

Ireland – Stability Programme 1999–2000

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Introduction and Summary

1.1 In January 1999, Ireland will, along with ten other EU Member States, adopt the single currency – the Euro. With the commencement of Stage 3 of EMU, the surveillance of Member States' economic and budgetary position will be enhanced. The Stability and Growth Pact requires Member States to submit *Stability Programmes* setting out their medium-term budgetary objectives and projections and the main assumptions about future economic developments.

1.2 This *Stability Programme*, covering the period 1999–2001, is being submitted to the European Commission in accordance with these requirements*. It is also being presented to Dáil Éireann by the Minister for Finance in conjunction with the 1999 Budget.

*Council Regulation (EC) 1466/97 No. of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies.

1.3 This Programme sets out the Irish Government's budgetary objectives for the next three years. For the period 1999–2001, an average General Government Surplus of 1.6 per cent of GDP is projected. These budgetary projections meet the medium-term objective of the Stability and Growth Pact of keeping budget positions close to balance or in surplus in normal economic circumstances.

1.4 This Programme is framed against a background both of robust, albeit slowing, economic growth in Ireland and of a more uncertain international environment. GDP is forecast to increase at an annual average rate of over 6 per cent over the next three years compared with growth of 9½ per cent this year. The prospective slowdown in Ireland's economic growth rate is primarily driven by a decline in the contribution of net exports to growth, particularly in 1999, and somewhat slower growth in domestic demand in 2000 and 2001.

1.5 Despite strong economic growth in recent years, inflation has remained moderate, averaging 2 per cent between 1994 and 1997. However inflation rose to an estimated 2.5 per cent in 1998, reflecting mainly the effects of the depreciation in the Irish pound's Effective Exchange Rate (EER) in 1997 and early 1998. More recently, the EER has recovered and, as the impact of these currency movements passes through, inflation is expected to moderate to an average of about 2 per cent for the period 1999–2001.

1.6 Reflecting a slower pace of export growth, a reduction in international transfers and the continuation of strong domestic demand growth, the balance of payments surplus is projected to be eliminated over the period of the *Stability Programme*.

1.7 The primary macroeconomic objective of the 1999 Budget and the *Stability Programme* is the continuation of sustained economic and

employment growth supported by Social partnership, low inflation and prudent budgetary policies. In keeping with the three *Convergence Programmes* previously submitted by the Irish Government, stability-orientated policies remain the priority. This is essential to ensure Ireland's successful participation in stage 3 of EMU and is critical to a continuation of economic and social progress.

1.8 The Government believes that the resources now available due to the favourable economic conditions must be used in a balanced way. The Government's budgetary plans continue with tax reform, while tackling social priorities and addressing infrastructural needs. The Government also intends to prepare the public finances for the longer-term costs of an ageing population in the early decades of the next century.

Chapter 2: Recent Economic Performance

Economic Performance in the 1990s

2.1 The 1990s has been a decade of exceptional growth for the Irish economy. GDP has grown by about 7 per cent on average per annum and it grew by an average of 9 per cent per annum since 1993. Employment expanded by over a quarter and unemployment fell from a peak of almost 16 per cent in 1993 to 7.8 per cent in March 1998.

2.2 Macroeconomic stability was a key factor underpinning this performance. Reflecting a prudent approach by successive Governments, the General Government Deficit has not exceeded 3 per cent of GDP in any year since 1988 – despite considerable fluctuations in the pace of growth – and a surplus was recorded in 1997. Combined with robust growth, this has enabled a rapid reduction in the indebtedness of the Government – from almost 120 per cent of GDP in 1986 to a prospective 52 per cent of GDP by end-1998 on an ESA79 basis.

2.3 Social partnership agreements between the Government, Employers, Trade Unions, farming interests and, in the most recent agreement, the social and voluntary sector have played a crucial role during this sustained period of fiscal consolidation and economic recovery. Four agreements have been negotiated since 1987. Each accepted the need for prudent fiscal and economic policy. Moderate wage increases linked to targeted tax reductions and improved social services underpinned the economic progress made. Monetary and exchange rate policy was directed at keeping inflation low.

Performance under the Convergence Criteria

2.4 The Maastricht convergence criteria have provided one of the key backdrops for macroeconomic policy in recent years. In March 1998, performance under the criteria for participation in Stage 3 of EMU was assessed by both the Commission and the European Monetary Institute (EMI).

Ireland was deemed to have fulfilled each of the Maastricht convergence conditions. Accordingly, Ireland, together with ten other Member States, will participate in the single currency from 1 January 1999.

2.5 The 1990's was also a decade of considerable real convergence of living standards in Ireland towards the EU norm although GNP* per capita is still below the EU average.

* size="1">There is a relatively large gap between GNP and GDP in Ireland because of profit repatriations of the multinational sector and foreign debt servicing costs. GNP amounts to only about 87 per cent of GDP

size="1">

Reasons for Ireland's Recent Strong Growth

2.6 Ireland's economic performance in the 1990s was based on a set of interrelated factors. Macroeconomic stability and social partnership are a key part of the story. These provided the necessary framework for growth; but other factors have also been influential, including a dynamic demographic structure, strong business investment, and high levels of public investment in physical and human capital, undertaken with the help of substantial EU Structural and Cohesion funding.

