

# **Ireland - Stability Programme**

**December 2000 Update**

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## **Executive Summary**

This document is the second annual update of Ireland's Stability Programme, first published in December 1998, and sets out the Government's economic and budgetary objectives for the period 2001-2003.

### **Economic Review and Outlook**

This updated Stability Programme is framed against a prospect of strong but moderating economic growth, underpinned by a supportive international economic environment. The prospective moderation in Ireland's economic growth reflects the emergence of supply-side, particularly labour, constraints.

GDP is forecast to increase at an annual average rate of 6.9% over the three years 2001-2003 compared with growth of 10.7% in 2000. GNP growth, a more accurate reflection of national income in Ireland, is anticipated to average 6% over the period 2001-2003. These growth projections are predicated on moderation within social partnership, inter alia in response to the supportive provisions of Budget 2001. Pursuit of excessive expectations would inevitably damage economic and employment growth, push up unemployment and undermine our capacity for further social progress. This is why reaffirmation of the latest national agreement with the social partners, the Programme for Prosperity and Fairness (PPF) is so important.

Employment is expected to continue expanding - by about 2.5% on average over the next three years - reflecting Ireland's relatively strong, if moderating, labour force growth and a further, albeit limited, decline in unemployment.

While headline inflation will fall substantially through the year ahead and beyond - in particular as the impacts of this year's oil price and exchange rate developments unwind - inflation remains an important focus of policy attention.

### **Budgetary Policy Framework**

The primary macroeconomic objective of Budget 2001 and the updated Stability Programme is the continuation of sustainable economic growth, supported by moderate inflation and competitive wage developments reflecting the Programme for Prosperity and Fairness.

To this end, the aim of Budget 2001 has been to strike a sensible balance between the implications for inflation and growth of, on the one hand, failing to underpin adherence to the terms of the PPF or to respond adequately to emerging infrastructural bottlenecks and, on the other, of adding unduly to the demand pressures in the economy.

In this context, a General Government Surplus is projected each year over the period 2001-2003, averaging 4.2% of GDP. The projected surpluses comfortably meet the medium term objective of the Stability and Growth Pact of keeping budgetary positions close to balance or in surplus in normal economic conditions. General Government Debt as a percentage of GDP is projected to continue to fall, reaching 24% by 2003.

The taxation and expenditure changes of Budget 2001, which are reflected in this Stability Programme Update, fully meet the first stage of the Government's commitments under the PPF.

The Government's budgetary and investment plans are designed to address the challenges facing the economy and society over the medium term. Critically, they further enhance work incentives, support increased labour force participation and tackle other supply side pressures, address key investment needs in the economy and, equally important, underpin the further realisation of social and other goals.

## **Chapter 1 - Economic Review and Outlook**

### **Summary**

This updated Stability Programme is framed against a prospect of strong economic growth, underpinned by a supportive international economic environment. Economic growth is expected to moderate over the forecast period, reflecting the emergence of supply-side, particularly labour, constraints.

GNP growth in 2000 is now estimated at 8.6%, compared with a forecast of 6.3% at the time of last year's Budget. The economy has now expanded by an average of 7.8% since 1993. GNP growth of 7.4% is forecast for 2001 moderating to 5.1% by 2003. Accordingly, Ireland's GNP per head should continue to converge to that of our more prosperous EU partners.

Recent and ongoing investment growth promises to support a continued expansion in exports over the period ahead. Export growth of 11.5% is forecast for 2001. On the basis of some limited deterioration in our relative costs, export growth is projected to slow to 8.1% by 2003.

Employment growth is expected to moderate to an average of 2.5% over the period to 2003. Personal consumption is forecast to ease in tandem, with an average annual increase of 6.4% projected to 2003.

Inflation increased by more than expected during 2000. The headline Consumer Price Index rose by an estimated 5.5% compared with 1.6% in 1999. With the labour market expected to remain tight, domestic wage pressures are unlikely to diminish over the period to 2003. However, external factors will have a reduced impact on prices next year as the effects of recent interest rate, oil price and exchange rate developments unwind. Taking this into account, inflation is forecast to fall to 4.5% next year, and to 2.5% by 2003.

The inflation projections are based, inter alia, on the technical assumption of unchanged interest and exchange rates - and key commodity prices - from end-November, 2000 levels.

### **1.1 Introduction**

This document updates Ireland's Stability Programme and includes a new set of macroeconomic projections out to 2003. It takes account of the measures adopted in Budget 2001, the new National Agreement with the social partners - the Programme for Prosperity and Fairness (PPF) - and the National Development Plan 2000-2006.

This Update has been prepared in conjunction with Budget 2001 and is being presented to Dáil Éireann on Budget Day, 6 December 2000. As such it also provides an economic background to Budget 2001. It has been prepared in accordance with Council Regulation 1466/97, which sets out the rules covering the content of Stability Programmes.

The Stability Programme Update is organised as follows :

- **Chapter 1** reviews recent economic performance and presents macroeconomic projections for the period 2001-2003.
- **Chapter 2** sets out the Government's budgetary policy.
- **Chapter 3** details structural challenges facing the economy and the Government's policy responses to them.

## **1.2 Economic Review: 2000**

A year ago most forecasters expected the economy to slow in 2000, but it has exceeded expectations once again. It is now estimated that real GNP will expand by 8.6%, compared with the Department of Finance's forecast of 6.3% at the time of last year's Budget. A stronger international economy, the weak euro and more buoyant domestic demand conditions all contributed to this better performance. The economy has now grown in GNP terms by a remarkable average of 7.8% since 1993.

