*".
- The ***OECD*** (*Country Report – Ireland*, 2003) has stressed that potential growth is difficult to measure "*given the endogenous nature of both productivity and labour supply*". As a result "*care should be taken in drawing any conclusions about the fiscal policy stance*".

Estimates of the Irish economy's output gap and any CABB results used in assessing the underlying budgetary position should be treated with caution. Reasons for this include the following:

- it is very difficult reliably to establish the potential rate of economic growth in Ireland, because of shifts in productivity, labour force participation and migration patterns;
- with large structural changes having taken place, it is difficult to isolate an identifiable Irish economic 'cycle'; and
- there is a large degree of uncertainty regarding potential growth estimates generally.

The Commission's estimate of the non-accelerating inflation rate of unemployment (NAIRU) is central to the methodology for estimation of potential growth for the purpose of the Programme update. In the case of Ireland, these NAIRU estimates have fluctuated sharply over a very short period of time. The most recent Commission forecasts for the years 2003 to 2006 are as set out in Table 8.

Table 8: Commission NAIRU estimates

	2003	2004	2005	2006
Spring Economic Forecasts 2003	4.5%	3.7%	3.4%	3.2%
Autumn Economic Forecasts 2003	5.5%	5.0%	4.6%	4.4%

This volatility in the estimates of the NAIRU (over a period of less than one year) is unhelpful in applying the CABB methodology for Ireland.

Budget Sensitivity to changes in GDP

As in the case of the NAIRU, estimates of the Irish Budget's sensitivity to changes in the rate of GDP growth vary somewhat. Table 9 sets out budget sensitivity estimates from the OECD, Commission and the ECB.

Table 9: Estimates of Budget Sensitivity for Ireland

	OECD 1995*	OECD 2000**	Commission 2000#	ECB 2001##
Income Tax	}	}	}	
Employment	} 1.3	} 1.0	}	1.0
Earnings	}	}	}	1.5
Corporate Tax	2.5	1.2	} 0.3	0.8
Indirect Tax	1.0	0.5	}	1.0
Social Security	0.5	0.8	}	0.9
Unemployment Expenditure				0.9
Current Expenditure	-0.2	-0.4	0.1	-
Overall	0.37	0.32	0.4	0.42

Notes to table 9:
* *'Potential Output gaps and structural budget balances'*, OECD Economic Studies, No. 24
** *'The Size and Role of Automatic Stabilisers in the 1990's and beyond'*, Working paper no. 230
# *Public Finances in EMU, 2000*
'Cyclically adjusted budgetary balances: An alternative approach', ECB Working Paper No.77

The Commission currently uses the more conservative sensitivity factor in the range. The reasons for the choice of this estimate are unclear, as are the reasons for the progressive downward revision of this factor over the last three years. The choice of 0.32 may be too low. For example:

- The OECD (2000, *op. cit.*) stressed that these sensitivity estimates are "*surrounded by significant margins of uncertainty*".
- Similarly their sensitivity analysis shows Ireland's baseline sensitivity varying from about 0.3 to well above 0.4, subject to certain assumptions.
- Tax reforms may change the sensitivity estimates over time. The 0.32 outcome is based on 1996 tax codes and may not capture more recent fundamental changes in taxation.
- The estimate of 0.32 is based on an elasticity for indirect tax of 0.5.
    - The Commission and the ECB both use an indirect tax elasticity of 1.0. The Commission concluded that "*countries that rely more on indirect taxation display a higher sensitivity to this shock.*"
    - If indirect tax elasticity 1.0 were used, this alone would shift the overall sensitivity estimate for Ireland to 0.37, given the weights used in the paper.
- Work by Ireland's Economic and Social Research Institute indicates that, depending on the nature of the economic shock, Ireland's budget sensitivity in year one could be up to 0.5%.

The points above once again highlight the difficulties of using the CABB approach for Ireland. It would appear that the more recent aggregate estimates of the budget sensitivity for Ireland made by the ECB, which include a more realistic assumption for indirect taxes, are more relevant to the current fiscal structure. Accordingly, the ECB estimate of 0.42 is used in this Stability Programme Update.

CABB Estimates
The required estimates of the CABB are presented in Table 10. The estimates are based on the macro-economic and budgetary forecasts set out elsewhere in this Stability Programme Update, and use the methodology of the European Commission published with the 2003 Autumn Forecasts. A budget sensitivity factor of 0.42 is applied.