2.7 Buoyancy in the labour supply permitted strong economic growth during the 1990s. The labour force has grown by an average of about 3 per cent per annum since 1993 – well above the EU average of under 0.4 per cent. Notwithstanding some moderation over the next decade, labour force growth in Ireland is expected to continue to exceed the EU average by a large margin. This – in conjunction with appropriate budgetary policy and social partnership arrangements – will enable the Irish economy to sustain much faster non-inflationary growth than the EU average. It should also be noted that these demographic factors themselves require strong growth in output and employment to keep unemployment low. It is crucial in assessing Ireland's economic prospects, and the stance of budgetary policy, to take account of these factors.

2.8 Investment in education and training has raised the quality of the labour force, providing a further impetus to potential growth. The interaction of macroeconomic stability, the development of the Single European Market, ease of access to this market and the availability of a large, skilled labour pool has underpinned investment in Ireland. Ireland will continue to benefit from all of these factors during the period of this *Stability Programme*.

EMU Stage 3

2.9 In Stage 3 of EMU, the institutional policy framework will change with responsibility for monetary policy transferring from national authorities to the European Central Bank (ECB). In these new conditions, the Irish Government is determined to maintain the stable economic environment and fiscal policies that have been crucial to our recent economic success. This represents a

considerable challenge. In particular, EMU places a greater onus on budgetary policy, in conjunction with social partnership, to deliver the right domestic conditions for sustainable growth.

Economic Review of 1998

2.10 1998 was the fifth successive year of very strong economic growth. GNP is estimated to have increased by about 8½ per cent in volume terms. Growth was well-balanced, with significant contributions from both domestic demand and net exports. Over the year as a whole, it is expected that personal consumption will have risen by 7¾ per cent. Strong growth in employment and earnings has supported this rise in consumer spending, as have lower interest rates and the prospect of further interest rate reductions.

2.11 In the year to March 1998, the numbers employed grew by 7 per cent, according to the most recent *Quarterly National Household Survey*. In response to this strong demand for labour, the labour force grew by 4 per cent. Unemployment also fell significantly to 7.8 per cent from 10.3 per cent a year earlier. For 1998 as a whole, it is expected that the numbers at work will increase by about 4½ per cent.

Table 1 – Economic and Budgetary Indicators 1993–1998

1.	1993	1994	1995	1996	1997	1998
	% Volume Change					
GNP	3.1	8.1	9.6	6.4	8.1	8.5
GDP	3.1	7.3	11.1	7.4	9.8	9.5
Personal consumption	2.4	6.3	4.1	6.1	6.3	7.8
Public consumption	0.4	5.0	2.6	1.5	4.8	5.0
Fixed investment	–3.6	12.2	10.9	13.6	10.9	11.3
Exports	9.7	14.2	19.6	11.7	16.9	18.9
Imports	7.2	14.8	15.8	12.2	15.6	18.2
Current Account (% GNP)	4.3	3.2	3.1	3.1	3.2	3.2
	1.5	2.4	2.5	1.6	1.5	2.5

Consumer Prices (% change)	4.5	1.2	0.5	1.7	2.3	3.5
<i>GDP Deflator (% change)</i>						
Unemployment (% labour force)	15.5	14.1	12.1	11.5	9.6	7.8
	1.9	3.5	4.7	3.7	5.2	4.6
Employment (% change)	22	42	58	47	70	65
Employment (`000's)						
General Govt. Balance	-2.3	-1.6	-2.2	-0.4	0.9	2.0*
Deficit(-)						
Surplus(+) as (%GDP)						
General Govt. Debt (% GDP)	93.1	86.5	78.9	69.4	61.3	52*

* ESA79 Basis

Sources: CSO and Department of Finance

2.12 The manufacturing sector continues to benefit from record levels of investment. Year-on-year growth in manufacturing output was up 17 per cent in the first 8 months of 1998 while exports rose by almost 27 per cent. Imports are expected to grow by about 18 per cent for the year as a whole, leaving a contribution of net exports to GDP growth of 3 percentage points.

2.13 In volume terms investment is estimated to have been over 11 per cent higher than in 1997. This is a reflection of buoyant economic conditions and high levels of investor confidence. It also reflects public sector investment which has been increased by over 20 per cent on 1997 to address Ireland's considerable infrastructural needs.

Budgetary position

2.14 The budgetary outturn for 1998 will be substantially better than the budget-day forecast of a General Government Surplus of 0.3 per cent of GDP. A surplus of 2.0 per cent is now expected*.

*This is on an ESA79 basis which equates to 1.7 per cent of GDP on an ESA95 basis as shown in Table 4.