**Table 1 - Economic and Budgetary Indicators: 1994-1999**

|                               | 1994 | 1995 | 1996 | 1997 | 1998 | 1999             |
|-------------------------------|------|------|------|------|------|------------------|
| % Volume Change               |      |      |      |      |      |                  |
| GNP                           | 6.3  | 8.2  | 7.4  | 9.3  | 7.8  | 7.8              |
| GDP                           | 5.8  | 9.7  | 7.7  | 10.7 | 8.6  | 9.8              |
| Personal consumption          | 4.4  | 4.3  | 6.3  | 7.4  | 7.8  | 7.7              |
| Public consumption            | 4.1  | 2.8  | 3.1  | 5.7  | 5.1  | 5.2              |
| Fixed investment              | 11.9 | 12.7 | 16.4 | 17.9 | 15.5 | 12.9             |
| Exports                       | 15.1 | 20.0 | 12.2 | 17.4 | 21.4 | 12.4             |
| Imports                       | 15.5 | 16.4 | 12.5 | 16.8 | 25.8 | 8.7              |
| Current Account (% GNP)       | 3.2  | 3.2  | 3.7  | 3.5  | 1.1  | 0.8              |
| Consumer Prices (% change)    | 2.4  | 2.5  | 1.6  | 1.5  | 2.4  | 1.6              |
| GDP Deflator (% change)       | 1.7  | 3.0  | 2.3  | 4.4  | 5.8  | 3.8              |
| Unemployment (% labour force) | 14.1 | 12.1 | 11.5 | 9.8  | 7.4  | 5.5              |
| Employment (% change)         | 3.6  | 4.6  | 3.8  | 4.5  | 5.7  | 6.4              |
| Employment ('000s)            | 43   | 57   | 49   | 62   | 82   | 97               |
| General Govt. Balance         |      |      |      |      |      |                  |
| Deficit(-)                    | -2.0 | -2.6 | -0.4 |      |      |                  |
| Surplus(+) as (% GDP)         |      |      |      | 0.7  | 2.1  | 3.9 <sup>1</sup> |
| General Govt. Debt (% GDP)    | 90.5 | 83.1 | 74.3 | 65.1 | 55.0 | 50.1             |

ESA95 Basis

Sources: CSO and Department of Finance

### **External Developments**

Strong growth in the world economy provided the basis for continued progress in Ireland. The European Commission's Autumn 1999 Assessment expected the European economy to grow by 3% in 2000, with the UK expanding by 3.4%. The US was forecast to slow with GDP expanding by 2.8%. Trading conditions have turned out to be rather more favourable. Growth in the US for the year as a whole is now expected to be higher than last year, although there are signs of a slowdown. The recovery in Asia continued. With Europe also growing more rapidly than expected - by an estimated 3.4% - the world economy may expand by 4.4% this year. World imports are now estimated to have grown by over 10.7% this year, and OECD estimates indicate that Ireland's export markets expanded by 11.1%.

Against this favourable background, Irish exports performed well ahead of expectations, according to the latest trade statistics and the Balance of Payments data. Trade data to September, 2000 show an increase in the value of visible exports of almost 25% compared with the same period of 1999. Given the available information on export prices, this points to a volume increase of the order of 20%.

<sup>1</sup> To maintain comparability, the above 1999 General Government Surplus of 3.9% does not take account of discharging future pensions liabilities associated with some of the employees and former employees of An Post and Eircom (formerly the state owned telecoms company) at a cost of 1.8% of GDP.

Exports outside the euro-area – which account for 64% of total visible exports - are particularly strong, up 34% in value terms for the same period. Exports to the euro area grew by a more moderate 11%. This repeats the pattern for 1999 when the increases were 9% for the euro area and 20% for non-euro countries.

The particularly rapid growth in non-euro exports can be explained by a number of factors. Firstly, demand in the US and in Asia is exceptionally buoyant. Secondly, euro-area exports have been given a strong boost by the fall in the value of the euro. Against the US dollar, the euro is now 15% lower than at the beginning of the year. On a trade-weighted basis it is estimated to be about 13.5% below its average for 1999. This has enhanced competitiveness. The differential between export growth to euro countries and to countries outside the euro area is a salutary reminder (at a time when Irish earnings are rising faster than those of other euro-area countries) of the relationship between cost competitiveness and export - hence growth - performance.

Services exports are increasingly important. For 1999 they accounted for about one sixth of total exports. Balance of Payments data show that for the first half of this year Ireland's services exports rose by 11% compared to the same period last year.

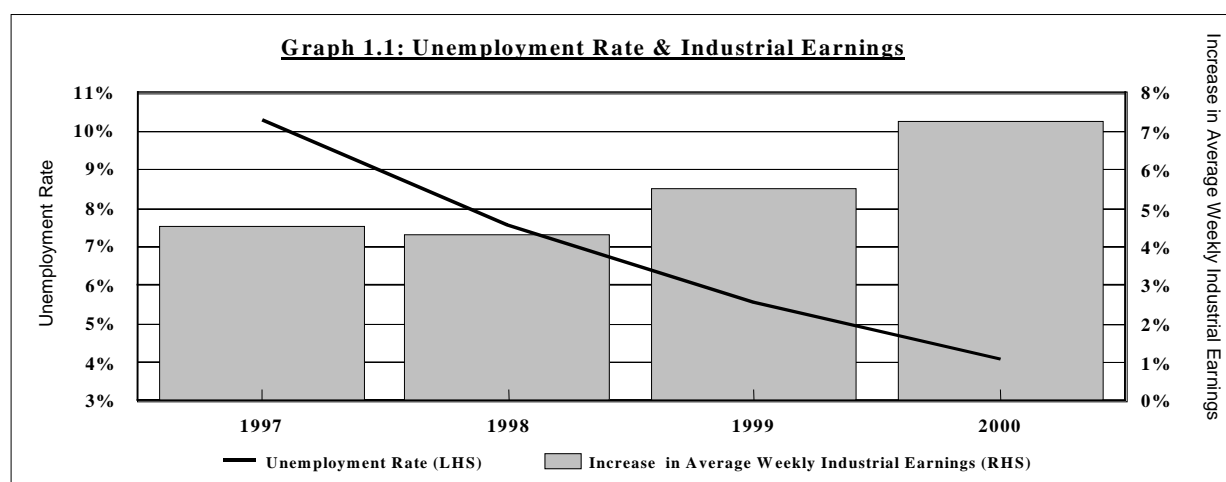
It is now likely that export volumes overall will grow by over 16.5% in 2000, compared to the original forecast of 11.5%.