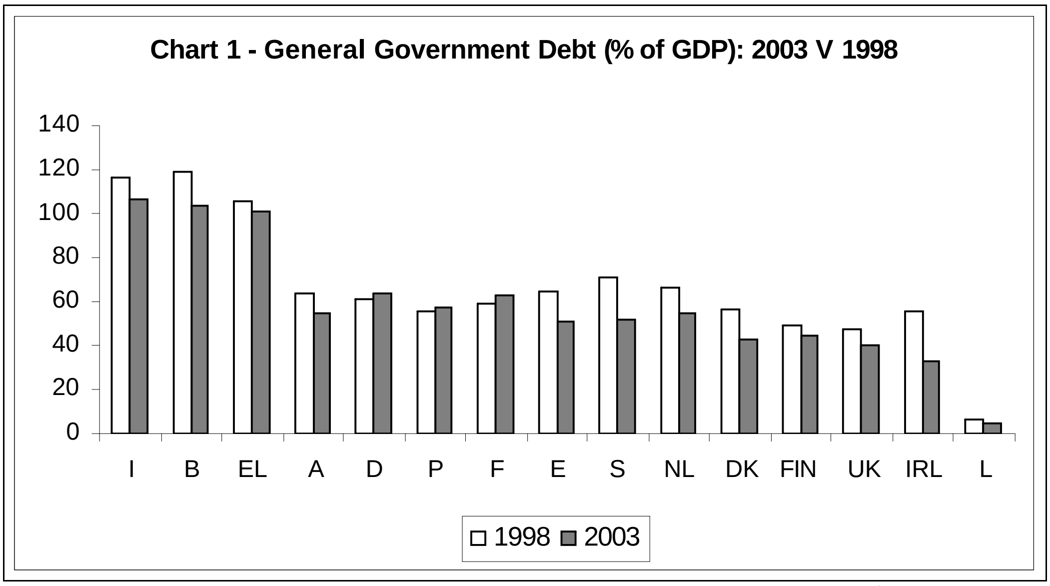
Table 10 – Cyclical Developments

% of GDP	2002	2003	2004	2005	2006
GDP growth at constant prices	6.9	2.2	3.3	4.7	5.2
Actual balance	-0.2	-0.4	-1.1	-1.4	-1.1
Potential GDP growth	7.0	6.3	5.9	5.6	5.2
Output gap (% potential output)	5.0	1.0	-1.5	-2.3	-2.3
Cyclically adjusted balance[4]	-2.3	-0.8	-0.5	-0.4	-0.1
Change in cyclically adjusted GGB	-1.1	1.4	0.4	0.1	0.2
Source: Department of Finance					

[4] If a budget sensitivity of 0.32 were used, the equivalent CABBs for 2003 to 2006 would be -0.7%, -0.6%, -0.6% and -0.4% respectively.

3.5 Debt Level and Developments

As indicated by Chart 1 overleaf, Ireland has one of the lowest debt/GDP ratios in the EU, and has achieved the greatest reduction in its debt/GDP ratio between the onset of stage 3 of EMU in 1998 and 2003.



Source: European Commission 2003 Autumn Economic Forecasts; Department of Finance

Over the Programme period as a whole, the gross debt level is expected to remain below 34% of GDP. When account is taken of the build-up of assets in the National Pension Reserve Fund, the net debt to GDP ratio is considerably lower than the gross debt levels set out in Table 11. At end 2002, it was well below 30% of GDP.

Table 11 - General Government Debt Developments

% of GDP	2002	2003	2004	2005	2006
Gross debt level	32.4	33.1	33.3	33.5	33.3
Change in gross debt level	-3.7	0.7	0.2	0.2	-0.2
Primary balance	-1.2	-1.0	-0.3	-0.1	-0.3
Interest payments	1.4	1.5	1.4	1.4	1.4
Nominal GDP	-4.1	-1.4	-2.2	-2.4	-2.4
Net Receipts of Social Security Funds[5]	0.8	1.1	1.1	1.2	1.3
Other factors influencing the debt ratio	-0.6	0.5	0.2	0.1	-0.2
Of which: Privatisation receipts	-0.1	–	–	–	–
Increase in local authorities' debt[6]	0.6	0.5	0.4	0.4	0.4
p.m. implicit interest rate on debt	4.4	4.6	4.5	4.4	4.4

Source: Department of Finance

3.6 Balance by Sub-sectors of General Government

The balance by sub sectors of general government is set out in detail in Table 7. In Ireland Central Government accounts for around 90% of total Government expenditure (including transfers to local government). Ireland does not have a federal or state government system: Local Government, the Social Insurance Fund and the National Pension Reserve Fund (from which no expenditure is scheduled before 2025) account for the balance. These Funds had a combined surplus of more than 8% of GDP at end-2002, and this is expected to grow over the Programme period.

[5] Central Government transfers, contributions and investment income
[6] Substantially offset by increased mortgage assets

Chapter 4 – Sensitivity Analysis and Comparison with Previous Updates

4.1 Summary

This Chapter briefly outlines the impact on the underlying budget balance of different possible economic scenarios. It is estimated that a 1% change in the growth rate would change the General Government Balance (GGB) by about a cumulative ½% of GDP in years one and two, easing to below 1% of GDP in year three. In addition it is estimated that a 1% change in interest rates could affect economic growth by about ⅓% by year three, with a similar impact of around ⅓% on the GGB.

4.2 Alternative Scenarios and Risks

A number of points should be borne in mind when examining the results of the sensitivity analysis set out below. Firstly, the estimates should be seen as indicative and are subject to considerable uncertainty. Secondly, no fiscal policy response to the changed budgetary position is assumed over the period of the Programme. In reality such a response would occur if desirable in the interests of economic or budgetary sustainability, or if required in terms of the Stability and Growth Pact. Thirdly, the results vary according to the type of economic shock experienced

4.3 Sensitivity of Budgetary Projections to Different Scenarios and Assumptions

In line with estimates for previous years, the Economic and Social Research Institute has calculated that a 1% impact on the growth rate would change the General Government Balance by up to ½% of GDP in the first year. The budgetary impact of a 1% change in the growth rate per annum compared with the central projection is given in Table 12 below.

Table 12 - Impact on the Budget Balance of 1% Change in Rate of Growth Per Annum

	2004	2005	2006
Baseline GDP Growth (%)	3.3	4.7	5.2
GGBalance (% GDP) (including contingency)	-1.1	-1.4	-1.1
Cumulative impact of 1% change in growth per annum on GGBalance	Up to 0.5%	Up to 1.1%	Up to 0.9%
GGBalance Range (%GDP)	-1.6 to -0.6	-2.5 to -0.3	-2.0 to -0.2

Source: Department of Finance

Interest rate changes would impact on the budgetary position in two ways. They would affect debt service costs directly; and they would have an impact on economic activity, with consequences for both revenue and expenditure.

The impact on economic activity is highly uncertain. Higher interest rates would reduce investment and consumption spending. The size of the impact clearly depends on future expectations. Interest rate changes which are seen as temporary in nature will have a smaller impact than changes that are considered to be longer-lasting. The financial balance sheets of the personal and business sectors are also important. A more indebted economy would suffer a greater impact.

