Ireland – Stability Programme – December 1999 Update

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Executive Summary

This document updates Ireland's Stability Programme, which was first published in December 1998, and sets out the Government's economic and budgetary objectives for the period 2000–2002.

- The primary macroeconomic objective of Budget 2000 and the updated Stability Programme is the continuation of sustainable economic and employment growth, supported by low inflation, wage moderation and prudent budgetary policies.
- Stability orientated policies remain the priority. Macroeconomic stability is seen as essential to maintaining Ireland's capacity for economic and social progress.
- In this context, over the period 2000–2002, a General Government Surplus is projected for each year averaging 3% of GDP. This meets the medium term objective of the Stability and Growth Pact of keeping budgetary positions close to balance or in surplus in normal economic conditions. This is the projected General Government Surplus before taking account of the costs associated with the part pre–funding of future state pensions and other once–off pensions costs associated with the sale of Telecom Eireann.

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- The Government has begun to address the long term challenge of population ageing and the associated Exchequer costs in the decades ahead. Part of the proceeds from the sale of Telecom Eireann plus an annual 1% of GNP is being set aside towards these future costs. After taking these factors into account, the forecast General Government Surplus, as a percentage of GDP, is 1.2% in 2000 and is 2.5% in 2001 and 2.6% in 2002, on an ESA 95 basis.
- The Government has also decided to use part of the proceeds from the recent sale of Telecom Eireann to pay off, in 1999, all Exchequer

pension liabilities arising from the service given by employees of both Telecom Eireann and An Post (the Post Office) before their establishment as commercial entities in 1984. After taking this into account, the forecast General Government Surplus, as a percentage of GDP, is 1.4% in 1999, on an ESA 95 basis.

- Accordingly, after taking account of these prefunding and other pensions transactions, the General Government Surplus is projected to average 2.1% over the next three years.

- Over the same period, General Government Debt as a percentage of GDP is projected to continue to fall, reaching 36% by 2002.

- The updated Stability Programme is framed against a background of continuing strong economic growth, underpinned by a recovering international economic environment, but with the pace of growth decelerating.

- GDP is forecast to increase at an annual average rate of 6½% over the three years 2000–2002 compared with growth of 8 ½% in 1999. GNP growth[1], a more accurate reflection of national income in Ireland, is anticipated to average 5¾% over the period 2000–2002. The prospective continued moderation in Ireland's economic growth reflects the emergence of supply side constraints, particularly with regard to labour, as unemployment has fallen rapidly.

- Despite continued strong economic growth, inflation should remain moderate. While external developments and domestic pressures, particularly in non–traded sectors of the economy, together with indirect tax increases on tobacco, are expected to raise the consumer price index (CPI) in 2000 to 3%, inflation should average below 2½ % over the updated Programme period.

- Relatively strong employment growth is expected to continue with the numbers employed increasing by about 2½% on average over the next three years while the unemployment rate will continue to fall.

- The Government's budgetary and investment plans are designed to address the challenges facing the economy over the medium term. Critically, they incorporate a range of reforms to encourage increased labour force participation and measures to tackle other supply side pressures, key investment needs in the economy, and social inclusion priorities.

[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.

Chapter 1 – Economic Policy Context

1.i Introduction

1.1 This document updates Ireland's Stability Programme 1999–2001, which was submitted in December 1998, and includes a new set of macroeconomic projections out to 2002. It takes account of the measures adopted in Budget 2000 and the National Development Plan 2000–2006 published in November 1999.

1.2 This update has been prepared in conjunction with Budget 2000 and is being presented to Dáil Éireann on Budget day, 1 December 1999. As such it also provides an economic background to Budget 2000. It has been prepared in accordance with Council Regulation 1466/97 of 7 July 1997.

1.3 This Chapter reviews recent economic performance and presents macroeconomic projections for the period 2000–2002. Chapters 2 and 3 set out the Government's budgetary and economic policies.

General Policy Context

1.4 Ireland's economic progress in the 1990s has been outstanding. GNP grew in real terms by an average of 7.6% per annum between 1994 and 1999. This growth has led to a significant increase in employment with the numbers employed increasing by over 30%. The unemployment rate has fallen from over 15% in 1993 to around 5¼ % today.

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1.5 Side by side with significant economic progress, sound budgetary management has allowed the General Government Balance, as a percentage of GDP, to move from a deficit of 2.2% in 1993 to surpluses of 1% in 1997, 2.5% in 1998 and an estimated 3.5% in 1999, on an ESA 79 basis. At the same time, General Government Debt has fallen from 93% of GDP in 1993 to about 47% by 1999, on an ESA 79 basis.

1.6 This economic progress has allowed living standards to increase and converge towards average EU levels. By 1999, Ireland's GNP per head has reached over 90% of the EU average compared to 79% in 1994 and this process of convergence is likely to continue over the medium term.

Table 1 – Economic and Budgetary Indicators 1993–1998 [2]

	1993	1994	1995	1996	1997	1998
% Volume Change						
GNP	2.6	6.3	8.0	7.2	9.0	8.1
GDP	2.6	5.8	9.5	7.7	10.7	8.9
Personal consumption	2.9	4.3	3.7	6.5	7.3	7.4

Public consumption	–0.4	4.1	2.9	2.8	4.8	5.9
Fixed investment	–4.1	12.0	22.9	15.9	18.9	16.7
Exports	9.1	14.7	19.6	11.8	17.0	20.5
Imports	7.0	15.1	16.1	12.0	16.1	23.2
Current Account (% GNP)	4.1	3.0	2.9	3.1	2.8	1.1
Consumer Prices (% change)	1.5	2.4	2.5	1.6	1.5	2.4
GDP Deflator (% change)	5.2	1.7	2.7	2.3	3.5	5.6
Unemployment (% labour force)	15.5	14.1	12.1	11.5	9.8	7.4
Employment (% change)	1.9	3.6	4.6	3.7	4.6	5.7
Employment (`000's)	22	43	57	48	62	82
General Govt. Balance Deficit(–) Surplus(+) as (%GDP)	–2.2	–1.7	–2.1	–0.2	1.0	2.5
General Govt. Debt (% GDP)	93	86	78	69	60	49

* ESA79 Basis; Sources: CSO and Department of Finance

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1.ii Economic Review : 1999

1.7 1999 was another year of strong growth. GNP growth of 7½% is now expected compared with the 6% forecast in the December 1998 Stability Programme. This higher level of economic activity has led to an improved budgetary position. A surplus of 3.2%[3] is now anticipated compared with a projected surplus of 1.7% in the December 1998 Stability Programme, on an ESA 95 basis. The Table below compares, on an ESA 95 basis, the December 1998 Stability Programme projections with the estimated outturn.

Table 2 – Economic & Budgetary Indicators 1999 : Forecast & Estimated Outturn

	1999 Forecast	1999 Outturn
% Volume Change		
GNP	6.0	7.4
GDP	6.7	8.4
Consumer Prices	2.0	1.6
	6.8	5.5

Unemployment Rate (as a % of labour force)	45	74
Employment ('000)		
General Government Surplus (as a % of GDP)	1.7	3.2[3]
General Government Debt (as a % of GDP)[4]	52	52

* ESA 95 Basis

[2] All Tables are sourced from Department of Finance unless otherwise stated.

[3]Before impact of discharging once off pensions liabilities of 1.9% of GDP in 1999

[4]Includes impact of a Securities Exchange Programme which added 4% to the Debt/GDP ratio in 1999

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Domestic Demand

1.8 Domestic demand has remained buoyant For the fourth consecutive year personal consumption is growing very strongly. The Retail Sales Index shows an increase of 9¼% for the first nine months of 1999. Car sales also continue their exceptional growth and are expected to be about 20% higher for the year as a whole. VAT and excise duty receipts confirm this buoyant picture. Thus, it is expected that the volume of personal consumption will expand by 7 ¾ % this year.