### **Domestic Demand**

Domestic demand also contributed to the higher-than-expected growth. The buoyant labour market and relatively low interest rates continue to underpin consumer confidence. Consumer spending is still growing strongly and, indeed, accelerated in the first half of the year compared to 1999. The Retail Sales Index is up 11.3% in volume terms in the twelve months to September. Excluding car sales – which are up 39% for the first eight months of the year - the index is up 10.2%. This buoyant demand is also reflected in strong VAT and excise duty receipts. Personal consumption, in real terms, is now expected to increase by 8.5% this year.

Once again there were significant increases in employment. The latest Quarterly National Household Survey indicates that employment grew by almost 69,000 or 4.1% in the year to the third quarter. While impressive, these data confirm that growth in employment is easing from the peak of 7% seen in the third quarter of 1999.

While fully up-to-date information on earnings developments is not available, the latest data do suggest that as unemployment is falling, earnings growth is accelerating. While earnings rose much more modestly in some sectors, weekly earnings of all employees in industry increased by 8.1% in the year to March last and by 7.9% in the services sector in the year to June. In the construction sector - where demand and output have essentially doubled over the past five years - the latest data show an increase in weekly earnings of 15.5% in the year to December 1999.



It is estimated that average non-agricultural earnings are running 7¼% ahead of 1999. While prices are also higher, this average increase combined with reductions in personal taxation means a substantial increase in disposable incomes for employees generally.

Investment in building and construction continues to expand. The demand for housing remains high due to demographic factors, higher employment and net immigration. Statistics from the Department of Environment and Local Government point to an increase of 7-8% in housing output. Employment in construction is still rising despite the apparent shortage of labour: the index is 5.7% higher in the year to July 2000. Other investment indicators - such as capital imports and sales of business vehicles - confirm these positive investment trends. The National Accounts for the first quarter report real investment growth of 16.6% compared with Q1 of 1999.

It is now estimated that fixed investment volume this year will be almost 11% above last year's level.

### **Final Demand and Imports**

Final demand is estimated to be rising by 13% this year in volume terms. Not surprisingly, therefore, the Trade statistics and Balance of Payments data indicate that imports are growing rapidly. Monthly trade data show that the value of visible imports grew by 25% in the year to September. Given trends in import prices this suggests a volume increase of the order of 16%.

Balance of Payments data show that services imports rose 11.3% in value in the first half of the year compared with the first half of 1999. In volume terms, imports of goods and services are now expected to rise by 15.5% for the year as a whole. On this basis, the import intensity of final weighted demand is increasing, and imports will be well above last year's surprisingly low figure. The contribution of net exports to growth, while remaining positive, will be down on 1999 if current trends continue.

### **Gross National Product**

In summary, GNP is expected to grow by 8.6% this year. This is over 2 percentage points higher than the forecast included in last year's Stability Programme update. Net exports will make a greater contribution to growth than forecast, but stronger domestic demand is the main reason for the revision. However, the current estimate for 2000 is broadly in line with estimates in the mid-year *Economic Review and Outlook* publication.

**Table 2 - Economic & Budgetary Indicators 2000: Forecast & Estimated Outcome**

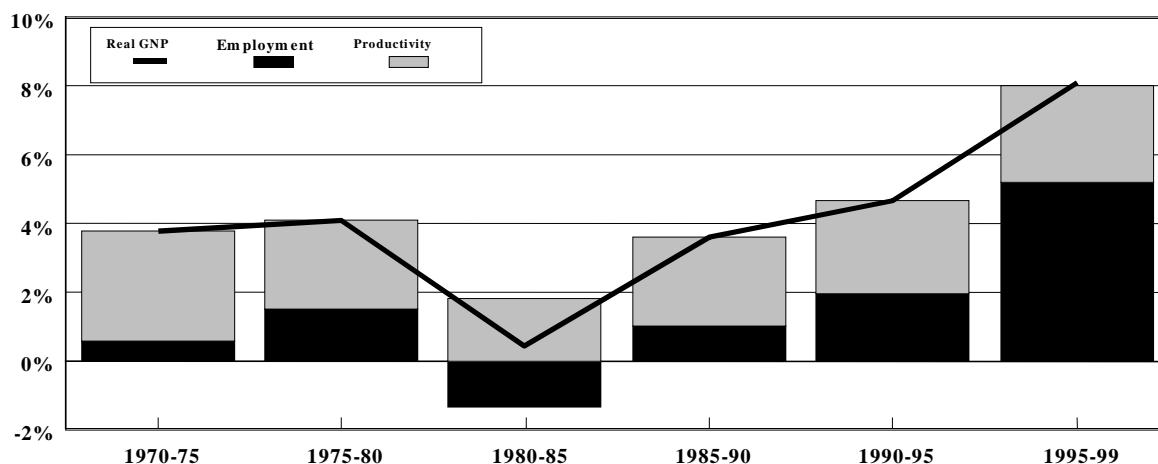
|  | <b>2000 Forecast</b> | <b>2000 Outcome</b> |
|--|----------------------|---------------------|
| <i>% Volume Change</i>                     |                      |                     |
| GNP  | 6.3                  | 8.6                 |
| GDP  | 7.4                  | 10.7                |
| Consumer Prices                            | 3.0                  | 5.5                 |
| Unemployment Rate (as a % of labour force) | 4.8                  | 4.1                 |
| Employment ('000)                          | 54                   | 74                  |
| General Government Surplus (% GDP)         | 3.3                  | 4.7                 |
| General Government Debt (% GDP)            | 46                   | 39                  |



### Box 1.1 : Potential Growth

In anticipating the extent and timing of the likely slowdown in growth it is instructive to look at the 1990s experience in more detail. The dramatic improvement in economic performance over the period was primarily due to a better labour market performance. Employment growth averaged 5% over the period 1995-1999 while output per head expanded by an estimated 3%. These data suggest that growth in labour productivity did not register a discernible up-tick compared to the historical experience.