2.15 In March 1998, the Government declared its resolve not to exceed the expenditure commitments in the 1998 Budget and to ensure that any revenues above those anticipated in that Budget would be used to raise the primary budget surplus. In line with this commitment, additional revenues have been used to increase the surplus and reduce the General Government debt.

Price Developments

2.16 Ireland's inflation rate has increased during the course of 1998. By August 1998 it had risen to 3.2 per cent compared with an average of 1.5 per cent for the whole of 1997. However, by October 1998, inflation had moderated slightly to 2.9 per cent. On the basis of the Harmonised Index of Consumer Prices (HICP) measure, Ireland's inflation rate was 1.2 per cent in 1997. It has risen sharply relative to the Euro 11 average this year and was 2.6 per cent in October 1998 compared with the Euro 11 average of 1 per cent.

2.17 The increase in inflation in 1998 was due, to a large extent, to the 10 per cent fall in Ireland's Effective Exchange Rate (EER) between the first quarter of 1997 and the first quarter of 1998. It is clear that this depreciation has been reflected in the price of some traded goods prices but it also would be expected to impact indirectly on the price of non-traded goods and services. Domestic demand factors have also played a part. Higher prices in the services sector reflect in part higher input costs due to these exchange rate movements but also increased wages. Developments in this sector are being monitored closely.

2.18 The exchange rate movements which contributed to the rise in inflation in 1998 are beginning to unwind. Since March, the EER appreciated by more than 4 per cent. As a result, it is reasonable to expect that inflation has peaked and that a return to more moderate rates of inflation during the course of next year can be expected. More moderate economic growth, in addition to lower international inflation, should also reinforce this downward trend.

Emerging Supply-Side Pressures

2.19 The rapid growth in output and employment is giving rise to some supply-side pressures, particularly in the labour market. Private sector earnings are expected to grow by about 5½ per cent this year compared with less than 4 per cent in 1997. This is due to tighter labour market conditions – particularly in the "high-tech" and construction sectors. In these sectors, because of very strong labour demand and despite a significant increase in employment, wages have increased ahead of expectations. Faster wage

growth this year also reflects the early payment of productivity payments under Partnership 2000 and higher pay claims in the public sector.

2.20 These trends are a cause for concern. The Government is determined that future wage developments, in the context of social partnership, will be consistent with maintaining the economy's underlying competitiveness. However, the very strong employment growth between early 1997 and early 1998, as indicated by the *Quarterly National Household Survey*, suggests that the economy-wide increase in pay rates may not have been as great as earlier thought. It should be noted, moreover, that despite the pick-up in pay rates, both manufacturing output prices and unit wage costs remain relatively stable due to strong growth in labour productivity.

2.21 House prices have been rising rapidly in Ireland in recent years. This can largely be explained as a lagged response to sharp rises in incomes, employment and household formation in the face of inadequate housing supply. However during 1997 and 1998, the scale of the rise in house prices was causing concern.

2.22 There was a serious danger that high increases could eventually spill over into general inflation. In response to these trends, a number of measures were introduced by the Government on foot of a detailed analysis of the housing market. These included proposals to increase the potential supply of housing and the removal of some fiscal supports which were having an inflationary impact. While there was an easing of house price inflation in the Autumn of 1998, the long-term solution to this problem must be based on a greatly increased supply of housing to bring supply and demand into balance.

2.23 Money supply and credit growth have been rising at rates considerably in excess of the growth in nominal GDP. However, because of the openness of the Irish economy, there has generally been little relationship between these indicators and inflation.

Chapter 3: Macroeconomic Projections 1999 – 2001

3.1 This chapter sets out the main economic projections underpinning this *Stability Programme* and the main international and domestic economic assumptions on which these projections are based.

Uncertain International Environment

3.2 As a small and open economy, with a high dependence on exports and inward investment, Ireland's economic performance is crucially dependent on conditions elsewhere. The international economic background against which this *Stability Programme* has been prepared is more uncertain than seemed likely earlier this year. In the course of 1998, the world economic outlook has deteriorated significantly. The impact of events in Russia and Asia has spread quickly. Emerging markets are under increasing pressure. Some estimates suggest that countries accounting for over a third of world GDP are in recession.

3.3 The projections for growth in Ireland's trading partners used for the macroeconomic projections underpinning the *Stability Programme* are included in Table 2 below. These are taken from the European Commission's Autumn 1998 forecasts.

Table 2 – Real GDP Growth in Ireland's Main Trading Partners

	1998	1999	2000
Germany	2.8	2.2	2.6
France	3.1	2.6	2.8
Italy	1.7	2.1	2.5
United Kingdom	2.5	1.3	2.1
EU – 15	2.9	2.4	2.8
Euro – 11	3.0	2.6	2.9
United States	3.3	2.1	2.2

Source: European Commission (Autumn 1998)

3.4 In the OECD area, growth next year is now expected to slow to less than 2 per cent. In the EU (which accounts for over two thirds of Ireland's exports), the European Commission's Autumn forecasts project real GDP growth of 2.4 per cent in 1999 compared with 2.9 per cent this year. Growth in the US (which accounts for 11 per cent of Ireland's exports) is projected to moderate significantly. In the UK, Ireland's single most important trading partner accounting for almost one quarter of exports, a slowdown in growth to 1–1.5 per cent in 1999 is now forecast.