1.9 Gains in employment and rapid increases in real disposable incomes continue to support consumer spending. The latest Labour Force Survey indicates that employment grew by 6.4% in the year to March–May 1999. For the year as a whole, employment is now expected to increase by around 4¾% compared with the December 1998 Stability Programme forecast of 3.1%. Despite the emergence of capacity constraints, employment in construction is still growing, up by 8.5% in the twelve months to September 1999.

1.10 The latest earnings data show some acceleration. In the year to June 1999 weekly earnings in industry rose by 4.8% while weekly earnings in the public sector (excluding health) rose by 5.9%. Hourly construction earnings rose by 4.7% in the year to June 1999. However the increase in weekly earnings was just 1.6% reflecting a 3% decrease in the number of hours worked. The latest weekly earnings data in Banking, Insurance and Building Societies show an increase of 6.3% in the year to June 1999. For the year as a whole, it is expected that non–agricultural per capita earnings will increase by 5 – $5^1/_2$ %.

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1.11 Growth in fixed investment was extremely strong in 1998 at 16.7%. The available data, albeit limited, suggest further growth in 1999. The construction sector continues to expand with the number of new dwellings built up again this year. Investment in machinery and equipment is expected to show slower growth than in 1998, partly due to slower trends in foreign direct investment (FDI). In total, fixed

investment is forecast to grow by around 10½% in volume terms in 1999.

External Developments

1.12 Turning to external developments, export growth is well down on the exceptional increase of 20.5% in 1998. Around the beginning of 1999 there was a noticeable slowdown which reflected weak demand conditions in our markets. This slowdown is also shown by the results of the NCB Purchasing Managers' Index which declined towards the end of 1998. However exports have recovered steadily during the year. Export growth of goods and services of about 14% is expected for 1999 as a whole.

1.13 Given the strength of estimated final demand, the growth of visible imports to date in 1999, according to available data, is unexpectedly weak, though the recent trend is stronger. For the first eight months of the year, imports are up around 5%. In contrast, service imports are up over 25% for the first six months of 1999. It is expected that growth in imports will continue to strengthen in the second half of the year and that data for the first half of the year will be revised upwards. An increase in the volume of imports of goods and services of about 14% is expected. The current account will show a surplus of less than ½% of GNP in 1999.

Box 1.1 Visible Imports Mystery

Latest available figures indicate that visible imports have increased by around 5% for the first 8 months of this year compared with the same period last year, considerably lower than expectations.

A detailed breakdown of visible imports by category taken from the CSO Trade Statistics indicate that, in the first six months of 1999, imports of capital goods were up 4.5%, imports of materials for further production were up by 0.3%, and imports of consumption goods ready for use rose by almost 10%. Thus, there has been a marked deceleration in the growth of both imports of capital goods and imports of materials for further production.

In the recent past, total imports have grown faster than would have been expected on the basis of estimates of weighted final demand produced by the Department of Finance. Imports growth well in excess of 10% would be expected in 1999 on this basis. While faster growth in the latter half of the year is likely, revisions to import data for earlier months also seem probable. Accordingly, forecasts assume that imports for the year will grow much faster than suggested by the published data.

Price Developments in 1999

1.14 Headline inflation is expected to be lower on average in 1999 at 1.6% compared with 2.4% in 1998. The improvement in the headline rate is due to interest rates reductions which have reduced the CPI by more than 1% for much of the year. Traded inflation has also remained low in spite of the fall in the value of the euro. This reflects low international inflation, apart from increases in the price of oil. In addition, food prices, which make up in excess of 20% of the CPI, have moderated since 1998 reflecting improved supply conditions.

1.15 In contrast, higher services, fuel and transport prices have added to inflation this year. Services inflation was 5.3% in the year to October 1999 reflecting the strength of the domestic economy. HICP inflation was 2.8% in the year to October 1999 compared with an average of 2.2% in 1998.

1. iii Macroeconomic Projections for Ireland : 2000–2002

1.16 This section sets out the main elements of the economic projections underpinning this updated Stability Programme. It also sets out the main assumptions, both domestic and international, on which the projections are based.

International Economic Outlook

1.17 As a small open economy with a very high dependence on exports and inward investment, Ireland's economic performance is crucially reliant on conditions in the wider world. The international economic environment has significantly improved since late 1998, when there was considerable uncertainty. The fallout from the debt crisis in Russia and the financial turbulence in Asia was affecting growth prospects across the world. In Europe the fall in demand in Asia was leading to lower exports and undermining confidence. In the EURO–11 area, lower growth was expected, most notably in Germany. For the UK there were expectations among some commentators of a mild recession.

1.18 These expectations have turned out to be pessimistic. The OECD economy proved to be very resilient and recovered strongly. Growth prospects have picked up in Japan and Europe, while the US continues to grow strongly.

1.19 In the OECD area, growth in 2000 is now expected to average close to 3%. In the EU (which accounts for two–thirds of Ireland's exports), the European Commission's Autumn 1999 forecasts project real GDP growth of 3% in 2000 compared with 2.1% in 1999. In the UK, a pick up in growth to around 3.4% is forecast in 2000 compared to 1.8% in 1999.

1.20 Table 3, below, sets out the projections for growth in Ireland's trading partners which underpin this updated Stability Programme.

Table 3 – Real GDP Growth in Ireland's Main Trading Partners

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	1999	2000	2001
Germany*	1.5	2.6	2.7
France*	2.5	2.9	3
Italy*	1.1	2.2	2.5
United Kingdom*	1.8	3.4	3.6
Euro 11*	2.1	2.9	2.9

EU 15*	2.1	3	3
USA	3.8	2.8	2.5
Japan	1.3	1.6	2.1

Source : European Commission (Autumn 1999), *ESA 95 Basis

1.21 The improved outlook for our main trading partners, as set out above, should support continued growth in exports. However prospects for future growth are also dependent on Ireland's competitiveness and the extent of emerging supply–side constraints.

1.22 For most of the 1990's, export growth has exceeded growth in demand in Ireland's trading partners. These gains in market share resulted from competitiveness improvements and related growth of FDI which boosted industrial capacity. As discussed elsewhere in this updated Stability Programme, supply–side constraints are now becoming increasingly important. These are particularly evident in the labour market where unemployment is falling towards 5%.

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1.23 While tighter labour supply conditions now apply, Ireland's prospective labour force growth promises to remain far above the European average over the forecast period. Labour force growth of about 2¼ % per annum seems likely over the forecast period.

1.24 Against this background, it is anticipated that the growth rate of business investment including FDI will decelerate. This implies that growth in industrial capacity will be unable to support as rapid an expansion in exports as we have experienced hitherto. Nonetheless, exports should expand by over 11% next year, with growth moderating to below 8% by 2002.

1.25 The Government's investment plans, as outlined in the National Development Plan, will add to construction sector activity. However, with lower investment in machinery and equipment, the volume of overall investment is expected to slow but still expand at a robust 8% in 2000.

1.26 Consumer demand should remain strong in 2000. Real disposable income per head should grow slightly faster than in 1999. This, combined with low interest rates and further gains in employment will support continued growth in personal consumption, which is forecast to rise by over 7% in 2000.

1.27 Employment growth of about 3¼% is forecast next year, with unemployment falling below 5%. As unemployment falls, it is anticipated that the tightening labour supply will dampen the subsequent pace of economic and employment growth.

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Box 1.2 Labour Supply in Ireland

In recent years employment growth has been very strong. This has been met by both growth in the labour supply and a substantial fall in unemployment, particularly in 1998 and 1999. Approximately 60% of the increase in employment since 1997 has come from labour force growth, with the remainder due to lower unemployment. Given the low rate of unemployment, this potential source is now reduced.

There is now increasing evidence of labour market tightening. Employers are having difficulty filling vacancies while there is some upwards drift in wages. The increasing tightness in the labour market is confirmed by indicators of potential labour supply compiled by the CSO. The narrowest definition of potential labour supply, which consists of the unemployed and discouraged workers, has fallen from over 11% of the labour force in 1997 to less than 6½% earlier this year. The ESRI National Survey of Vacancies points to a similar picture. This is a survey of vacancies in over 1,100 firms in private sector manufacturing and services. The vacancy rate has increased from less than 2% in 1996 to 6% in the latest survey.