Graph 1.2: Contributions of Employment and Productivity Growth to Real GNP



Source: Economic and Social Research Institute, Dublin

This has implications for future prospects. Employment growth must slow - and indeed this is already happening as unemployment falls to low levels. The "natural increase" in the labour force will contribute less to labour force growth than in the past, as the number of births fell through the 1980s. In addition, given the scale of the increases to date in female participation rates, the scope for future gains has clearly diminished.

Of course, favourable employment prospects will continue to attract more labour from abroad. But a decline in net migration is anticipated in response to housing cost and availability developments. Overall, it is assumed for these projections that employment growth will average about 2.5% per annum over the period. Thus, assuming labour productivity in line with the 1995-1999 period, potential growth is estimated at around 5-5½%. For 2000 it is expected that, due to cyclical factors and the recent rapid increase in the investment share in GDP, labour productivity will be somewhat higher than recent averages. The projections assume that productivity growth will moderate subsequently.

## 1.3 Macroeconomic Projections: 2001-2003

This section sets out the economic projections for the period 2001-2003. A benign scenario of gradually moderating growth is seen as the most likely path for the economy. Labour market tightness is expected to increase, putting upward pressure on costs and leading to a gradual loss in competitiveness and slower growth in foreign direct investment. This will moderate activity over time and return the economy to more sustainable growth rates by 2002/2003. The key factors affecting estimates of sustainable growth are outlined in Box 1.1.

### International Outlook

As discussed earlier, the international environment is very supportive of growth at present. While conditions are expected to remain generally favourable into 2001, world growth will slow somewhat. Demand in the euro area is expected to decelerate marginally: the European Commission's Autumn Assessment forecast growth of 3.2% in 2001 compared to an estimated 3.5% this year. A marginal slowdown is also forecast for the UK - 3% versus 3.2% for 2000.

Looking further afield, growth in the US - now Ireland's largest export market - is expected to slow to 3.3%. Elsewhere prospects remain relatively favourable. Asia, including Japan, will grow by more than 5% according to the European Commission. Latin America and the emerging economies of Central and Eastern Europe are also expected to achieve strong growth.

Overall, world growth of more than 4% is expected for the second year in a row. Demand in Ireland's export markets will expand by 8.3% according to the OECD. This is slower than in 2000 but still constitutes a positive outlook.

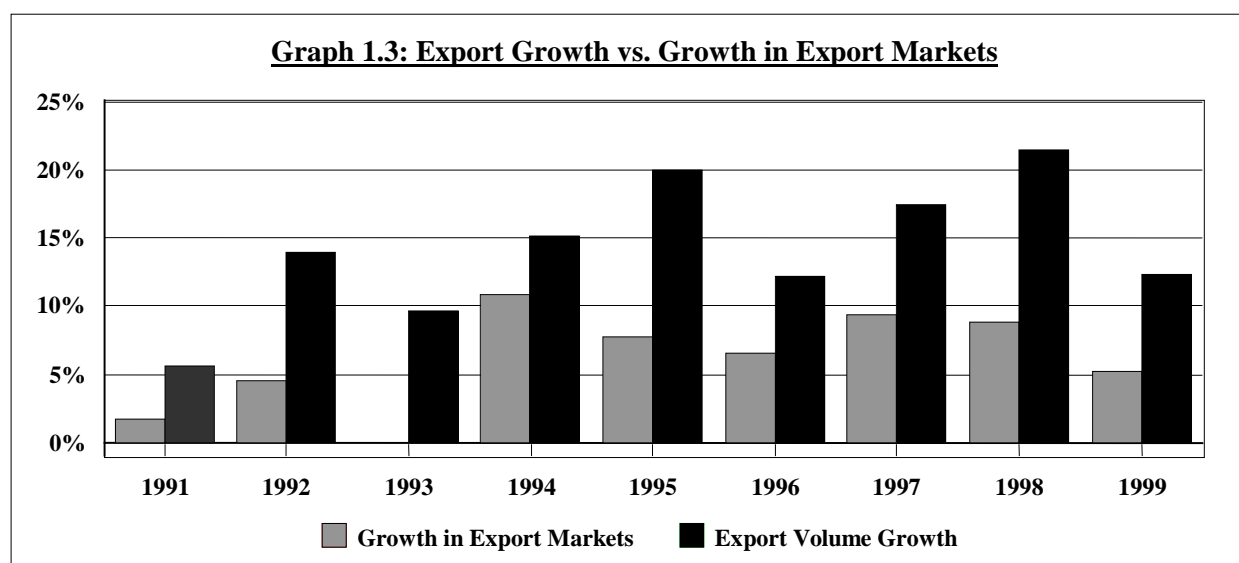
**Table 3 - Real GDP Growth in Ireland's Main Trading Partners**

|                       | 2000 | 2001 | 2002 |
|-----------------------|------|------|------|
| <b>Germany</b>        | 3.1  | 2.8  | 2.6  |
| <b>France</b>         | 3.3  | 3.1  | 2.8  |
| <b>Italy</b>          | 2.9  | 2.9  | 2.7  |
| <b>United Kingdom</b> | 3.2  | 3.0  | 3.0  |
| <b>Euro area</b>      | 3.5  | 3.2  | 3.0  |
| <b>EU 15</b>          | 3.4  | 3.2  | 3.0  |
| <b>USA</b>            | 5.1  | 3.3  | 3.0  |
| <b>Japan</b>          | 1.4  | 1.9  | 2.2  |

Source : European Commission (Autumn 2000).