Estimates by the Economic and Social Research Institute suggest that a 1% increase in interest rates could reduce growth by as much ⅓% within three years. As a result, a 1% change in interest rates could change the General Government Balance by around ⅓% of GDP in this period also. It would also directly affect debt servicing costs but, as the debt burden declines, these effects are becoming more and more marginal relative to the impact on growth and Government revenues.

4.4 Comparison with Previous Update

Table 13 compares this Stability Programme Update with the updated Programme of December 2002. GDP growth in 2003 is now estimated at 2.2% of GDP, compared with the projection of 3.5% in last year's Stability Programme Update. At 2.5%, 2003 GNP growth (with which overall tax yields are more strongly associated) is slightly above the forecast of 2.2% in last year's Stability Programme Update. GDP growth rates for 2004 and 2005 have also been revised accordingly.

The General Government Balance in 2003 is now projected at -0.4% of GDP, somewhat better than the level anticipated in last year's Update. The forecast outturn for 2003 has been revised primarily because of stronger growth in tax revenues in the latter part of the year. The General Government debt ratio, already far below the 'Maastricht' threshold, is set to remain low over the period to 2006.

Table 13 - Divergence from Previous Update

% of GDP	2002	2003	2004	2005	2006
GDP growth					
previous update	4.5	3.5	4.1	5.0	–
latest update	6.9	2.2	3.3	4.7	5.2
Difference	+2.4	-1.3	-0.8	-0.3	–
Actual budget balance					
previous update	-0.3	-0.7	-1.2	-1.2	–
latest update	-0.2	-0.4	-1.1	-1.4	-1.1
Difference	+0.1	+0.3	+0.1	-0.2	–
Gross debt levels					
previous update	34.1	34.0	34.5	34.9	–
latest update	32.4	33.1	33.3	33.5	33.3
Difference	-1.7	-0.9	-1.2	-1.4	–

Source: Department of Finance

Chapter 5 - Quality of Public Finances

5.1 Summary

The objectives set out by Government include sustaining a strong economy, ensuring balanced regional development and building a caring society. In pursuit of these objectives funding has been provided to:

- underpin incentives to reward effort and enterprise, consolidating the progress made in recent years;

- raise the share of national resources devoted to public investment. Exchequer investment in infrastructural development has increased from 3% of GNP in 1997 to 5% of GNP for the last four years; and

- improve a broad range of key day-to-day public services – including developments in the health sector, in education and in measures to improve Research and Development;

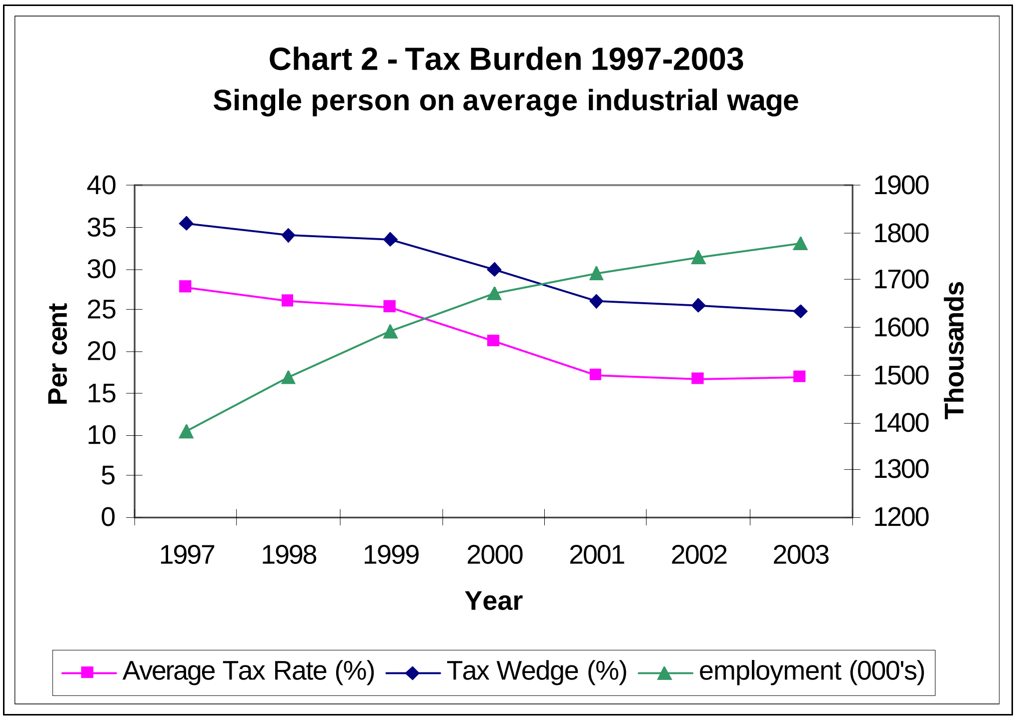
5.2 Revenue Strategy

Tax policy in recent years has been geared to promoting a job-friendly environment to facilitate robust employment growth, the development of a favourable environment for business development, and a better quality of life for citizens. This strategy is in line with the objectives of the Lisbon strategy.

As to its effectiveness, the figures published in connection with Census 2002 illustrate employment growth of over 25% (+334,000) between 1996 and 2002.

The Central Statistics Office (CSO) has pointed out that growth in the labour force reflects a combination of the underlying growth in the population aged 15 years and over, and increasing female labour force participation, with the latter increasing from below 40% in 1995 to almost 49% in 2002. Proactive labour market tax policies have played an important role in matching this labour force growth with positive employment growth. Chart 2 shows that the average tax rate at the average industrial wage has fallen quite significantly over this period.