The labour force will continue to grow at a rate well in excess of the EU average. Natural increases will be augmented by increased participation and net immigration. However, growth in Ireland's labour supply, whilst remaining high relative to that of the EU, will moderate over time. Over the period of the projections, we assume an annual average increase in employment of about 2.5%. Government policies to reintegrate the long–term unemployed are expected to further reduce the unemployment rate with unemployment falling to about 4 ½ % by the end of the Programme period.

1.28 Overall, GNP growth of around 6¼% is forecast for 2000 with GDP expanding by about 7½ %. For 2001 and 2002 a further slowdown is predicted. The current account is expected to move into deficit in 2000 and is forecast to rise to over 2% of GNP by 2002. This deterioration in the external position reflects the supply constraints facing the economy.

Table 4 – Macroeconomic Projections 1999–2002

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	1999	**2000**	**2001**	**2002**
% Volume Change				
GNP	7.4	6.3	5.7	5.0
GDP	8.4	7.4	6.5	5.7
Personal consumption	7.8	7.2	6.5	5.8
Public consumption	4.3	4.4	3.7	2.7
Fixed investment	10.8	8.0	6.5	6.0

Exports	13.7	11.4	8.8	7.8
Imports	14.1	11.3	8.8	7.4
Current Account (% GNP)	0.4	–0.9	–1.6	–2.2
Consumer prices	1.6	3	2¼	2.0
GDP Deflator	3.4	3.1	2.8	2.7
Employment	4.8	3.3	2.4	2
Employment ('000)	74	54	40	34
Unemployment Rate	5.5	4.8	4.6	4.5

Source: Department of Finance

Price Developments and Prospects

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1.29 As discussed earlier, headline inflation is expected to be lower on average in 1999 than in 1998, as a result of lower interest rates. However, strong domestic inflationary pressures have emerged. Prices in the non–traded sector are increasing faster than the general rate of inflation with services sector prices currently increasing by over 5% *per annum*. In addition, international commodities prices are beginning to rise. Crude oil prices, which had been falling for much of the previous two years, have doubled since March 1999. This is already feeding through into higher transport and home heating costs. Better demand conditions internationally, as a result of the recoveries in Europe and Asia, will support these increases in the short term at least.

1.30 Measured inflation will also be increased significantly in 2000 by the exceptionally large increase in excise duties on tobacco products from 1 December 1999 – which will raise the CPI by about 0.75%. This socially desirable measure is intended to improve public health by encouraging smokers to give up or reduce smoking – and to help fund the increasing cost of health provision, a cost to which smoking significantly contributes. The increased taxes on tobacco products can be seen as analogous to increased environmental taxes on energy products which have been imposed or are contemplated in other Member States and which also increase the measured inflation rate.

1.31 The headline inflation rate is set to rise over the remainder of 1999 and the early part of 2000 as the mortgage interest reductions fall out of the year–on–year comparisons and as higher excise duties on tobacco are reflected in the headline CPI. In the second half of 2000, inflation is expected to moderate due primarily to lower food and fuel inflation. Overall, the average headline inflation rate is likely to be around to 3% in 2000 (2¼ % excluding tobacco).

1.32 Inflation should moderate again to around 2¼% in 2001 and 2 per cent in 2002 giving average inflation of below 2 ½% over the Programme period. Excluding the tobacco price increase, inflation should average about 2¼% over the Programme period. This would be broadly similar to the average underlying inflation rate over the last five years of very strong economic growth.

Chapter 2 : The Budgetary Position

2.i Budgetary Review 1999

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2.1 In the December 1998 Stability Programme, a General Government Surplus for both 1998 and 1999 of 1.7% on an ESA 95 basis was forecast. The outturn for 1998 has since been revised upwards to 2.1% of GDP on an ESA 95 basis. Excluding pensions prefunding and other associated once off pensions costs, the General Government Surplus estimate for 1999 has been revised upwards to 3.2% of GDP on an ESA 95 basis.

2.2 This improved budgetary position can largely be explained by higher tax receipts resulting from stronger economic growth. Increases in net current expenditure were held at 4%, in line with Government targets. Table 5 below sets out the comparison between the General Government position for 1998 and 1999, as set out in the December 1998 Stability Programme, and the 1998 and 1999 outturns as now estimated. Figures are set out on both an ESA 79 and ESA 95 basis, in accordance with Commission guidelines (II/466/99). The General Government Debt outturn for 1999 is on target with the December 1998 Stability Programme forecast. The General Government Debt level for 1999 would have been lower but for the impact of a Securities Exchange Programme which added 4% to the Debt/GDP ratio in 1999.

Table 5 – General Government Position for 1998 and 1999

	Stability Prog Dec'98 forecast	Outturn	Stability Prog Dec'98 forecast	Outturn
	1998	1998	1999	1999
	As a % of GDP			
Current Account Surplus – ESA 95	3.7	3.8	4.0	5.2
– ESA 79	3.8	4.0	4.1	5.2
Capital Account Deficit[5] – ESA 95	–2.0	–1.7	–2.3	–2.0
– ESA 79	–1.7	–1.6	–2.1	–1.7
	1.7	2.1	1.7	3.2

General Government Surplus – ESA 95	2.1	2.4	2.0	3.5
– ESA 79	5.4	5.2	5.1	6.0
– of which Primary Surplus – ESA 95	5.4	5.3	5.1	5.6
– ESA 79				
General Government Debt[6] – ESA 95	59	55	52	52
– ESA 79	52	49	46	47
	IR£			
GDP – ESA 95	56,675	59,637	62,125	66,850
– ESA79[7]	60,200	63,350	66,175	71,015

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

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[6]Includes impact of a Securities Exchange Programme which added 4% to the Debt/GDP ratio in 1999

[7]These data do not include the latest national accounts revisions relating to the International Financial Services Centre

2.3 The General Government Balance in 1999 is somewhat complicated by decisions regarding prefunding of future pensions and once off costs associated with the pensions of pre−1984 employees of Telecom Eireann and An Post (the Post Office). Tables 5 to 10 set out the budgetary position **before** taking these costs into account. These issues, together with the resulting implications for the General Government Balance, are discussed in detail in section 2.vii below.

Disposal of State Assets

2.4 In June 1999, the Government sold the majority of its remaining shareholding in Telecom Eireann, the former state telecoms company, with a consequent once off gain to the Exchequer of £3.667 billion. A further £1.15 billion will be received in 2000. In 1999, £1.25 billion of the receipts are being used to pay off the future Exchequer liabilities associated with the pensions of pre−1984 employees in Telecom Eireann and An Post. The remainder of the receipts are being placed in two funds designed to prefund future state pension liabilities associated with the ageing of the population. These issues are discussed in greater detail in section 2.vii.

2.ii Budgetary Policy Framework

2.5 Maintaining stability and sustaining economic and employment growth are the primary macroeconomic objectives of budgetary policy in Ireland over the next three years. This involves striking a balance between running a large budgetary surplus, addressing emerging labour supply and infrastructural needs, implementing tax reform and tackling social priorities.

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2.6 Over the period 2000 to 2002, on the basis of continuing strong growth, the Government intends to continue to run significant budget surpluses each year and to further reduce the burden of Government debt.

2.7 Within this general budgetary framework, social needs will continue to be addressed while strategic public capital investment priorities, as set out in Budget 2000 and the National Development Plan 2000–2006, will be tackled in order to reduce Ireland's still large infrastructural deficit compared with other EU Member States.

2.8 As discussed in Chapter 1, the growth in labour supply in the 1990s, and competitive wage evolution, supported by social partnership, has been central to Ireland's rapid economic convergence towards EU average living standards. However, evidence of labour market tightening, combined with wage acceleration in certain sectors, has recently begun to emerge. In light of this, the taxation changes announced in Budget 2000 are designed to significantly enhance work incentives, including for the lower paid, with the objectives of prompting a further increase in labour supply and addressing the emerging pressures in the labour market. This approach is in keeping with the budgetary strategy outlined in the December 1998 Stability Programme and the Government intends to continue with tax reform in the remaining years of the Programme.