### Exports

Throughout the 1990s Ireland's exporters made gains in market share, as indicated in Graph 1.3. During this period the economy remained extremely competitive as an abundant supply of labour and pay agreements, reflecting anticipated tax reductions, delivered internationally-competitive cost developments.



The situation has changed, however. With unemployment now below 4%, shortages of both skilled and unskilled labour are increasingly evident. Wages are rising in response to this new labour market situation. Average earnings growth of around 7¼% is expected in 2000 - albeit partly of a "once-off" nature as the National Minimum Wage was introduced. While earnings growth is not anticipated to moderate over the forecast period – given the terms of the PPF and a continuing relatively tight labour market situation – the export, investment and overall growth projections to 2003 are predicated on moderation within social partnership, inter alia in response to the supportive provisions of Budget 2001.

The projections accordingly assume further, but limited, diminution in Ireland's competitiveness going forward. As discussed earlier, the divergence between export growth to euro and non-euro areas suggests that this may already be occurring. Output data also offer some support for this view. Total manufacturing output is growing rapidly but a sectoral analysis shows a mixed picture. Some traditional sectors are experiencing only moderate growth or actual declines in output.

However, the available information indicates that new investment is still strong. US Commerce Department data suggest US investment flows into Ireland in 1999 were similar to 1998. Indications for this year are also

encouraging. The imports of capital goods are performing well while the first quarter National Accounts show that fixed investment is still increasing. This augurs well for export potential.

To sum up, the export position in the near-term remains favourable. However, while accepting that the relationship between cost developments and export growth is not clear-cut, infrastructure and cost pressures are likely to moderate both investment and export growth going forward. Thus, export growth of 11.5% is forecast for 2001 but, on the basis that gains in export market share will slow in response to those pressures, it is projected to slow to 8.1% by 2003.

**Table 4: Export volume growth vs. Export market growth (% Change 2000-03)**

|                      | 2000 | 2001 | 2002 | 2003 |
|----------------------|------|------|------|------|
| Export Volume Growth | 16.6 | 11.5 | 9.2  | 8.1  |
| Export Market Growth | 11.1 | 8.3  | 7.0  | 7.0  |

Source : Department of Finance, OECD

### **Domestic Demand**

While real personal incomes will continue to improve given the earnings and taxation assumptions underpinning this forecast, the numbers in employment are expected to expand less rapidly in future (as discussed in Box 1.1). This implies that aggregate real disposable income will not increase as rapidly as in recent times. As a result, personal consumption growth will slow: an average annual increase of 6.4% is projected out to 2003.

As discussed earlier, investment appears buoyant at present. Given our assumptions, interest rates will continue to support confidence, but supply constraints will lead to slower investment growth over time. Machinery and equipment investment are forecast to grow by an average of 7% over the period to 2003. Housing demand should remain high and supply is expected to increase gradually. Overall, investment growth could average 6.8% over the period. By the end of the period investment as a share of GDP may exceed 25% compared with a current euro area average of around 21%.

Finally, it is projected that the contribution to growth from net exports will decline and the current account will move into deficit as the supply-constrained economy is unable to meet demand. It is forecast that the current account will register a deficit of around 2% by 2003.

### **GNP and Risks**

Summing up, these projections assume a moderation in growth out to 2003. GNP growth of 7.4% is forecast for 2001 moderating to 5.1% by 2003. Notwithstanding the slowdown, Irish GNP per head will continue to rise more rapidly than the EU average.

Of course, a less benign scenario is always possible. There are potential risks to future prospects from both international and domestic sources.

Given Ireland's openness to trade and investment, a shock to the international economy would clearly upset the growth profile that is envisaged. A sudden reversal of the large gains in the US stock markets, for example, could be a trigger for a period of slower growth as the US is now Ireland's largest export market and the source for most of incoming foreign investment.

There is also potential for the euro exchange rate to appreciate significantly. A flexible labour market response would be required to sustain growth and keep unemployment low in this event.

Even in the absence of an external shock, the rapid pace of growth requires vigilance. The higher productivity growth in traded sectors which makes Ireland a rapidly-growing, convergent economy, is leading to faster price increases in non-traded sectors than among our trading partners. In consequence, Ireland's real exchange rate is appreciating - and will continue to do so until equilibrium wage rates consistent with sustainable growth are reached.

Prevailing tightness in the labour market creates a risk that the economy could "overshoot" this equilibrium rate - significantly, if that tightness was exploited to pursue excessive expectations. The ensuing loss of competitiveness would damage economic and employment growth, push up unemployment and undermine capacity for further social progress. This is why reaffirmation of the PPF is so important.

Therefore, while the benign scenario of gradually moderating growth is seen as the most likely path for the economy, there is a range of factors that could upset these economic and budgetary projections. Estimates of the impact of some of these on the General Government Surplus are set out in Appendix I.