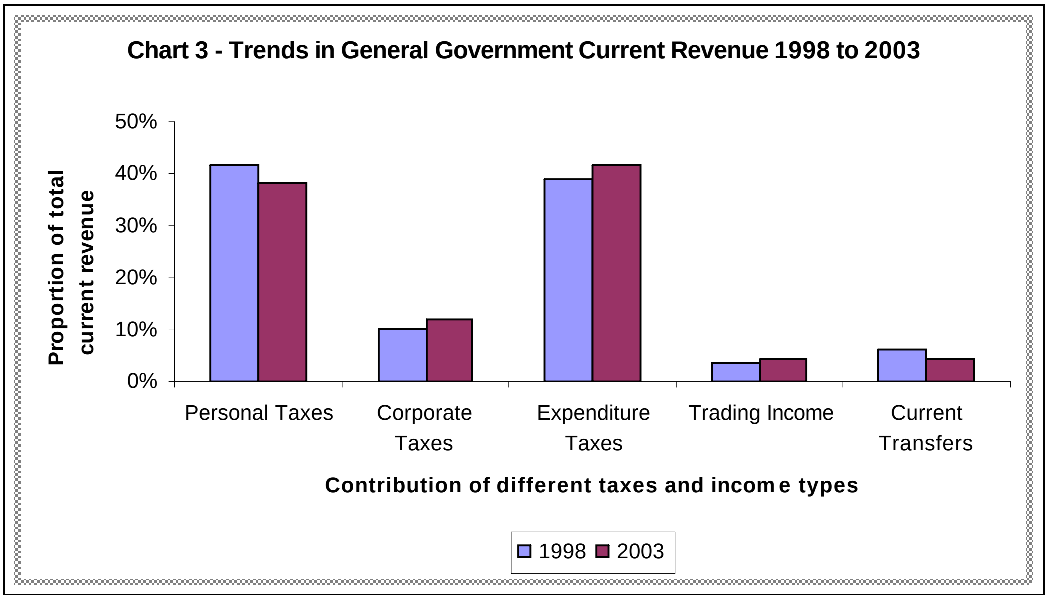
Budget 2003 and Budget 2004 have been framed under difficult budgetary circumstances with only limited funds being available for income tax reductions. Consolidating and preserving the employment-friendly income tax environment that has been achieved through the budgetary policy of previous years is now of paramount importance. Recognising this, Budget 2004 has sought to copperfasten the achievements of previous years by maintaining a low tax burden, and focuses the limited resources available towards the lower end of the income scale.



Source: Department of Finance

5.3 Changing Sources of Government Revenue

The evolution of the shares of general government current revenues over the last five years is indicated in Chart 3.



Source: Department of Finance

The policy-driven easing of personal taxation, especially for those on lower incomes, led to a decline in its share in total current government revenues over the period. The shares of net trading income arising in the government sector, and of both indirect and corporate taxes, rose – the latter despite further progress towards a unified corporate tax rate. Reflecting the continued diminution of net EU transfers to Ireland, government's net current transfer income declined in importance.

5.4 General Government Expenditure

Against a background of current economic and revenue growth, Ireland has been able to make considerable progress in addressing the national infrastructural deficit, and in improving a broad range of key public services. In relation to health, education and social welfare, the level of resources invested has been significantly increased, with corresponding improvements in the quality of public services and outcomes. Some specific examples include the following.

- Improvements in access to healthcare and a reduction in waiting lists, increased funding for services for people with physical and intellectual disabilities resulting in extra residential, respite and day care places, improved services for the elderly and in the areas of childcare and mental health services.

- Improvements in educational achievement. The most recent OECD Programme for International Student Assessment (PISA) finds that Ireland ranks above, or significantly above, the OECD average in reading literacy, mathematical literacy and in scientific literacy among 15 year olds.

- Advances made in addressing poverty. The National Action Plan against Poverty and Social Inclusion, published recently, indicates that the proportion of Irish households living in "consistent poverty" fell to 5.2% in 2001, compared with 9.7% in 1997 and 16% in 1987.

- EU Member States have committed to collectively increasing their Overseas Development Aid (ODA) to 0.39% of GNP by 2006. Since 1997 Ireland's ODA contributions have increased from €157m (or 0.31% of GNP) to €480m in 2004 (or 0.41% of GNP) compared to the European average contribution of around 0.34%.

Expenditure monitoring and control

The Broad Economic Policy Guidelines 2003-2005 recommended that Ireland "improve expenditure control through setting norms and ensure in the 2003 Budget and beyond that expenditure priorities and resource generation are targeted at a sustainable budgetary and economic outcome". Public expenditure is currently planned within an overall 3 year fiscal framework. The Irish Government is committed to framing and managing its expenditure policy, along with other fiscal policies, to achieve a sustainable match between spending and resources and meet the circumstances of the Irish economy. Chapter 7 includes additional material regarding expenditure management.

The record on control of public expenditure is good as is evidenced by Table 14 below:

Table 14 - Measuring Expenditure Management: 1997-2002

Year	Variance: Budget Estimate v. Outturn	Variance as a % of GNP
1997	+1.7%	+0.4%
1998	-0.8%	-0.2%
1999	+1.6%	+0.4%
2000	+1.7%	+0.4%
2001	+1.5%	+0.4%
2002	-0.4%	-0.1%

Source: Department of Finance

At end 2002, the Government agreed revised procedures to further improve the arrangements for the control and management of public expenditure. These measures, which were listed in the December 2002 Stability Programme Update, are now in place. In 2003, the Minister for Finance reported to Government on a monthly basis on the emerging trends in the public finances. Furthermore, the four Departments with the largest current spending allocations – Education & Science; Health & Children; Justice, Equality & Law Reform and Social & Family Affairs – reported directly to Government on a bi-monthly basis on the emerging spending trends in their areas.