2.iii Budgetary Projections 2000–2002

2.9 A General Government Surplus is projected for each year of the updated Stability Programme as shown in Table 6. Excluding prefunding and other associated once off pensions costs, an average annual surplus of 3% of GDP is forecast for the three years 2000–2002, compared to an anticipated outturn of 3.2% this year on an ESA95 basis.

Table 6 – Budgetary Projections – 2000–2002[8]

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	1999	2000	2001	2002
as a percentage of GDP				
Current Account Surplus	5.2	5.8	6.4	7.3
Capital Account Deficit[9]	–2.0	–2.5	–2.6	–2.7

Contingency[10]	–	–	–0.9	–1.7
General Government Surplus[11]	3.2	3.3	2.8	2.9
– of which Primary Surplus	6.0	5.8	4.8	4.6
General Government Debt[12]	52	46	40	36

* ESA95 Basis [Preliminary National Accounts Assessment]

[8]The projections are based on ESA95 conventions. ESA 95 rules reduce the surplus by about 0.3–0.4% of GDP and add about 5½ percentage points to the Debt/GDP ratio compared with ESA 79 conventions.

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

[10]This is a provision made against factors that may impact on the Budget but cannot be quantified at this stage.

[11]Before taking pensions prefunding and other associated once off costs into account. See also Table 11

[12]Includes impact of a Securities Exchange Programme which added 4% to the Debt/GDP ratio in 1999.

2.10 These budgetary projections take account of an increase in the deficit on the capital account from 2.0% of GDP in 1999 to 2.7% in 2002 reflecting increased public sector investment.

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2.11 A current account surplus of 7.3% of GDP by 2002 is forecast, compared with a surplus of 5.2% of GDP in 1999. A contingency provision against possible future developments, including public sector pay, which could adversely affect the budgetary position is included and extends to 2002. This amounts to 0.9% of GDP in 2001 and 1.7% in 2002.

2.12 The debt/GDP ratio is expected to fall to 36% of GDP by 2002 from an expected 52% at end–1999 on an ESA95 basis.

2.iv Expenditure Projections 2000 – 2002

2.13 Despite significant progress in recent years, challenges remain to be addressed in the area of long–term unemployment, social exclusion, and in health and education services. The Government's expenditure proposals seek to address these needs and additional resources have been allocated for future improvements in all of these areas.

2.14 The 1999 Broad Economic Policy Guidelines recommended that Ireland should restrain annual growth in Government expenditure. In the

Government's Programme – *Action Programme for the Millennium* – a commitment was given to restrict annual nominal growth in net current expenditure to 4%. This commitment was restated in the December 1998 Stability Programme.

2.15 In this context, net current expenditure is defined as total gross current outlays less the Social Insurance Fund and other receipts associated with expenditure programmes. As in previous years, the Government's expenditure plans over the period 2000 to 2002 set out to meet the various policy challenges while staying within agreed expenditure limits.

2.16 Expenditure projections over the period 2000–2002 are complicated by the ongoing negotiations among the social partners concerning a successor to the current national agreement – Partnership 2000 – which expires in the year 2000. For this reason, potential public sector pay increases on foot of any successor agreement have not been included in the expenditure projections. An allocation, to take account of these and other future developments which could impact adversely on the budgetary position has, however, been included in the contingency provision.

2.17 The expected trend in general government current expenditure as a percentage of GDP on this basis is given in Table 7 below. Excluding the contingency, it is projected to decrease from 28.9% of GDP in 1999 to around 25.3% by 2002.

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Table 7 – Total Government Current Expenditure[13]

	1999	2000	2001	2002
as a percentage of GDP				
General Government Current Expenditure	28.9	27.8	26.4	25.3
of which:	2.8	2.4	2	1.7
– Interest payments	13	12.7	12.2	11.8
– Goods and Services	13.1	12.7	12.2	11.8
– Other Transfers				

[Preliminary National Accounts Assessment]

[13]These apportionments for general government current expenditure by category are provisional.

Public Sector Investment

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2.18 Despite substantial investment in recent years, including EU assisted activity, Ireland still has a significant infrastructural deficit. Investment was constrained in the past, particularly in vital areas such as transport, water and sewerage services, by relatively low per capita income. Due to the recent rapid pace of economic growth, bottlenecks and other signs of pressure on capacity are now becoming evident in faster growing regions of the country, while other regions are lagging behind in terms of growth performance. This regional imbalance must be addressed if Ireland's growth potential is to be fully realised.

2.19 In response to these urgent needs, capital expenditure will average 3.8% as a percentage of GDP over the Programme period in line with the National Development Plan 2000–2006. The bulk of this planned investment in roads, public sector transport and water and sewerage services aims at addressing existing bottlenecks and allowing for further economic growth in the years ahead. The National Development Plan 2000–2006 is discussed in more detail in Chapter 3.

Table 8: Capital Account

	1999	2000	2001	2002
as a percentage of GDP				
Total Government Investment	3.4	3.8	3.9	3.7
Capital Resources	1.4	1.3	1.3	1.0
Capital Deficit	−2.0	−2.5	−2.6	−2.7

[Preliminary National Accounts Assessment]

2.20 The investment measures contained in Budget 2000 and in the National Development Plan represent a prudent use of available resources to support sustained economic progress into the future. Their financing, despite an expected reduction in EU funding, will respect the Stability and Growth Pact. With a view to maintaining investment efficiency, new approaches to public investment are envisaged including Public Private Partnerships.

2.v Taxation Policy

2.21 Budget 2000 continues the Government's programme of income tax reform. The significant tax changes are designed to improve work incentives, assist general wage moderation, address unemployment and poverty traps and improve the interaction of the tax and social security systems. Cuts of two per cent in the top and standard rates of tax will increase the reward from work of all taxpayers. A radical change in the structure of the standard rate band will ensure that all taxpayers up to and at the average industrial wage will now pay tax at the standard rate. This change, which will remove 125,000 taxpayers from the top rate of tax and will increase the incentives for spouses to join the labour force, is particularly aimed at increasing the effective labour supply. Budget 2000 will also remove nearly 40,000 taxpayers on low income from the tax net. These tax changes will complement the Government's structural

reform agenda, as set out in Chapter 3.

Table 9: Total Government Current Resources

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	1999	2000	2001	2002
as a percentage of GDP				
General Government Current Resources	34.1	33.7	32.8	32.6
of which:				
–Central Government Taxes	28	27.8	27.2	27.1
–Social Security Receipts	4.2	4.2	4.0	4.0
– Miscellaneous Current Receipts	1.9	1.7	1.6	1.5

[Preliminary National Accounts Assessment]

2.22 The Government intends, in 2001 and 2002, to continue with appropriate tax changes designed to meet the needs of the labour market and to maintain general wage moderation. The foregoing resources estimates incorporate, as a technical assumption, the effects of personal tax changes each year with a full year cost of £350 million.

2.23 The changes in taxation announced in Budget 2000 will result in taxes and social security receipts as a proportion of GDP falling to 31.1 % of GDP by 2002 compared with 32.2% in 1999.

2.vi Compliance with Stability Programme Targets

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2.24 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 implies that cyclical factors and their effect on the Budget need to be considered in assessing the underlying budgetary position. 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. The Budgetary tables indicate the Government's resolve on this issue.

2.25 The 1999 Broad Economic Policy Guidelines recommended that Ireland should be ready to use budgetary policy should there be evidence of wage inflation gathering pace. The Government's commitment, as set out in its Programme for Government, is to continue to reform the tax system, inter alia to increase work incentives in a context of wage moderation. The 1999 Broad Economic Policy Guidelines also emphasised that over the past ten years social partnership has succeeded in boosting economic growth, employment growth, increasing competitiveness and restraining unsustainable wage growth. The Government has entered into negotiations on a new Social

Partnership agreement with the social partners.