3.5 The Irish economy will be more affected than most European countries by this expected slowdown in world economic growth. As noted above, over one third of Ireland's exports go to the US and UK economies which are expected to post the slowest growth of any of the major OECD economies bar Japan. In addition, the overall share of Ireland's exports outside the EU is 25 per cent compared to 10 per cent for the EU as a whole. These factors are expected to slow export volume growth to under 11 per cent in 1999 from almost 19 per cent this year. The contribution of net exports to GDP growth is likely to fall from 3 percentage points this year to a small amount in 1999.

3.6 The contribution of Foreign Direct Investment (FDI) to growth in the Irish economy in 1999 is also likely to be lower than in recent years. Even before the global economic crisis of mid-1998, it had been expected that inward investment would gradually slow from the exceptional levels recorded over recent years. This reduction is likely to be exacerbated by the slowdown in the US economy, stock market volatility and the increased overall economic uncertainty. All of these factors are likely to lead to lower foreign investment

being undertaken by US-based operations in Ireland. However, these very uncertainties have contributed to an easing of international interest rates which should provide some countervailing support to economic activity.

Economic Outlook in Ireland 1999 – 2001

3.7 The main assumptions, underpinning the projections are:

- unchanged exchange rates*
- interest rates to remain at present core eurozone rates
- the international economic outlook as outlined in Table 2
- the maintenance of cost competitiveness
- the Government's budgetary plans as set out in Chapter 4

*In the case of EMU participant countries, the bilateral central rates of the ERM agreed in May last as the basis for conversion to the euro are assumed, with pro-rata adjustments for other currencies.

Based on these assumptions the macroeconomic projections for 1999–2001 are summarised in Table 3 below.

Table 3 – Macroeconomic Projections 1999–2001

	1998	1999	2000	2001
	% Volume Change			
GNP	8.5	6.0	5.7	5.2
GDP	9.5	6.7	6.4	5.8
Personal consumption	7.8	7.5	7.0	6.2
Public consumption	5.0	4.0	3.0	2.0
Fixed investment	11.3	11.0	7.9	7.0
Exports	18.9	10.9	7.6	8.1
	18.2	12.8	8.1	8.5

Imports				
	3.2	1.7	0.1	-0.6
Current Account (% GNP)				
	2.5	2.0	2.0	2.0
Consumer prices				
	3.5	2.7	2.1	2.1
GDP Deflator				
	4.6	3.1	2.3	1.7
Employment				
	65	45	35	27
Employment ('000)				
	7.8	6.8	6.2	5.9
Unemployment Rate				

Source: Department of Finance

3.8 Growth in real GNP is forecast to moderate to 6 per cent in 1999 compared with 8.5 per cent in 1998 and an annual average of 9 per cent since 1993. As discussed in paragraph 3.5, this mainly reflects the reduced contribution from the external balance as export growth slows. Strong growth in personal consumption will contribute to growth in imports of almost 13 per cent in 1999. The surplus on the current account will fall from a prospective 3.2 this year to 1.7 per cent in 1999 and is likely to decline further over the period of the Programme.

3.9 The impact on growth of a weaker international environment will be partly offset by the continued strength of domestic demand in 1999. A broad range of factors including lower interest rates, strong gains in disposable income, robust employment growth and lower unemployment will all help to support consumer confidence in the years ahead. Inflation is projected to moderate to an average of 2.0 per cent compared with 2.5 per cent in 1998. Inflation should remain at about 2 per cent on average in 2000 and 2001.

3.10 Looking beyond 1999, GNP growth is expected to moderate further to an annual average of about 5½ per cent out to 2001. This represents a marked deceleration in the pace of growth compared with the very high rates experienced in recent years. Growth in all the main components of GNP – exports, investment and personal consumption – will moderate. Ireland's prospective competitive position is likely to mean that the large gap seen in recent years between export growth and the growth of export markets is likely to narrow in the years ahead – with export growth being much closer to export market growth.

3.11 Conditions in the labour market will also ease somewhat but the expansion in employment is expected to remain strong at over 2 per cent per annum during this Programme period. The increase in employment will come

mainly from the continuing strong growth in the labour force but a significant reduction in the numbers out of work will also make a contribution. This will be assisted by the Government's labour market reforms and proposed tax changes aimed at improving work incentives.

Chapter 4: Medium-Term Budgetary Policy

Introduction

4.1 Sustaining low inflation and economic and employment growth is the primary macroeconomic objective of budgetary policy in Ireland over the next three years. Over the period of this *Stability Programme*, the Government intends to run significant budget surpluses each year and to continue to reduce the burden of Government debt. Within this general budgetary framework, social needs will be addressed while public capital investment will be increased in order to tackle Ireland's still large infrastructural deficit compared with other EU Member States. On taxation, the changes announced in the 1999 Budget are designed both to enhance work incentives, particularly for the lower paid, and to promote greater equity. The Government intends to continue its tax reform policies in the remaining years of this Programme.