The expected 2003 outturn included in the *Budget 2004 Statistics and Tables* shows that the new arrangements have delivered an improvement in expenditure control. The overall difference in the outturn *vis-à-vis* the Estimates provision relates mainly to the negotiation and agreement of the parallel benchmarking process. As this process was not finalised until mid to late 2003, a provision for the likely cost was not included in the Estimates or Budget last December.

Introduction of multi-annual envelopes
Continuing the process of improving arrangements for the management and control of the public finances the Minister for Finance announced in his Budget Statement the introduction from 2004 of 5 year multi-annual capital investment envelopes. As a result, Departments will have greater assurance about the future availability of resources for capital investment. They will have a multi-annual capital investment framework in which to plan and manage their capital programmes more efficiently and effectively than the existing annual allocation process allows. The introduction of new Capital Appraisal Guidelines accompanying the envelopes, and which will be applied to all projects funded under them, will ensure that better value for money is obtained from public investment in infrastructure in the future.

The ongoing development of other recent initiatives undertaken to improve the evaluation, management and monitoring of expenditure – and the delivery of quality services – is set out in detail in Chapter 7.

Outlook for Expenditure 2004-2006
In 2004, while sustaining strong public investment, resources for day-to-day services will increase by 7.7% on 2003. Within the total provision, key priority areas have been targeted:

- an additional €770 million (9%) in gross current spending for health services;
- an additional €608 million (11%) in gross current spending for education and science; and
- an additional €765 million (7%) in gross current spending for social welfare.

In 2005 and 2006, gross spending on day-to-day services will increase by 5.4% and 4.7% respectively, in line with the Government's commitment to sustainable improvements in public services. Table 7 shows the development of public expenditure in General Government terms.

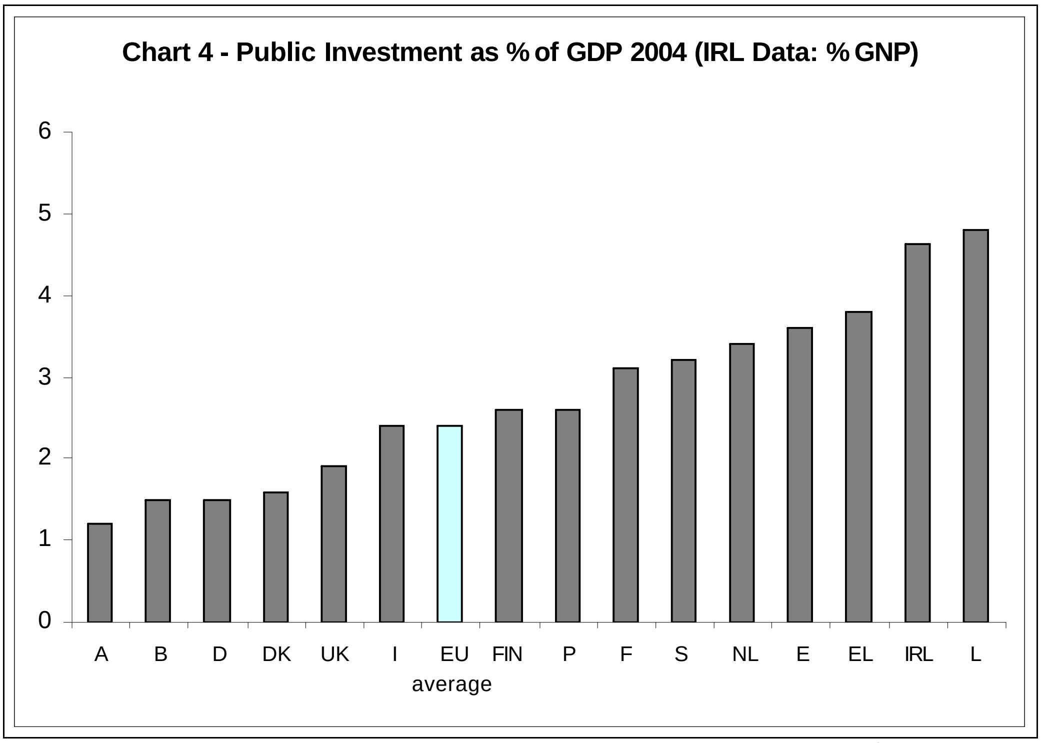
5.5 Infrastructural Investment
The Government has demonstrated its commitment to the provision of key infrastructure through continued investment under the Economic and Social Infrastructure Operational Programme (ESIOP) of the National Development Plan (NDP). Cumulative exchequer investment under the ESIOP by end 2004 (over €16 billion) will be well ahead of target. The bulk of this planned investment in roads, public sector transport and water and sewerage services is aimed at addressing existing bottlenecks and supporting further economic growth in the years ahead. In 2004 alone, the Government will invest €3.6 billion under the ESIOP. The programme covers areas such as:

- Roads & Public Transport €1.7 billion
- Housing €1.1 billion
- Water & Sewerage €0.3 billion
- Health €0.5 billion

Given the significant infrastructural deficit in Ireland, we currently commit twice the EU average to investment, as illustrated by Chart 4 overleaf. In 2004 gross Exchequer capital spending of about €5.6 billion is planned, some 4.9% of GNP, compared with €2 billion in 1997 – an increase of 177% over the period.

The investment measures contained in the Estimates, in Budget 2004 and in the NDP represent a prudent use of available resources to support sustained economic progress into the future. Their financing, despite an expected continuing reduction in EU funding, will respect the Stability and

Growth Pact. The new approaches to public investment underway, including Public Private Partnerships and the introduction of a multi-annual capital investment framework based on 5 year envelopes will complement the substantial investment planned in infrastructure.