Cyclically Adjusted Budget Balance

2.26 The extent to which Ireland's economy is above or below its trend growth position (i.e the estimated output gap), and the magnitude of the related Cyclically–Adjusted Budget Balance, are very difficult to estimate. The cyclically adjusted budget analysis is further complicated by the use of large privatisation receipts for the prefunding of pensions and for paying off the Exchequer's future liabilities for employees' pensions in Telecom Eireann and An Post (the Post Office). For this reason, estimates of the Cyclically Adjusted Budget Balance have been undertaken excluding the budgetary impact of these factors. These estimates are set out in Appendix 2.

Table 10 : Budgetary Projections

	1999	2000	2001	2002
General Government Balance[14]	3.2	3.3	2.8	2.9
>	0.9	0.2	–0.1	0.6
Change in Cyclically–Adjusted General Government Balance (+ = tightening)				

14

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

2.27 Before taking account of pensions prefunding and other associated once off costs, the General Government Surplus, on a comparable ESA95 basis and including the contingency provision, is projected to reduce from an expected 3.2% of GDP in 1999 to 2.9% in 2002.

2.28 Despite the projected slowdown in economic growth, significant budget surpluses are forecast. Under the cyclically–adjusted methodology used by the Commission, this represents a tightening of fiscal policy over the period of the Programme. Results of the cyclically adjusted budget analysis are set out in Table 10 and details are provided in Appendix 2.

1. Sensitivity to Lower Growth

2.29 The economic projections contained in this updated *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.

2.vii Effect on General Government Balance of Prefunding and Once Off Pension Costs

2.30 In the next century, the number of people aged over 65 in Ireland, as in the rest of Europe, will increase dramatically. With a currently favourable demographic situation, strong economic and employment growth and a rapidly reducing debt burden, the Government believes that it is appropriate to begin now to provide resources on a planned basis for the pensions of a progressively ageing population. Beginning in 1999, 1% of GNP is being set aside annually to prefund part of the prospective costs associated with population ageing.

Prefunding Pensions

2.31 Two funds are being established as part of this initiative. The first is a Social Welfare Reserve Fund, which, according to Eurostat accounting conventions, will be inside the General Government Sector, and will receive two thirds of all contributions. The other will be a Public Service Pensions Fund which, according to Eurostat accounting conventions, will fall outside the General Government Sector. These two funds will be established on a statutory basis in 2000. Receipts, in 1999, from the sale of Telecom Eireann, other than those used to buy out staff pensions liability (detailed below) will be placed in the two funds. The sale of shares in Telecom Eireann will give rise to further receipts in 2000, which (subject to approval of the Oireachtas) will also be paid into the funds. As Table 11 below indicates, the impact of establishing the two funds results in a General Government Surplus of 1.2% in 2000 and of 2.5% in 2001 and 2.6% in 2002. Pending the establishment of the funds, the receipts are being put into a Temporary Holding Fund for Pensions Pre–funding. (See Appendix 4 for a detailed explanation of effects on the Surplus)

Telecom Eireann and An Post Pensions Liabilities

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2.32 £1.25 billion of the receipts from the sale of Telecom Eireann are being used to discharge the Exchequer's future pensions liability in respect of the pre–1984 service of employees in Telecom Eireann and An Post. For General Government accounting purposes, this is counted as a cost on the General Government Balance in 1999. After taking this into account, this results in a 1999 General Government Surplus of 1.4% of GDP. The impact of these transactions on the General Government Balance is set out below in Table 11. (See Appendix 4 for more details)

Tables 5 to 10 are presented before taking account of the effects of these prefunding and once off costs. Table 11 below sets out the effect on the Surplus of these decisions.

Table 11 : Effect on GGB of Pensions Prefunding and Once Off Pensions Costs

	1999 GGB effect	2000 GGB effect	2001 GGB effect	2002 GGB effect
Payment in **1999** of An Post & Telecom Eireann	–1.9%			
Pensions Liability – £1.25 Billion from Telecom Proceeds				
Payment in **1999** of £2.417 bn – from Telecom Sale – to Temporary Holding Fund for Pensions Prefunding	No effect as still in General Government Sector (GG)			
Payment in **1999** of 1% of GNP (£0.582 Bn) to Temporary Holding Fund	No effect as still in GG Sector			
Two funds established on a statutory basis in **2000**. Payment of 2/3 of £2.999 bn to Social Welfare Reserve Fund. Eurostat regard this fund as part of the GG Sector so it **does not impact** on the GGB		No effect as still in GG Sector –1.4% as outside GG Sector		
Public Service Pension Fund gets 1/3 of £2.999 Bn. Eurostat regard this as outside the GG Sector so **does impact** on GGB		–0.5%		
Payment in **2000** of further proceeds from the sale of shares in Telecom Eireann. 2/3 go to Social Welfare Fund. Only 1/3 affects GGB as only 1/3 is placed in Public Service Fund.				
Payment of 1% of GNP in **2000** to two funds. Only 1/3 is regarded as outside the GG Sector so only 1/3 of 1% of GNP impacts on the GGB		–0.3%		

As above, Payment of 1% of GNP in **2001** to two funds			–0.3%	
As above, Payment of 1% of GNP in **2002** to two funds				–0.3%

as a % of GDP

	1999	**2000**	**2001**	**2002**
GGB Excluding Prefunding and Once off costs	**3.2**	**3.3**	**2.8**	**2.9**
Total Impact on GGB of Prefunding & Once off Costs	**–1.9**	**–2.2**	**–0.3**	**–0.3**
GGB Adjusted for Prefunding & Once off Costs	**1.4**	**1.2**	**2.5**	**2.6**

Box 2.1 The Changeover to ESA95 from ESA79

An important consequence of moving to the ESA 95 conventions, is that the national accounts interest charge will increase by the amount accruing due on national savings schemes each year. This change will reduce the General Government Balance by around 0.3 to 0.4% of GDP.

National savings schemes are operated by An Post (the Post Office) and managed on behalf of the Exchequer by the National Treasury Management Agency (NTMA). The conditions attaching to the main schemes provide that interest is paid out only when the investment is actually encashed, regardless of the period of investment. Given that these products have normal maturities of at least three years and that investments may be left untouched for longer periods, interest covering a number of years will usually be payable when the investments are eventually encashed.

The changeover to ESA 95 also adds around 5 ½ percentage points to the Debt/GDP ratio. This is principally due to two reasons – (i) the recording of accrued interest on national savings schemes in the debt and (ii) a decrease in the level of GDP, when measured on an ESA 95 rather than an ESA 79 basis.

Chapter 3 – Structural Reform Initiatives

Introduction

3.1 This updated Stability Programme is primarily concerned with

macroeconomic policy. However, it complements structural reform measures which are currently being undertaken. Initiatives designed to boost labour supply, support wage moderation and increase the efficiency of the economy through large scale public and private sector investment and measures to improve the functioning of product, capital and labour markets are all very important in a macroeconomic policy context, as is investment designed to enhance productive capacity and to address infrastructural deficiencies.

3.2 Ireland's structural reform agenda is set out in detail in the 1999 National Employment Action Plan and in the 1999 Progress Report on Reforming Product and Capital Markets. Ireland's investment intentions are detailed in the National Development Plan 2000–2006. A summary of some of the key features of these is set out below.

3.i Addressing Labour Supply Side Pressures

3.3 A primary macroeconomic objective of Government is the maintenance of non–inflationary economic growth. Microeconomic initiatives designed to make the labour market more efficient and boost labour supply are an integral part of this policy. These were integrated into Ireland's National Employment Action Plan (NAP). Summaries of some specific measures to boost the effective labour supply are outlined below.

Reform of Tax and Social Welfare System

3.4 The Government is committed to tax reform policies which improve competitiveness, boost labour supply by encouraging take up of employment and support wage moderation. The Government intends to achieve these objectives through a balanced strategy of removing the low–paid from the tax net, reducing the burden of personal taxation more generally, ensuring that a large majority of taxpayers are subject to no more than the standard rate of tax and completing the changeover to a more progressive system of tax credits.