**Table 5 - Macroeconomic Projections: 2000-2003**

|                      | 2000 | 2001 | 2002 | 2003 |
|----------------------|------|------|------|------|
| % Volume Change      |      |      |      |      |
| GNP                  | 8.6  | 7.4  | 5.4  | 5.1  |
| GDP                  | 10.7 | 8.8  | 6.3  | 5.7  |
| Personal consumption | 8.5  | 8.5  | 5.3  | 5.3  |
| Public consumption   | 6.1  | 2.8  | 4.1  | 2.7  |
| Fixed investment     | 10.8 | 8.3  | 6.9  | 5.3  |
| Exports              | 16.6 | 11.5 | 9.2  | 8.1  |
| Imports              | 15.5 | 10.8 | 9.0  | 7.7  |
| Contribution to GNP: |      |      |      |      |
| - Domestic Demand    | 8.8  | 7.7  | 5.5  | 4.9  |
| - Net Exports        | 3.6  | 2.9  | 2.1  | 2.1  |
| - Factor Incomes     | -3.8 | -3.2 | -2.3 | -1.9 |
| Consumer prices      | 5.5  | 4.5  | 3.5  | 2.5  |
| GDP Deflator         | 5.5  | 4.6  | 3.6  | 3.0  |
| Employment           | 4.5  | 3.5  | 2.1  | 1.8  |
| Employment ('000)    | 74   | 60   | 37   | 33   |
| Unemployment Rate    | 4.1  | 3.2  | 3.2  | 3.2  |

Source: Department of Finance

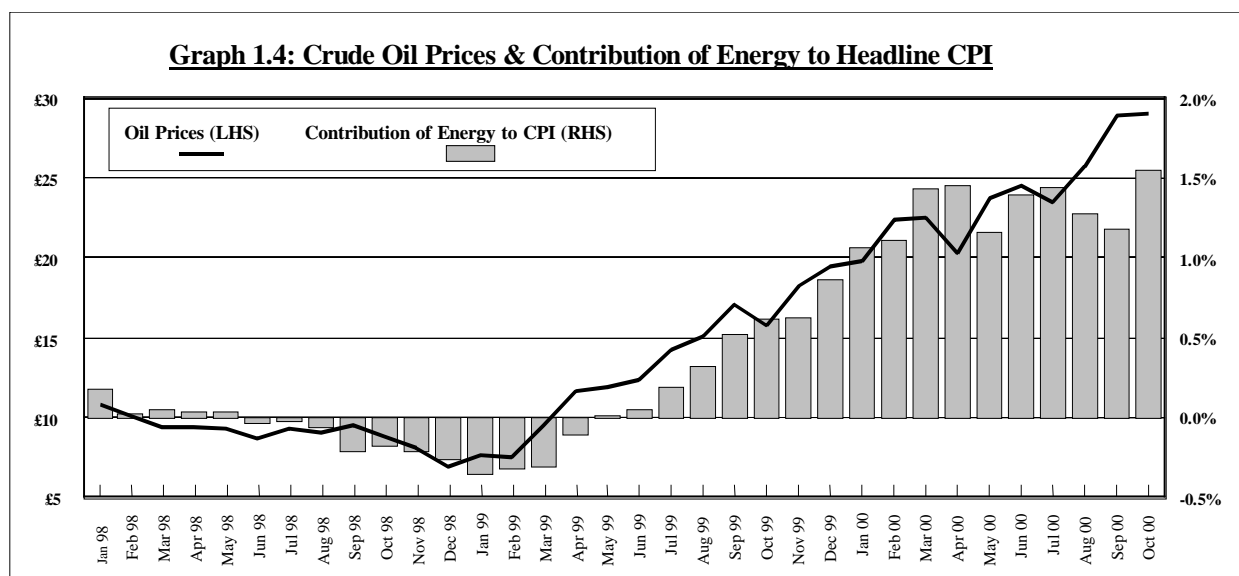
## 1.4 Inflation

### Developments in 2000

Inflation increased during 2000. The headline Consumer Price Index rose by an estimated 5.5% compared with a modest 1.6% in 1999. Key factors in the acceleration include recent increases in interest rates and energy prices, a weakening euro, and higher excise duties on tobacco products.

The ECB increased interest rates from 2.5% at the beginning of December 1999 to 4.75% at present, while increased competition in the mortgage market reduced rates in 1999.

The increase in international oil prices has also had a large impact on price developments. The price of crude oil in euro terms has quadrupled since its low point in December, 1998. In line with most forecasts, last year's Stability Programme Update had assumed that prices would stay in the region of \$20 dollars per barrel. Instead prices continued to rise during this year and to-date the year on year increase of the energy component of the CPI is running at 15.7%, adding over 1.5% to the headline CPI

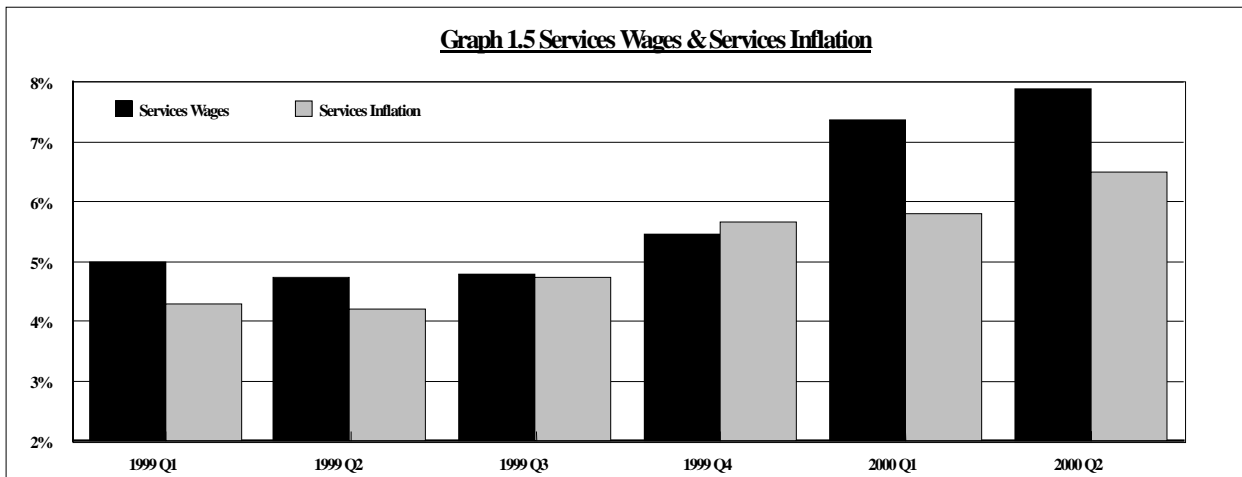


The continued decline in the euro is also adding to energy costs in addition to pushing up import prices of a range of goods. However, the impact of the latter on the CPI to-date has been less than econometric analysis based on historic data would have suggested. This suggests that more increases could be in the pipeline and, indeed, this is assumed in the inflation projection.