Source: European Commission Autumn Forecasts 2003; Irish data: Department of Finance

Other Productive Investment

Over recent years, investment in Research & Development, Education, Employment Supports and Training has increased significantly, aimed at improving competitiveness and boosting the supply side of the economy. Productive investment (current and capital) in 2004 in these areas will amount to €7.3 billion (6.3% of GNP) as against €3.6 billion in 1997. The investment can be broken down as follows:

- Education: €6.3 billion
- Research & Development: €290 million
- Employment Supports and Training: €693 million

Investment in Balanced Economic Development

The 2004 Budget contains an additional capital expenditure provision of €20 million to meet the initial up-front investment required to underpin an ambitious new programme of decentralisation of Government departments and agencies. This programme will involve the progressive relocation of some 10,000 personnel out of Dublin City to regional centres and is designed to support the objectives of balanced regional development and economic growth contained in the National Spatial Strategy. Any capital funding requirements for future years will be dealt with within the overall five year capital allocation framework which was also announced in the Budget.

Mid-Term Review of National Development Plan and Community Support Framework for Ireland, 2000-2006

The Economic and Social Research Institute (ESRI), in its mid-term evaluation of the National Development Plan found that the objectives and strategy underlying the Plan are “as valid as when it was drawn up” and “the NDP/CSF has made substantial progress towards its objectives of continuing sustainable national economic and employment growth and consolidating Ireland’s economic competitiveness". The ESRI concluded that Ireland's GNP will be around 3% higher than it would otherwise have been but for the investment under the Plan over the past three years and that the investment in Plan represented a real rate of return of around 14% in the long run. Tackling the infrastructural deficit was highlighted as a key stepping stone to realising the economy's full potential. The ESRI saw continued investment in human capital, with more focus on preventing short term unemployment, as also important.

The NDP provisions in the 2004 Estimates are broadly in line with the ESRI recommendations for financial allocations in the key priority areas of infrastructural investment under the Economic and Social Infrastructure Operational Programme and in Human Resource development.

Chapter 6 - Sustainability of Public Finances

6.1 Long term Budgetary Prospects, including the Implications of Ageing

Recent studies by the Economic Policy Committee, and associated policy conclusions by the European Commission, acknowledge that Ireland is relatively well-placed to meet the budgetary challenges arising from population ageing, given Ireland's low tax rates and low levels of government debt[7]. The Commission also recognises that the gradual build-up of assets in the National Pension Reserve Fund will contribute toward meeting the budgetary costs of an ageing population. At the same time, the Commission notes that a long-term financing challenge may arise as spending on pensions and health care, as a share of GDP, approaches levels in other EU countries.

It should also be noted that in Ireland's case, the increase in budgetary costs associated with ageing are projected to be lower than the EU average in the period 2005-2010 and to be around the EU average in the period 2010-2015 and 2015-2020.

A central pillar of Government strategy is to ensure that issues of long term sustainability are fully addressed in current policies. Government policies which have public expenditure implications continue to take account of the spending pressures which will arise as a result of population ageing. The main policy initiatives which should have a positive effect on the sustainability of public finances are as follows.

- The establishment of the National Pension Reserve Fund in 1999 to assist in meeting the increased costs of social welfare and public service pensions. The Government is legally required to contribute 1% of GNP to this fund annually the assets of which will be drawn down from 2025 onwards. The assets of this fund now stand at €8.4 billion or 6.9% of GDP (2002).

- In relation to the occupational pensions sector in Ireland, the Government aims to increase coverage to 70% of people over 30. At present, coverage is only 51% and, when the public sector is excluded, approximately 30%. The Government has recently introduced a new Personal Retirement Savings Account (PRSA) system, to be offered to consumers by the pensions industry, with the objective of increasing coverage, particularly among those not covered by occupational pensions schemes. The Government has indicated that it will monitor the success of this initiative and formally review its progress within a three-year period.

- Over the past number of years, the Government has introduced a series of significant tax initiatives which are aimed at enhancing pension provision for the self-employed, employers in non-pensionable employment and proprietary directors and encouraging people to plan pensions earlier in their working careers.

- In mid-2003, the Government published a major study on the future financing of long-term care in Ireland as well as a review of the existing nursing home subvention scheme. These reports identified possible templates for future support arrangements in both community and residential settings and how they might be financed.

- The health reform programme takes account of a range of reports on organisation, financial management and manpower reform. The reform programme will establish a single organisation to manage the delivery of health services and put in place clear accountability structures and modern financial management systems to allow key decision-makers in the

[7] Economic Policy Committee document - *The impact of ageing on public finances: overview of analysis carried out at EU level and proposals for a future work programme*, October 2003

health service to link activities with budgets and to evaluate the effectiveness of decision making.

In conjunction with these initiatives, the Government continues to review demographic issues and to study the detailed spending implications across the main spending area of public spending and taxation. This will help us to focus on crucial strategies to address demographic change including achieving further increases in labour force participation rates, especially among females and older age groups, maintaining unemployment at its current low level and continuing the policy of five-yearly actuarial reviews of the Social Insurance Fund and the National Pensions Reserve Fund.

Public service pensions

Public service pensions are a significant issue for the Irish public finances. At present, spending on public service pensions is equivalent to 1.4% of GNP. It is estimated that, by the middle of the century, spending on public service pensions will have increased to about 2.5% of GNP.

A Commission on Public Service Pensions was established in 1996 to examine and report on all aspects of the issue. In 2001, the Government accepted the recommendations of the Commission in principle.

The Government has now decided to implement the bulk of the key recommendations of the Report of the Commission. With effect from 1 April 2004, the following reforms to public service pensions will be introduced for new entrants to the public service.