3.5 The focus of the 1999 Budget was on the lower paid through the standard rating of both the personal and PAYE allowances, which equalised the value of the personal tax allowances to all taxpayers at the standard rate and removed 80,000 people from the tax net.

3.6 As set out in Chapter 2, Budget 2000 builds on the reform measures in the previous two budgets. It will assist all earners, reduce the level of tax for all taxpayers, exclude more low income earners from the tax net and remove a large number of middle income earners on the average industrial wage from the top rate of tax. Budget 2000 will remove nearly 40,000 taxpayers on low income from the tax net and will remove 125,000 taxpayers from the top rate of tax. Cuts of two per cent in the top and standard rates of tax will increase the reward from work for all taxpayers.

Passive to Active Labour Market Measures

3.7 The Government has recently extended the strategy of systematic engagement, which offers training, employment opportunities and vocational guidance to the unemployed. FÁS, the training and employment agency, is on target to achieve 20% participation by the long term unemployed on industry training courses by the end of the year, up from 11% in 1997. Community Employment has also been reformed, with reallocation of resources to schemes with better market linkages in line with recommendations from the Deloitte & Touche report [15]commissioned by the Government. Incentives have been enhanced by the targeted changes in the tax system already mentioned.

15

Murphy, A., Deloitte and Touche (1998) – Review of Community Employment Programme.

Social Partnership

3.8 As recognised in the 1999 Broad Economic Policy Guidelines' Recommendations on Ireland, adherence to the National Agreement between the social partners – Partnership 2000 – plays an important role in the furtherance of wage moderation. Negotiations on a successor to Partnership 2000, involving all of the social partners, commenced in November 1999.

3.9 The renewal of Social Partnership, on a basis which maintains competitiveness while enabling all citizens to benefit from the fruits of economic growth, should assist in maintaining a non–inflationary robust economy which is resilient to adverse external developments.

Improvement in Educational and Skills Level of Labour Force

3.10 A Skills Advisory Group has been established to provide policy advice on skills shortages. On foot of recommendations by this Group[16], the number of places at 3rd level for IT education were increased by 5,400. This Group is now examining labour shortages in other sectors and will submit new recommendations to Government in due course.

3.11 Investment in human resources in training and education has increased the productivity of the labour force. Notwithstanding the advances made, the National Development Plan also has a very strong focus on continuing development of our human resources. There is a host of measures in the Plan which focus on preventing early school leaving, expanding adult education and training, developing a strategy for lifelong learning and promoting Research, Technological Development and Innovation.

16

First Report of the Expert Group on Future Skills Needs – June 1998

Measures to Assist Female Participation

3.12 Despite a steady increase in female participation in the labour force in recent years there is scope for further growth. The 1999 Budget contained measures to encourage an expanded supply of child care places to meet the growing need for such facilities. Child care facilities provided by employers on a free or subsidised basis to employees are tax free in the hands of employees. Capital expenditure on the provision and refurbishment of child care facilities – which meet the required standards for such facilities – attract normal capital allowances.

3.13 Budget 2000 will promote the supply of child care places. It provides for accelerated capital allowances at the rate of 100% in year one. Also, provision has been made, in the 2000 Expenditure Estimates, for (i) Local Child Care Network Initiatives, (ii) subsidies for projects providing pre–school, sessional and full day–care services and (iii) grants to upgrade premises. In addition, funding is being made available for (a) the establishment of a Health Board Advisory service, (b) Community Based Groups to develop out of school hours services and (c) grant aid to school managements to provide after school services.

3.ii Tackling the Investment Needs of a Fast Growing 'Catch up' Economy

3.14 As already discussed in Chapter 1, recent rapid economic expansion has exacerbated a number of structural weaknesses which need to be addressed in the short to medium term in order to sustain economic progress. These include:

- infrastructural deficits, especially in transport and environmental services ; congestion in major urban areas and on main road arteries ;
- a growth imbalance between and within regions ;
- human resource skills and training needs ;
- an underdeveloped indigenous industrial sector ; and
- concentrations of deprivation and lack of opportunities in certain areas, urban and rural.

3.15 The Council Opinion on Ireland's December 1998 Stability Programme (1999/C42/03), commented that it supported :

> " *the programme's emphasis on increasing public investment both to meet the infrastructural needs of a strongly growing economy and to replace the expected reduction of Community Structural Funds in Ireland. A more detailed capital investment plan, would however, be a useful adjunct to the Stability Programme and could help avoid supply constraints which could affect the prospects for growth and inflation* ".

3.16 The Government is committed to continuing to respond to the investment needs of a strongly growing economy. In addition to measures outlined in Budget 2000, as set out in Chapter 2, the Government published a new National Development Plan 2000 – 2006 in November 1999. The Plan sets out Ireland's main development priorities for the next seven years. The key

elements of the National Development Plan strategy are :

- a continuation of the stable macroeconomic policies of recent years;
- a major investment programme in Economic and Social Infrastructure;
- a commitment to a better regional distribution of public and private investment;
- the promotion of education and employment training policies attuned to the needs of the labour market and a special focus on those most at risk of unemployment;
- a multifaceted approach to the promotion of Social Inclusion, including targeted interventions aimed at areas and groups particularly affected by poverty and social exclusion throughout the community.

3.17 The National Development Plan will involve investment of £40.588 billion (€ 51.5 billion) in 1999 prices over the period 2000–2006 of public, EU and private funds. The publicly funded element (including EU and Public Private Partnership sources) of the investment will be matched by an estimated £6.4 billion of private investment. The annual investment in the Plan is broken down by Region in line with the designation of Ireland into two Regions – Southern and Eastern Region and Border, Midlands and Western Region for Structural Funds purposes.

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3.18 The priorities and multi–annual allocations in the Plan reflect the current assessment of the situation. Over the seven year period of the Plan priorities may change in line with economic and social circumstances. Implementation of the Plan will be monitored and there will be flexibility to switch resources if necessary.

3.19 The development strategy to achieve the national objectives set out in the Plan will concentrate investment on the following key priority areas.

3.20 **Economic and Social Infrastructure :** this will be the largest programme with investment of £17.6 billion (€ 22.4 billion). In summary it will consist of a series of sub–programmes for national roads, urban public transport, regional public transport, environmental services (water, waste water and waste management), energy and communications, social housing and health capital. Social housing and health capital are included in recognition of their key role in the nation's social and economic infrastructure.

Category	Total allocation 2000–2006 (IR£ million)
National Roads	4,700
Public Transport	2,234
Water and Waste Water	2,495

Coastal Protection	35
Energy	146
Social Housing	6,000
Health Capital	2,000
Total	**17,610**

3.21 **Employment and Human Resource Development :** the priorities for this programme will reflect those of the National Employment Action Plan and will be organised under four sub–programmes to reflect the four pillars of the EU employment guidelines : Employability, Entreprenuership, Adaptability and Equal Opportunities. An allocation of just under £10 billion (€ 12.6 billion) is being provided which is being allocated as follows.

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Pillar	2000–2006 Allocation (£ million)
Improving Employability	4,631
Entrepreneurship	413
Adaptability	4,647
Equality	202
Total	**9,893**

3.22 **Productive Investment :** the success of any economy is dependent on the success of those sectors which produce tradable goods and services, namely the productive sectors. An allocation of £4.5 billion (€ 5.7 billion) is being provided for productive investment. The Programme will be allocated as follows.

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Category	2000–2006 allocation (£ million)
Research, Technological Development and Innovation (RTDI)	1,946
Industry	1,903
Agricultural Development	278
Fisheries Development	45
Marketing	337
Total	**4,509**

3.23 **Rural Development :** an allocation of £6.7 billion (€8.5 billion) is being provided for rural development.

3.24 **Social Inclusion :** one of the Government's key concerns in framing the National Development Plan was its impact on poverty. Reflecting this up to £15 billion (€19 billion) of total investment is in areas to promote social inclusion.