Higher excise duties on tobacco products for health promotion reasons also added a further 0.75% to inflation which will fall out of the year-on-year comparison, in December.

Inflation in the services sector, which reached a peak of 7.0% in July, has also been a significant contributor to inflation. The Graph below indicates that cost developments may be playing a role in this regard. However, the various measures introduced by the Government in June, focusing on increasing competition and limiting price increases and public charges, are having some impact on services inflation which has fallen back in recent months.

Average inflation of 5.5% for the year as a whole is now expected. But for the impact of interest rates, energy prices and higher excise duties, inflation might have averaged close to 3% for the year.



## Prospects for 2001 and Beyond

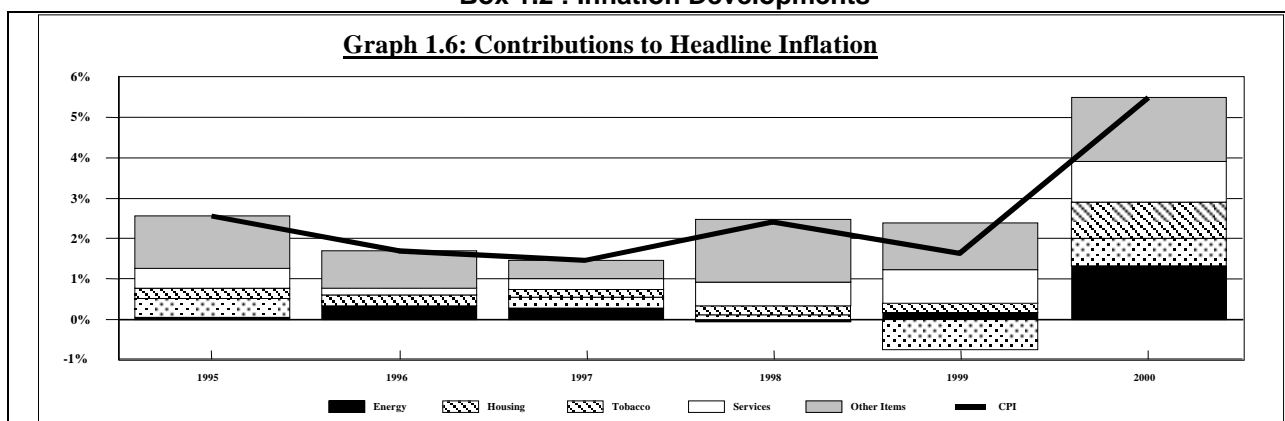
The inflation projections for the period are based on a number of assumptions. Crucially, unchanged interest and exchange rates and commodity prices are assumed.

On this basis, the adverse effects of this year's increases in oil prices and interest rates, and of the declining euro, will unwind through next year. Indeed, should these factors move favourably, the inflation rate would fall more rapidly than forecast. While domestic pressures are not anticipated to moderate through the period ahead on the basis that unemployment will remain at historically low levels, the projections are also predicated on moderation within social partnership over the period.

The indirect tax and excise duty changes of Budget 2001 will reduce inflation by an estimated 0.5% assuming that the reductions are passed on in full to the consumer.

In conclusion, headline inflation is forecast to decline through 2001, with the CPI showing an average increase of 4.5% next year and 3.5% in 2002. Of course, there are both upside and downside risks to these projections.

### **Box 1.2 : Inflation Developments**



The increase in inflation during 2000 has led a number of commentators, both domestic and international, to suggest that the Irish economy is overheating. In this view strong demand against the background of prevailing supply constraints is leading to a generalised inflation problem. Two key considerations need to be borne in mind which sometimes tend to be overlooked.

First, Ireland's potential growth rate is significantly higher than that of most developed countries. As such, assessments of whether Ireland's ongoing growth performance suggests "overheating" should begin from an assessment of *Ireland's* potential growth rate.

Second, while Ireland's (HICP-measured, to October, 2000) 6.0% inflation rate is clearly higher than the 2.7% average for other euro area countries, a number of factors must be considered. The first of these, a 0.75% contribution from increased excises on tobacco introduced for health policy reasons, is clearly not an element of *underlying* inflation.

In addition, there is the impact on Irish prices of Ireland's much greater trade with non-euro countries. Ireland's imports from outside the euro-area represent over 80% of GDP, far above the share for most euro countries, with the bulk being sourced from the UK and the US. Thus, the weak euro will have more of an impact on inflation in Ireland than other euro countries. Taking account of these factors, it seems that the differential between *underlying* Irish inflation and that among euro-members generally is less than 2%. This differential must be seen in the context of Ireland's rapid economic growth.

### **Independent Forecasters**

It may be helpful to compare the Department of Finance's projections with those of other institutions. The Table below reports the latest available projections in 2001 of several agencies which it should be noted, are based on budgetary assumptions which differ from the actual decisions that were taken.

**Table 6 - Comparison of Macroeconomic Forecasts for Ireland: 2001**

| <i>Annual % Change</i>                     | <b>GDP</b> | <b>GNP</b> | <b>CPI</b> | <b>Employment</b> |
|--|------------|------------|------------|-------------------|
| <b>Department of Finance (Budget 2001)</b> | 8.8        | 7.4        | 4.5        | 3.6               |
| <b>EU Commission (Autumn 2000)</b>         | 8.2        | N/A        | 3.6*       | 3.3               |
| <b>Central Bank (Autumn 2000)</b>          | 8.8        | 7.5        | 4          | 3.5               |
| <b>ESRI (December 2000)</b>                | 7.5        | 6.6        | 4.4        | 3.4               |
| <b>OECD (Outlook, December 2000)</b>       | 7.9        | 6.2        | N/A        | N/A               |

\*HICP measure of inflation

## **Chapter 2 - The Budgetary Policy Framework**

### **Summary**

The primary macroeconomic objective of Budget 2001 and the updated Stability Programme is the continuation of sustainable economic growth, supported by moderate inflation and wage developments reflecting the latest national agreement with the social partners, the Programme for Prosperity and Fairness (PPF).