4.2 Due to the current favourable economic and budgetary conditions, the Government is in a position to address key social and investment priorities. However, it also regards it as essential to take advantage of these favourable circumstances to reduce the burden of debt further and to prepare the public finances now for the long term challenges in the next century, particularly those arising from the ageing of the population.

Budgetary Projections 1999–2001

4.3 A General Government Surplus is projected for each year of the *Stability Programme* as shown in Table 4 below. An average annual surplus of 1.6 per cent of GDP is forecast for the three years 1999–2001, compared to an anticipated outturn of 1.7 per cent for this year on an ESA95 basis.

Table 4 – Budgetary Projections – 1999–2001 [^]

	1998	1999	2000	2001
	as a percentage of GDP			
Current Account	3.7	4.0	4.6	5.1
Surplus	–2.0	–2.3	–2.8	–2.7
Capital Account	–	–	–0.4	–0.8
Deficit^{^^}				
Contingency^{**}				
	1.7	1.7	1.4	1.6

General Government Surplus	5.4	5.1	4.2	4.1
– of which Primary Surplus				
	59	52	47	43
General Government Debt				

* ESA95 Basis [Preliminary National Accounts Assessment]

^These projections are based on ESA95 conventions. These new accounting rules reduce the surplus by about 0.4 per cent of GDP from 1999 and add about 6 percentage points to the Debt/GDP ratio.

^^This is the net amount of investment that must be financed by Government after internal resources and EU transfer payments are taken into account.

**This is a provision made against factors outside the control of government that may impact on the Budget but which cannot be foreseen at this stage.

4.4 These budgetary projections take account of an increase in the deficit on the capital account from 2.0 per cent of GDP in 1998 to 2.7 per cent in 2001 reflecting both the expected drop in transfers from the EU in 2000 and 2001 and increased public sector investment. A current account surplus of 5.1 per cent of GDP by 2001 is forecast, compared with 3.7 per cent of GDP in 1998.

4.5 A contingency provision against possible adverse developments affecting the budgetary position is included. This amounts to 0.4 per cent of GDP in 2000 and 0.8 per cent in 2001.

4.6 The debt/GDP ratio is expected to fall to 43 per cent of GDP by 2001 from an expected 59 per cent at end-1998 on an ESA95 basis.

Expenditure Projections 1999 – 2001

4.7 Irish society faces many pressing social problems. Despite significant progress in recent years, there are challenges to be addressed in the area of long-term unemployment, social disadvantage and in our health and education services. The Government's expenditure proposals seek to address these social needs. Additional resources have been made available to continue the improvements in health, education and the social security area.

4.8 The Government's expenditure plans set out to meet these policy objectives while staying within agreed expenditure limits. In the Government's Programme – *Action Programme for the Millennium* – a commitment is given to restrict annual growth in net current expenditure to 4 per cent. In this context, net current expenditure is defined as the total of gross current outlays less social security and other receipts.

4.9 The expected trend in general current expenditure as a percentage of GDP is given in Table 5 below. It is projected to decrease from 31.4 per cent of GDP in 1998 to just over 28 per cent by 2001. The cost of servicing the national debt is set to fall – reflecting the combined impact of interest rate reductions and the falling debt burden. These savings will allow higher growth in non-interest expenditure while enabling total net current expenditure growth to stay within the Government's 4 per cent limit.

Table 5 – Total Government Current Expenditure *

	1998	1999	2000	2001
as a percentage of GDP				
General Government	31.4	30.5	29.2	28.1
Current Expenditure	3.7	3.4	2.8	2.5
of which:	13.3	13.3	13.0	12.6
• – <i>Interest payments</i>	14.4	13.8	13.4	13.0
• – <i>Goods and Services</i>				
• – <i>Other Transfers</i>				

[Preliminary National Accounts Assessment]

*These apportionments for general current expenditure by category are provisional

Public Sector Investment

4.10 Despite substantial investment in recent years Ireland still has a major infrastructural deficit compared with many of its EU partners. This has accumulated over decades as Ireland's relatively low per capita income constrained such investment, both public and private. Notwithstanding EU-assisted activity in recent years, the quality of infrastructure is well below the requisite standard in vital areas such as transport, water and sewerage services. Due to the recent rapid, and in part unexpected, pace of economic growth, bottlenecks and other signs of pressure on capacity are now becoming severe. In addition, some regions of the country are lagging behind the average in terms of growth performance and efforts must be made to deal with this problem. These issues must be addressed if Ireland's growth potential is to be fully realised.

4.11 In response to these urgent needs, capital expenditure will increase by over 30 per cent in 1999 and will be increased further in subsequent years. The bulk of this planned investment is in roads, public sector transport and

water and sewerage services which will address existing bottlenecks and allow for further growth in the years ahead.