3.25 The overall aim of the National Development Plan 2000–2006 is to underpin the development of a dynamic competitive economy. The central challenge which is addressed in the Plan is the implementation of public policies which will increase the capacity of the economy to maintain strong and sustainable output and employment growth. It must prepare the economy for the competitive challenges arising from new and rapidly changing domestic and international economic conditions. In doing this, it will help to ensure that Ireland's recent economic progress is consolidated and built on in a sustainable way.

3.iii Implementing 1999 Broad Economic Policy Guidelines' Recommendations

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3.26 The Government has responded in a number of ways to the country specific recommendations on Ireland contained in the 1999 Broad Economic Policy Guidelines. A summary of the recommendations made in the 1999 Guidelines together with a list of some of the main policy responses by Ireland are set out in Appendix 3 to this updated Stability Programme.

3.27 The country specific recommendations contained in the 1999 Guidelines were divided into three sections, budgetary policy, product and capital markets and labour markets.

3.28 Issues in relation to **budgetary policy** have already been discussed in Chapter 2. In relation to recommendations concerning **product and capital markets**, a detailed update on the various policy developments which have taken place in 1999 will be set out in Ireland's *Progress Report on the Reform of Product and Capital Markets 1999.*

3.29 Some of the key reforms undertaken in the products and capital markets area in 1999 include the following.

- The former State telecoms company was privatised in June 1999.
- An electricity regulator was established in advance of the opening up of that market in 2000.
- An aviation regulator has been appointed.
- Strategic reviews are underway in relation to future options for the development of the state airline, the state airports authority and the state forestry development company.
- As part of the National Development Programme a major programme of investment in research and development is being put in place.

Labour Market Recommendations in the 1999 Broad Economic Policy Guidelines

3.30 The 1999 Broad Economic Policy Guidelines recommended that Ireland should seek to place a greater emphasis on a balanced approach involving preventive as well as active labour measures while seeking to increase the participation rate of the long term unemployed in particular.

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3.31 The range and scale of interventions to assist the long term unemployed, as set out in the National Employment Action Plan, reflects the determination of the Government to reintegrate the long term unemployed into the labour force. The level of long term unemployment is on a declining trend.

3.32 As regards the setting of the National Minimum Wage in Ireland, another issue highlighted in the 1999 Guidelines, proposals are being progressed in this area in consultation with the social partners taking account of competitiveness, employment and overall economic conditions.

3.33 Ireland's employment and labour market strategy is set out in detail in the *1999 National Employment Action Plan*.

Appendix I – Sensitivity Analysis

The central economic forecasts included in this updated Stability Programme represent the Department of Finance's best assessment of Ireland's future growth prospects. These forecasts underpin the budgetary projections.

Crucially these forecasts assume that the international economy continues to recover and that the Irish economy achieves a "soft–landing" from the current period of rapid growth. The economy is projected to moderate towards its estimated potential growth rate after 2000.

Actual economic developments could, of course, differ from these projections. Unexpected domestic or international developments could alter the expected growth path. The purpose of this Appendix is to briefly outline the impact on the underlying budget balance of different economic scenarios. It is assumed that there is no fiscal policy response to the changed budgetary position. In reality such a response would occur, if required, having regard to the terms of the Stability and Growth Pact.

The estimates set out below should be seen as indicative and are for illustrative purposes only.

Alternative Scenarios

– Impact of 1% change in growth compared with central projection

It is estimated that a 1% impact on the growth rate would change the General Government Balance by about a ½% of

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GDP. The budgetary impact of a 1% change in the growth rate per annum 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

	2000	2001	2002
Baseline GDP Growth	7.4	6.5	5.7
GGSurplus (% GDP)	3.3	2.8	2.9
(including contingency)			
Cumulative impact of 1% change in growth per annum on GGSurplus	up to 0.5%	up to 1.0%	up to 1.5%
GGSurplus Range (%GDP)	2.8 to 3.8	1.8 to 3.8	1.4 to 4.4

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

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 on economic growth 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 less of an 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.

(1) Impact on Economic Growth

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In last year's Stability Programme it was estimated that in the first year, interest rate changes of 1% would have an impact of 0.2% on GDP growth. After a full three years the impact on the level of GDP is just over 0.6%. Thus, the General Government Balance would be affected by a marginal 0.1% in the first year, increasing to 0.3% by 2002.

More recent estimates by the Economic and Social Research Institute produce a different set of results. These suggest that a 1 % increase in interest rates could reduce growth by as much as ½ % in the short–run. Such simulations are clearly uncertain. However, the sensitivity of the Irish economy to interest rates changes has increased over time according to the model.

(2) Impact on debt servicing costs

The impact of interest rate changes on debt servicing costs is also difficult to forecast, as it is extremely sensitive to the timing of any changes. However, the impact is falling due to the declining debt burden. It is estimated that a 1% increase in interest rates would add only a marginal amount to General

Government Expenditure of less than 1%.

Appendix II – Output Gap and Cyclically Adjusted Budget

By subtracting the estimated cyclically induced variation in the Budget from the observed budget balance, the Cyclically Adjusted Budget Balance (CABB) can be estimated. Comparing Cyclically Adjusted Balances from year to year can give an indication of the discretionary changes in the Government's fiscal position.

The ***Cyclically Adjusted Budget Balance*** represents the budget balance which would be expected if the economy was at its trend level of output. It is derived by choosing a benchmark economic scenario – usually its trend growth rate – and determining the effect on the Government revenues and expenditure of deviations of actual output from trend.

The ***Output Gap*** is usually represented as the percentage difference between actual output (or GDP) and trend output (trend GDP). In the context of inflation, output gap analysis is based on the premise that a positive output gap is an indication of inflationary pressures.

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Measurement of the CABB can perform a useful role in elucidating in broad terms the conduct of fiscal policy in the economy. However, as indicated in the December 1998 Stability Programme, 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 CABB 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.

There is little or no evidence of a robust relationship between Ireland's price level and any computed measure 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 much less clear in Ireland's case than for larger and less 'open' Member States.

Work recently undertaken on output gap methodology by the EU Economic Policy Committee supports the view that estimates of potential output and output gaps, regardless of technique, should be treated with caution.

Estimate of Cyclically Adjusted Budget Balances and Output Gaps

Notwithstanding these reservations, estimates of the cyclically adjusted balance have been prepared and are presented below. They are based on the projections described in this updated Stability Programme and use a similar methodology to that of the European Commission.

Estimating a Cyclically Adjusted Budget Balance for Ireland in 1999 is complicated by the once off effect on the General Government Balance of the costs associated with paying the Exchequer liabilities of employees' pensions in Telecom Eireann, now privatised, and An Post (the Post Office) and in future years by pensions' prefunding. For this reason, estimates of the Cyclically Adjusted Budget Balance have been prepared without taking these costs into account.

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It is estimated that Ireland's output gap will be eliminated over the period to 2002. As indicated in the table, a significant improvement in the Cyclically Adjusted Balance is also projected.

Cyclically Adjusted Budget Balance Without Taking into Account Once Off Costs on GGB in 1999 and Effects of Prefunding Pensions from 2000 onwards

	Actual Growth rate %	Trend Growth rate %	Output Gap (% trend GDP)	Actual GGB (% of GDP)	Cyclically adjusted GGB (% trend GDP)	DGGB [+=tightening] %
1997	10.8	7.5	1.3	0.6	0.2	0.2
1998	9	7.7	2.5	2.1	1.4	1.2
1999	8.4	7.8	3.1	3.2	2.4	0.9
2000	7.4	7.8	2.7	3.3	2.6	0.2
2001	6.5	7.8	1.5	2.8	2.4	–0.1
2002	5.7	7.8	–0.5	2.9	3	0.6

* ESA 95

Appendix III – Policy Responses to Broad Economic Policy Guidelines 1999

Each of the country specific recommendations concerning Ireland, contained in the 1999 Broad Economic Policy Guidelines, is set out below alongside relevant policy responses adopted by the Government in 1999.