- The minimum pension age will be increased to 65 for most new entrants to the public service.
- The compulsory retirement age of 65 will be removed for these new entrants; enabling staff to remain in work should they wish, subject to suitability and health requirements.
- The minimum pension age will be increased to 65 for members of the Oireachtas and Office Holders elected or appointed on or after 1 April 2004.
- The minimum pension age will be increased by 5 years to 55 for new entrant Gardaí and Prison Officers.
- In the case of Gardaí, the compulsory retirement age for new entrants will be increased to 60, subject to annual health and fitness certification after age 55.
- A minimum pension age of 50 will be introduced for new entrants to the Defence Forces.

It is estimated that the annual savings, which will arise from the introduction of these pension changes, will be of the order of €300 million in current terms in 30-40 years time, with some savings being realised earlier than that.

Chapter 7 - Horizontal Issues Affecting Public Finances

7.1 Summary

This Chapter sets out a number of continuing reform measures being implemented in relation to the public finances. These include:-

- the Expenditure Review Initiative
- embedding of the revisions to the Estimates and Budgetary Process
- continued development of a Management Information Framework
- a pilot initiative to link resources to outputs and allow for better reporting on achievements
- ongoing reforms in the health services
- rollout of the modernisation and quality service delivery programme under *Sustaining Progress*
- implementation of the *Report of the Public Service Benchmarking Body*
- implementation of the reduction in public sector numbers
- ongoing work of the National Development Finance Agency; and
- agreement of multi-annual financial envelopes for capital investment.

7.2 Expenditure Review Initiative

The objectives of the Expenditure Review Initiative (ERI) are to analyse in a systematic manner what is being achieved by Exchequer spending and to provide a basis on which more informed decisions can be made on priorities within and between programmes. For the 2002-2004 Phase of the ERI, the Government has re-focused the reviews to deal primarily with areas that involve major policy issues or significant levels of expenditure. The ERI has been strengthened at a strategic level through the establishment of an Expenditure Reviewers' Network, the provision of central support and training, and the independent quality assessment of reviews. In addition, a Central Steering Committee, chaired by the Secretary General of the Department of Finance, has commenced a rolling series of meetings with Secretaries General to address the ongoing impact of expenditure reviews. These reforms will strengthen the contribution of the ERI to planning and resource allocation.

7.3 Embedding the revisions to the Estimates and Budgetary Process

In framing Budget 2004, the Minister for Finance has pursued a similar approach to the framing of the Estimates and Budget as in 2003. The important elements of this were the continuation of the Existing Level of Service (ELS) approach, and the setting aside of a Budget Day envelope.

The ELS approach focuses on the costs of continuing to provide the existing level of service in future years. This methodology has allowed a clearer distinction to be made between technical and policy adjustments, and has provided Government with a clearer basis for selecting priorities in the allocation of net extra resources. In framing the Budget, a Budget Day spending envelope was set aside to facilitate a more focused approach by Government in making its choices about the allocation of resources among priorities.

7.4 Management Information Framework

The Management Information Framework (MIF) is an integral part of the Irish Government's public service modernisation programme (the Strategic Management Initiative). It is a framework that will provide all Government Departments and Offices with flexible financial management systems integrated with output measurement to enhance performance and accountability. The MIF will facilitate both statutory and non-statutory reporting on both a cash and accruals basis. It will ensure better decision-making about the allocation of resources, better management of resources allocated and greater transparency in, and accountability for, the use of those resources. MIF systems are on target for installation in all Government Departments and Offices before end 2004.

7.5 Expenditure management and reform in the Health sector

The Government announced, in June 2003, a major programme of reform of the health services to ensure that the quantity and quality of services that people receive match the significant investment in those services. The reform programme draws on the recommendations of a number of key reports examining financial systems, practices and procedures as well as organisational structures within the health services. The priorities of reform are improved patient care, better value for taxpayers' money and improved health care. The key features include:

- a major rationalisation of existing health service agencies including the abolition of existing area-based health board structures;
- the establishment of a Health Service Executive to manage the health service as a single national entity;
- the devolution of responsibility for budgets to the people actually in charge of delivering services; and
- the complete modernisation of supporting processes (service planning, management reporting, etc.) to improve planning and delivery of services, including linking activities with budgets.

This is a large-scale reform programme which includes measures which will impact on every element of the health system. Detailed planning is now underway, in consultation with staff and staff representatives, and the necessary legislation to give effect to the new structures is expected to be in place by the end of 2004. In the meantime, the membership of the new Health Services Executive (HSE) has recently been announced. The HSE will operate on an interim basis pending the introduction of legislation which will underpin its formal establishment.

7.6 Pilot Project on Resource Allocation and Business Planning

A pilot project is underway with three of the larger spending Departments – Agriculture & Food, Social & Family Affairs and Transport – which is examining ways of improving the links between Departmental strategy statements, business planning and resource allocation in the Estimates to outputs and outcomes and performance measurement generally. The Pilot Project is being developed by a cross Departmental Steering Group assisted by a Working Group who will be responsible for producing a model and report in 2004. The Report will provide a basis for evaluating the pilot project and assessing whether the approach should be mainstreamed across all Departments.

7.7 Public Sector Pay

As noted in last year's Stability Programme Update, the Public Service Benchmarking Body's Report on pay in the public service was published in July 2002. Implementation of the Report is now underway, on the basis agreed under *Sustaining Progress,* the social partnership agreement.

The benchmarking process delivers benefits in terms of improved public service delivery (see 7.8 below) and an atmosphere relatively free from disruption due to industrial action. There is also a further structural benefit from this approach. The benchmarking exercise marks a significant change in the way public service pay is determined. The old system was based on a system of cross-sectoral relativities, centred on historical linkages between diverse groups of public service workers. The establishment of the benchmarking process discontinues that old system, focusing instead on comparable jobs in the private sector. This important structural change should lead, over time, to a better way of settling pay in the public service.