Table 6: Capital Account

	1998	1999	2000	2001
as a percentage of GDP				
Total Government Investment	3.5	3.8	3.8	3.7
Capital Resources	1.5	1.5	1.0	1.0
Capital Deficit	-2.0	-2.3	-2.8	-2.7

[Preliminary National Accounts Assessment]

4.12 This represents a prudent use of available resources. Through this increased investment, Ireland's infrastructural deficit will be reduced. However, eliminating it completely is a challenge that will require additional investment over a long period. This will have to be financed despite an expected reduction in EU funding from 2000 onwards, while respecting, at all times, the Stability and Growth Pact. Given the costs involved, all possible sources of funding are being examined by Government, including the scope for Public/Private Partnerships.

Taxation

4.13 The changes in taxation announced in the 1999 Budget will result in taxes and social security receipts as a proportion of GDP reducing slightly in 1999 to 33.0 per cent of GDP compared with 33.5 per cent in 1998.

Table 7: Total Government Current Resources

	1998	1999	2000	2001
as a percentage of GDP				
General Government Current Resources	35.1	34.5	33.8	33.3
of which:	29.3	28.7	28.2	27.9
– <i>Central Government Taxes</i>	4.2	4.3	4.1	4.0
– <i>Social Security Receipts</i>	1.6	1.5	1.5	1.4
– <i>Miscellaneous Current Receipts</i>				

[Preliminary National Accounts Assessment]

4.14 The 1999 Budget continued the Government's programme of income tax reform. The proposed tax changes are designed to improve work incentives, address unemployment and poverty traps and improve the interaction of the tax and social welfare systems. The planned measures are aimed at increasing the effective labour supply, thus helping to address emerging problems in the labour market.

4.15 In particular, a major reform is being introduced by making the main personal tax allowances available only at the standard rate of income tax, rather than at the taxpayer's marginal rate. This equalises the value of the allowances to all taxpayers. The Budget also provides for a significant increase in the standard-rated allowances and a widening of the standard tax rate band.

4.16 The Government intends, in the remaining years of this Programme, to continue with appropriate tax changes designed to meet the needs of the labour market and to maintain general wage moderation in the context of continued social partnership. The projected tax/GDP ratio, and the budgetary projections in Table 4, incorporate provisional annual provisions in 2000 and 2001 in this respect.

4.17 The tax changes proposed complement the Government's *National Employment Action Plan*. This is a strategic plan aimed at increasing sustainable employment and reducing unemployment, particularly long term unemployment. Combined with education and training initiatives and labour market reforms, this strategy should lead to further reductions in structural unemployment.

4.18 The *National Employment Action Plan* contains a two-pronged approach. First, there is the continuing focus on reducing the stock of long term unemployed. Second, there is a preventative strategy which focuses on early and systematic intervention with unemployed people, with the emphasis on reintegration into the labour market as quickly as possible. In this regard, an initiative was launched recently which offers all persons aged under 25, and registered as unemployed for six months or more, a range of options as an alternative to unemployment. The early indications suggest that this initiative is proving to be successful. Other elements of the strategy include measures to boost the flexibility of businesses, to strengthen equal opportunities policies, to develop entrepreneurship, to promote better provision of child care facilities, and to assist disabled persons in accessing employment.

4.19 On corporation tax, the Government's budgetary policy provides for the achievement of a single rate of corporation tax on trading income in 2003.

Compliance with Stability and Growth Pact

4.20 Adherence to the objectives of the Stability and Growth Pact requires that budget positions must be close to balance or in surplus in normal economic conditions. This suggests that cyclical factors and their effect on the budget need to be considered in assessing the underlying budgetary position.

4.21 As the Irish economy is growing strongly, and is projected to continue to grow strongly over the next three years, a policy of running significant budget surpluses is clearly appropriate. However the extent to which the economy is above or below trend (i.e the estimated output gap), and the magnitude of the related cyclically-adjusted budget balance, are very difficult to estimate. Indeed, the degree to which such analyses are meaningful at all for the Irish economy given its openness and the highly elastic labour supply is questionable. This is discussed in Appendix 2.

Table 8 : Budgetary Projections

	1998	1999	2000	2001
General Government Balance*	1.7	1.7	1.4	1.6
– <i>excluding contingency</i>	1.7	1.7	1.8	2.4
Change in Cyclically-Adjusted General Government Balance	–	+0.1	–0.3	+0.5
(+ = tightening)	–	+0.1	+0.2	+0.8
– <i>excluding contingency</i>				

*For comparative purposes, these figures are given on a ESA95 basis.

4.22 The budget surplus, on a comparable ESA95 basis and including the contingency provision, is projected to fall from an expected 1.7 per cent of GDP in 1998 to 1.6 per cent in 2001. As noted earlier, this reflects slower growth, higher capital investment and lower EU transfers. Excluding the contingency provision, the budget surplus is forecast to increase from 1.7 per cent in 1998 to 2.4 per cent in 2001.

4.23 Despite the projected slowdown in economic growth, significant budget surpluses are forecast. Under the cyclically-adjusted methodology used by the EU Commission, this represents a tightening of fiscal policy over the period of the Programme. The results of the cyclically adjusted budget analysis are set out in Table 8 above and details are provided in [Appendix 2](#).