SP = Stability Programme, PR = Progress Report on Reforming Product Markets, NAP = 1999 Employment Action Plan

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Budgetary Policy	
BEPG 1999 Recommendation	**Government Policy Responses**
– Since the public finances are already in strong surplus, the main challenge for budgetary policy is to ensure stability. Should there be evidence of wage inflation continuing to gather pace, there should be a readiness to use budgetary policy appropriately to restrain the economy	The Government is committed to running substantial budget surpluses for each year of the Stability Programme. The Government is beginning negotiations for a new agreement with the Social Partners which is aimed at keeping wage inflation under control. The Government is addressing labour market supply pressures. (See SP for more details)
– The growth in Government consumption should be steadily restrained from the estimated 5% volume increase in 1998 to 2% in 2001, as outlined in the Stability Programme.	The Government has renewed its commitment to keep net current expenditure at target levels as set out in its Programme for Government. (See SP for more details)
Product and Capital Markets	
BEPG 1999 Recommendation	**Government Policy Responses**
– Ireland should accelerate the reduction of its transposition deficit on Single market legislation especially in transport.	Ireland has succeeded in reducing the transposition deficit of Directives from 5.8% to 4.4%. Procedures have been put in place to speed up transposition. (See PR)
– The Competition Authority should be given power to enforce directly Articles 85 (cartels) and 86 (abuse of dominant positions) of the EC Treaty.	A Competition and Mergers Review Group has been appointed to review all aspects of Competition Policy It will report by early 2000. (See PR)
– Liberalisation and regulatory reform of the Irish network industries generally follows progress made in European Union legislation. However, telecoms, electricity and gas supply, and domestic and international transport are dominated by state–owned companies. Telecom Eireann is being partially privatised this year. Similar initiatives to promote competition in these sectors should be considered.	The State Telecoms company was privatised in June 1999. An Electricity Regulator has been appointed to prepare for 28% of the market to be opened to competition in February 2000. Part of the postal market has been opened to competition. Reviews regarding the future strategic direction for a number of state companies are currently ongoing. The State banks are in the process of being sold. (See PR)

– Venture Capital in Ireland is modest. This is a handicap to Irish SMEs particularly in the start up phase. However, since 1995, improvements are being made in the venture capital market and efforts in this direction should be continued. R&D expenditure is also low. In view of this, measures should continue to be taken to create incentives encouraging venture capital and local R&D and the Government should continue to participate and could consider participating more fully to improve Ireland's R&D performance.	Improvements continue to be made in venture capital funding and the OECD has ranked Ireland 5th out of 17 European countries. A number of measures have been put in place to address the equity funding problems faced by start–up companies and small business. R&D expenditure has improved significantly in the last year. Business sector expenditure has increased to 1.1% of GDP, in line with the EU average. In the National Development Plan, £1.9bn has been allocated to R&D over the period 2000–06. (See PR)
Labour Markets	
BEPG 1999 Recommendation	**Government Policy Responses**
– The 1999 Action Plan for Employment should place greater emphasis on a balanced approach involving preventive as well as active measures. Measures to increase the participation rate of the long–term unemployed and the low–skilled in education and training programmes remain important.	(GL 1&2) Preventative actions are being pursued including extension of strategy to additional adult unemployed as per commitments in 1999 Employment Action Plan (EAP). (GL 3) Range and scale of interventions to assist long term unemployed (LTU) as notified in 1999 EAP reflects determination to reintegrate LTU into employment. (See NAP)
– In line with the fourth national economic programme – Partnership 2000 – adherence to the social pact plays an important role in furtherance of the wage moderation that is necessary for the maintenance of employment growth.	Discussions have commenced with the social partners regarding the scope for a successor agreement to Partnership 2000.
– While the setting of a minimum wage can be important for addressing issues of social inclusion and poverty, potential negative effects from setting the minimum wage level too high should be avoided.	National Minimum Wage proposals are being progressed in consultation with the social partners and take account of competitiveness, employment and overall economic conditions.

Appendix IV – The General Government Balance and the Impact of Pensions Prefunding and Other Associated Once Off Costs

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The purpose of this Appendix is to explain the main differences between the Exchequer Balance and the General Government Balance (GGB). In particular the additional items included in the GGB but not included in the Exchequer Balance are set out. This in turn can help to explain the effect of pensions prefunding and associated once off pension costs on the GGB.

The Exchequer Balance is a cashflow measurement which in principle simply identifies the difference between, on the one hand, receipts actually paid into the Exchequer Account, and on the other, expenditures actually borne by the Exchequer in each calendar year.

The General Government Balance is calculated under European statistical (ESA) conventions, so that as far as possible budgetary performance is measured on a standard and comparable basis, despite the wide variation in the assembly and coverage of national Budget presentations in the individual Member States.

The General Government Sector is one of five 'Economic Sectors' recognised in the European System of Accounts. Each Sector represents a specific group of institutional units sharing common functions or primary characteristics (including the source of their resources). Taken together the five institutional Sectors encapsulate the entire economy of any one Member State. Any agency funded "directly or indirectly" out of tax revenue which provides services to the public either free or at a reduced rate must fall within the General Government Sector.

Three key factors generate the differences between the Exchequer Balance and the GGB. These differences help to explain the effects on the GGB of prefunding and other once off costs associated with the sale of Telecom Eireann.

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Factor 1 : Loan and Equity transactions do not affect the GGB. Loan and equity transactions are seen as financial transactions which do not impact on the GGB. Such transactions are seen as merely Balance Sheet items which change book assets into cash (and vice versa) but have no underlying economic effect. This distinction between the GGB and the Exchequer Balance can generate significant differences between the two in individual years. **Thus, the 1999 privatisation of Telecom Eireann benefits the Exchequer Balance accordingly but the GGB simply ignores the proceeds of the disposal.**

The position in this area is further complicated by the decision to use receipts from the Telecom Eireann sale to pay off the £1.25 billion Exchequer liabilities associated with the pensions of pre–1984 staff in Telecom Eireann and An Post. This involves Telecom Eireann and An Post pensions' liabilities changing from a 'pay as you go' pension scheme to a 'funded' pension scheme. The transfer of moneys to the funded scheme is treated as a capital transfer and therefore negatively affects the GGB in 1999.

Factor 2 : Only transactions with other Economic Sectors count. This brings in deficit funding by Non–Commercial Semi–State Bodies, Local Authorities, Health Boards and VECs. The principle is that only transactions across the boundary between the General Government Sector and the other Economic Sectors count for the General Government Balance. Transfers between individual state agencies are merely internal transactions which do not impact on the General Government Balance. **Similarly, transfers from the Exchequer to funds, such as the prefunding of pensions funds, only affect the General Government Balance to the extent that the fund is outside the General Government Sector.**

Legislation will shortly be introduced in Dáil Éireann which will provide for the establishment of a Temporary Holding Fund for the Exchequer moneys provided for this purpose in 1999. It is planned that further legislation will be introduced in Dáil Éireann in 2000 to provide for the establishment of two funds – a Social Welfare Reserve Fund and a Public Service Pensions Fund – on a permanent basis.

As set out in section 2.vii of Chapter 2, since the Public Service Reserve Fund is the only one of the two funds regarded by Eurostat as outside the General Government Sector only moneys put in this fund affect the General Government Balance.

The impact of prefunding on the General Government Balance, together with the other once off GGB costs associated with the sale of Telecom Eireann, is set out in Table 11 in Chapter 2.

Factor 3 : Accruals Adjustments. For General Government purposes, certain transactions are allocated on an accruals basis. These transactions generally have a more negative impact on the GGB than on the Exchequer Borrowing Requirement (EBR). This third factor is becoming more significant since the old system of European Accounts, ESA 79, is in the process of being phased out across the EU and is being replaced by a new set of conventions – ESA 95. ESA 95 will generally operate on an accruals basis. This issue is discussed in greater detail in Box 2.1.

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