7.8 Link to Modernisation and improved service delivery

The payment of the final two phases of benchmarking and the increases due under the general pay agreement are dependent on the fulfilment of certain conditions. These are the absence of industrial action and achievement of modernisation objectives and co-operation with change and flexibility. There is a general commitment to co-operation with public service-wide changes and with normal on-going change. In addition, in the major sectors there are modernisation changes specific to each sector. The achievement of the objectives will be monitored by independent verification groups who will give an opinion prior to each of the five payment dates involved. Non-fulfilment of the objectives or non-compliance will lead to non-payment of the increase due for the group, organisation or sector involved.

7.9 Implementation of the reduction in public sector numbers

In Budget 2003, the Minister for Finance announced that public service numbers would be capped and would decrease by 5,000 over a 3 year period. The Government has subsequently agreed the timing and details of the reductions. In agreeing proposals in this area, the Government endeavoured that front-line service delivery staff would not be targeted for reductions.

7.10 Public Private Partnerships

The Government is harnessing the potential of Public Private Partnerships (PPPs) to help deliver the conditions needed to sustain output and employment growth in the Irish economy over the medium term. PPPs are a key element in the delivery of the *National Development Plan* (NDP) 2000-2006 which has a minimum indicative target for PPP investment of €2.35 billion. The accelerated delivery of national priority infrastructure projects, together with the attainment of value for money over the full life cycle of the asset are potential key benefits of PPPs.

There are currently some 40 projects at various stages of procurement ranging from roads to environmental services, public transport and third level education. Details of all current PPP projects are available on the Government's PPP website at www.ppp.gov.ie

7.11 National Development Finance Agency

Following the enactment in December 2002 of the National Development Finance Agency Act 2002, the Government on 1 January 2003 established the National Development Finance Agency (NDFA). The role of the NDFA is to:

- provide advice to State authorities, including Government Departments, to assist them in evaluating financial risks and costs of public investment projects;
- assess optimal financing for public investment projects (including Public Private Partnerships) such as those set out in the NDP and other infrastructure priorities; and
- in certain circumstances, raise finance for public investment projects.

The NDFA will help to maximise value for money for the Exchequer in a number of ways, including the identification of the best financing packages and the application of commercial standards in terms of evaluating financial risks and costs for each project. A further benefit is the centralising of commercial (including financial and legal) expertise, thereby reducing dependence on external consultants with consequent cost savings to procuring authorities, and ultimately to the Exchequer. State authorities involved in the procurement of capital projects over a certain minimum cost (currently €20 million) are legally obliged to seek the advice of the NDFA.

Chapter 8 – Balanced Economic Development

Ireland's recent prosperity has disproportionately impacted on the Dublin region with large increases in both employment and population. While the performance of this region has been vital to overall national economic success, the economic pressures being experienced have further increased by reference to other parts of the country. There are growing contrasts between areas encountering congestion due to a concentration of economic activity and services, and areas experiencing under-utilisation.

Although Dublin remains vital to economic development, the Government's *National Spatial Strategy* recognised that Ireland also needs a more even spread of development. Unbalanced development is not sustainable in the longer-term, economically, socially or environmentally. More balanced regional development will contribute to sustainable long-term economic growth to the benefit of all.

The 2004 Budget contains a new programme of decentralisation of Government departments and agencies. This programme will involve the progressive relocation of some 10,000 personnel out of Dublin City to regional centres and is designed to support the objectives of balanced regional development and economic growth contained in the *National Spatial Strategy*. For the first time ever, decentralisation will involve the transfer of complete Departments – including their Ministers and senior management – to provincial locations. A total of eight Departments will move their headquarters from Dublin to provincial locations, leaving seven Departments with their headquarters in Dublin.

The Government has also decided that, save in exceptional circumstances, any new agencies/bodies being established in future should be located in areas compatible with the new programme of decentralisation.

The dispersal of jobs from Dublin has important advantages for securing a better regional balance and for the economic and social development of the chosen centres and their catchments. Decentralisation can provide high-quality jobs for regions that have not benefited as much as Dublin from recent economic success. It can provide a boost in terms of the provision of infrastructure in the regions concerned. It can also attract other investment and services into the areas concerned, and act as an incentive to local, national and international entrepreneurs to develop businesses in these areas, thus creating a positive domino effect. Dublin will also benefit in terms of reduced pressure on housing, transport and other infrastructure.

The locations which have been selected take full account of the *National Spatial Strategy*, the existence of good transport links – by road, rail and/or air – and the location of existing decentralised offices. The aim has been to establish viable clusters of work units within a region, either in the form of self-contained locations or clusters of sites located geographically close to each other or to existing decentralised locations. This will help to avoid the pitfalls of fragmentation and protect service delivery. It will also help to provide career opportunities for decentralised staff either within their own Department or in another Department within a reasonable distance.

An Implementation Committee is being established to drive forward implementation of the programme, with the Chair of the Committee reporting to a special Cabinet sub-Committee. An additional capital expenditure provision of €20 million is being provided in the Budget to meet the initial up-front investment required and as an indication of its commitment to the programme.

Annex 1

Table 15 - Basic Assumptions

	2003	2004	2005	2006
Short-term interest rate (annual average)	2.3	2.3	3.2	3.2
Long-term interest rate (annual average)	4.1	4.4	4.8	4.8
USD/€ exchange rate (annual average)	1.13	1.16	1.15	1.15
World excluding EU, GDP growth	4.0	4.6	4.6	4.6
EU-15 GDP growth	0.8	2.0	2.4	2.4
Growth of relevant foreign markets	2.8	5.8	6.8	6.8
World import volumes, excluding EU	6.3	8.3	8.6	8.6
Oil prices, (Brent, US$/barrel)	28.3	25.6	24.1	24.1

Source: European Commission