Sensitivity to lower growth

4.24 The economic projections continued in this *Stability Programme* are based on a prudent assessment of Ireland's growth prospects for the next three years. The impact on the budget position of different economic scenarios is considered in the sensitivity analysis contained in [Appendix 1](#). In the event of slower than expected growth, the Government is committed to ensuring that the budgetary position continues to respect the terms of the Stability and

Growth Pact.

Longer-Term Public Finance Objective

4.25 For the last decade one of the key objectives of fiscal policy has been to reduce the debt/GDP ratio towards 60 per cent. This has now been achieved with the debt ratio falling to 52 per cent of GDP at the end of 1998 on an ESA79 basis. However, the Government must continue, in addition to tackling social and economic priorities, to take advantage of the present buoyant economic conditions and favourable demographic trends to prepare the public finances for future challenges.

4.26 In particular, the ageing of the population will present considerable challenges for the public finances in the longer term. In the next century the number of people aged over 65 will increase dramatically. Estimates in the 1997 Report "*Actuarial Review of Social Welfare Pensions*" suggest that the number will increase from 400,000 now to over 750,000 by the year 2025 and to 1 million by 2050. As a result, there will be higher costs for both public sector and social welfare pensions. The ageing of the population will also put upward pressure on health costs.

4.27 These changes will occur at a time when the labour force will be growing at very moderate rates. The working-age population is likely to peak around 2020 and to fall steadily thereafter. This will result in lower long-term growth.

4.28 The Government is considering how it can reduce further the net burden of public debt and prepare for these challenges. In this context, the issue of pre-funding future pension costs is relevant. This issue was addressed in the Pension Board's Report "*Securing Retirement Income*". The Report suggested that in order to meet the increased cost of Social Welfare pensions associated with an ageing population, there should be part pre-funding of such costs. This is being examined by a special expert group. *The Commission on Public Service Pensions* is also considering the future of public service pensions which are likely to increase significantly in cost over the next thirty years. The Government will consider this issue further when the reports are available.

Structural Reform

4.29 The taxation changes proposed by the Government, in conjunction with the strategy already outlined in the *National Employment Action Plan*, have a crucial bearing on the success of macroeconomic policy. While this *Stability Programme* is primarily concerned with macroeconomic policy, reforms to improve the functioning of product and labour markets are crucially important.

4.30 EMU will both facilitate and make more important the achievement of economic reform. The progress made on budgetary consolidation and price stability in preparing for EMU has provided a sound macroeconomic background against which further structural reform can be undertaken. At the

same time, the loss of exchange rate and interest rate instruments of adjustment at the national level increases the need for a more efficient and flexible functioning of both product and labour markets.

4.31 Microeconomic initiatives designed to make markets work better have been an integral part of Irish Government policy for some time now. Loss-making State companies have been re-structured and given a clearer commercial mandate. New competition laws have been enacted and a Competition Authority was established with strong powers to ensure that dominant positions are not abused and that markets work as efficiently as possible.

4.32 A separate report on *Structural Reform* is being prepared and will be submitted to the Commission before the end of the year.

Appendix I

Sensitivity Analysis

The central economic forecasts included in this *Stability Programme* represent a prudent assessment of Ireland's growth prospects for the next three years. These forecasts provide the basis for the budgetary projections. It is recognised that actual economic developments could, of course, differ considerably from these projections. The purpose of this Appendix is to briefly outline the impact on the underlying budget balance of different economic growth and interest rate scenarios.

In these scenarios, it is assumed that there is no fiscal policy response to the changed budgetary position. Such a response would occur, if required, to stay within the terms of the Stability and Growth Pact.

Alternative Scenarios

• *Impact of 1% change in growth compared with central projection*

The budgetary impact of a change in the growth rate compared with the central projection is given in the Table below.

The Impact on the Budget Balance of 1% change in the

	rate of growth per annum		
	1999	2000	2001
Baseline GDP Growth	6.7%	6.4%	5.8%
GGSurplus (% GDP)	1.7	1.4	1.6
(including contingency)	up to 0.5%	up to 1.0%	up to 1.5%

Cumulative impact of 1% change in growth per annum on GGSurplus	1.2 to 2.2	0.4 to 2.4	0.1 to 3.1
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GGSurplus Range
(%GDP)

– Impact of 1% change in Interest Rates compared with central projection

The macroeconomic projections assume that Irish interest rates converge to core Euro 11 rates towards the end of this year and remain unchanged at this rate for the remainder of the period 1999–2001.

Interest rate changes would impact on the budgetary position in two ways: first they would affect debt servicing costs and, second they would have an impact on economic activity and revenue receipts. The impact of this latter point is highly uncertain. Over time higher interest rates would reduce investment and consumption spending. However, the magnitude of the effects depend on the impact on future expectations; interest rate changes which are seen as temporary in nature will clearly have less of an impact than changes that are perceived to be more permanent.

(1) Impact on Economic Growth

It is estimated that in the first year, interest rate changes of 1 per cent would have an impact of 0.2 per cent on GDP growth. After a full three years the impact on the level of GDP is just over 0.6 per cent. Thus, the General Government Balance would be affected by a marginal 0.1 per cent in the first year, increasing to 0.3 per cent by 2001.

(2) Impact on debt servicing costs

The impact of interest rate changes on debt servicing costs is difficult to forecast as it is extremely sensitive to the timing of any change. For the purposes of this analysis, it is estimated that higher interest rates of 1 per cent across the yield curve add about 0.2 per cent of GDP to General Government expenditure in the first **full** year but this figure would rise over time as fixed rate debt matures and is refinanced.

The figures in the Table overleaf covering both effects should be regarded as illustrative.

The Impact of 1% change in Interest Rates compared with baseline assumptions

	1999	2000	2001
GGSurplus (% GDP)	1.7	1.4	1.6

including
contingency

Cumulative impact of 1% interest rates change on GGSurplus	up to 0.3	up to 0.4	up to 0.6
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Appendix II

Output Gap and Cyclically Adjusted Budget

Explanatory Note: The Output Gap and the Cyclically Adjusted Budget (CAB) Trend output and the output gap

The concepts of trend (potential) output and the output gap are closely related. Trend (potential) output is defined as the maximum level of GDP which is consistent with stable inflation. The output gap is usually presented as the percentage difference between actual output (or GDP) and trend output (trend GDP). Consequently a positive output gap arises in the situation where the actual level of GDP exceeds the estimated trend GDP level. Similarly, a negative output gap arises when the actual level of GDP is below the estimated trend level.

Output gap and trend output measures are used in two distinct contexts:

- the calculation of cyclically adjusted budget (CAB) balances for government finances;
- as indicators of inflationary pressures in the economy.

Cyclically Adjusted Budgets (CAB)

The cyclically adjusted budget balance represents the budget balance which would be expected if the economy was at its trend level of output.

Output gap and inflation

In the context of inflation, output gap analysis is based on the premise that a positive output gap is an indication of inflationary pressures.

The structural or cyclically adjusted government budget balance is used by international organisations such as the EU Commission, the OECD and the IMF in order to assist in assessing the medium term orientation of fiscal policy by distinguishing between discretionary changes in the government's fiscal position and those which reflect the impact of the business cycle on the economic environment.

The cyclical correction is essentially intended to adjust the budget balance for the influence of the automatic stabilisers i.e. cyclically sensitive revenues and expenditures. The Cyclically Adjusted Budget (CAB) is derived by choosing a benchmark economic scenario – usually that which would occur if the economy were expanding at its trend rate of growth – and determining the effect on the government revenues and expenditure of deviations of actual

output from the trend. By subtracting the estimated cyclically induced variation in the government's budget from the observed budget balance, the cyclically adjusted deficit can be estimated. Comparing cyclically adjusted deficits from year to year can give an indication of the discretionary changes in the Government's fiscal position.

Measurement of the CAB can perform a useful role in elucidating in broad terms the conduct of fiscal policy in the economy. However, there are several pitfalls to the analysis:

- There is a large degree of uncertainty regarding trend growth estimates.
- The relevance of the concept of trend output for a small open economy has not been established.
- The CAB indicator is a backward looking rather than a forward looking indicator of the budgetary position. The key issue in terms of the sustainability of fiscal policy is where a country is expected to be over, say, three years ahead, not some notional trend estimate.

In any case, there is little or no evidence of a robust relationship between Ireland's price level (or inflation rate) and any computed measures of Ireland's output gap. The very open nature of the Irish economy means that inflation is, in the main, externally determined. Consequently the policy conclusions to be drawn from output gap analysis are unclear in the absence of the identification of a clear linkage between the output gap and inflation.

Department of Finance estimates of Cyclically Adjusted Budget Balances and Output Gaps.

Despite these reservations, estimates of the cyclically adjusted balance are presented below. These are based on the projections described in this Programme and using a similar methodology to that of the Commission. We estimate that Ireland's output gap would narrow over the period of the Programme. As indicated in the final column of the table below, an improvement in the cyclically-adjusted balance is also forecast.

	Actual Growth Rate %	Trend Growth Rate %	Output Gap (% trend GDP)	Actual GGB (% of GDP)	Cyclically adjusted GGB (% trend GDP)	DGGB [+=tightening] %
1996	7.1	6.7	-0.8	-0.9	-0.7	1.7
	9.5	7.0	1.5	0.5	0.0	0.7
1997						
	9.5	7.1	3.8	1.7	.5	0.5
1998						
1999	6.7	6.9	3.7	1.7	0.6	0.1
2000	6.4	6.7	3.4	1.4	0.3	-0.3

				1.8	0.8	0.2
2001	5.8	6.5	2.7	1.6	0.8	0.5
				2.4	1.6	0.8

* All data are based on ESA95 conventions. The forecasts in bold for 2000 and 2001 exclude the contingency.

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