To this end, the aim of Budget 2001 has been to strike a sensible balance between the implications for inflation and growth on the one hand of failing to underpin adherence to the terms of the PPF or to respond adequately to emerging infrastructural bottlenecks and, on the other, of adding unduly to demand pressures in the economy.

An average General Government surplus of 4.2% of GDP is forecast for the three years 2001-2003, (compared to an anticipated outturn of 4.7% this year) comfortably complying with Stability and Growth Pact obligations.

The debt/GDP ratio is expected to fall to 24% by 2003 from an expected 39% at end-2000. Further substantial sums of not less than 1% of GNP annually will continue to be set aside for the pre-funding of pension liabilities.

In response to the urgent infrastructural needs of the economy, capital expenditure will average 5.3% of GDP over the Programme period in line with the National Development Plan 2000-2006.

The Budget 2001 tax reductions will increase the reward from work of all taxpayers, remove 107,000 taxpayers from the top rate of tax and remove 133,000 taxpayers on low income from the tax net altogether. These measures will also help to increase participation in the labour market.

The provisions for day-to-day spending will, at the same time, underpin substantial progress across the broad range of social and other objectives.

### **2.1 Budgetary Review 2000**

The December 1999 Stability Programme Update forecast a General Government Surplus for 1999 of 3.2% and for 2000 of 3.3%. The outturn for 1999 has since been revised upwards to 3.9%<sup>1</sup> of GDP. The General Government Surplus estimate for 2000 has also been revised upwards to 4.7% of GDP, which represents a tightened fiscal stance compared with Budget.

Table 7 sets out the comparison between the General Government position for 1999 and 2000, as set out in the December 1999 Stability Programme Update, and as now estimated.

This improved budgetary position can largely be explained by higher tax receipts resulting from stronger than expected economic growth.

The General Government Debt/GDP outturn at end-2000 will also be significantly below the target set in last year's Stability Programme Update.

The 2000 Broad Economic Policy Guidelines recommended that the Government should "be ready already in 2000 to use budgetary policy to ensure economic stability". The better than projected outturn for 2000 is in line with this recommendation.

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<sup>1</sup> To maintain comparability, the above 1999 General Government Surplus of 3.9% does not take account of discharging future pensions liabilities associated with some of the employees and former employees of An Post and Eircom (formerly the state owned telecoms company) at a cost of 1.8% of GDP.



**Table 7 - General Government Position for 1999 and 2000**

|                                      | Stability Prog<br>Dec'99 forecast | Outturn          | Stability Prog<br>Dec'99 forecast | Outturn |
|--------------------------------------|-----------------------------------|------------------|-----------------------------------|---------|
|                                      | 1999                              | 1999             | 2000                              | 2000    |
| As a % of GDP                        |                                   |                  |                                   |         |
| Current Account Surplus              | 5.2                               | 6.1              | 5.8                               | 7.4     |
| Capital Account Deficit <sup>1</sup> | 2.0                               | 2.2              | 2.5                               | 2.7     |
| General Government Surplus           | 3.2                               | 3.9 <sup>2</sup> | 3.3                               | 4.7     |
| - of which Primary Surplus           | 6.0                               | 6.4              | 5.8                               | 6.7     |
| General Government Debt              | 52                                | 50.1             | 46                                | 39      |
| GDP IR£ M                            | 66,850                            | 69,052           | 74,025                            | 80,625  |
| GDP € M                              | 84,881                            | 87,677           | 93,992                            | 102,372 |

ESA95 Basis [Preliminary National Accounts Assessment]

## **2.2 Economic and Budgetary Policy Context**

The primary macroeconomic objective of Budget 2001 and the updated Stability Programme is the continuation of sustainable economic growth, supported by moderate inflation and competitive wage developments reflecting the latest national agreement with the social partners, the Programme for Prosperity and Fairness (PPF).

Chapter 1 set out the economic background to Budget 2001. The Irish economy is growing strongly reflecting both cyclical and structural factors. It is undergoing a period of rapid change as living standards converge on those of more prosperous EU Member States. Ireland's GNP per capita is currently estimated to be about 100% of the EU average. In this context policy must address supply side issues, especially in the labour market and infrastructure areas, to facilitate further 'catching-up' by the Irish economy without giving rise to unsustainable price pressures.

Managing the transition of the Irish economy to a more sustainable growth path while maintaining economic stability is a challenge for policy. In meeting that challenge, Ireland's participation in EMU means that the available tools are limited to incomes and budgetary policy.

Due to its direct impact on competitiveness, incomes policy is particularly important and that is why the continuation of a successful social partnership process is regarded by the Government as crucial. In recognition of this and of the less direct impact of budgetary policy in a small open economy, budgetary policy plays a key, if supporting, role.

Budgetary policy must therefore strike a balance between running a large budgetary surplus and not adding unduly to demand pressures on the one hand, or on the other hand, of failing to adequately address infrastructural, labour supply and other supply-side needs or to adequately underpin adherence to the terms of the social partnership agreement.

<sup>1</sup> 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

<sup>2</sup> To maintain comparability, the above 1999 General Government Surplus of 3.9% does not take account of discharging future pensions liabilities associated with some of the employees and former employees of An Post and Eircom (formerly the state owned telecoms company) at a cost of 1.8% of GDP.

### **Box 2.1 Social Partnership**

The Partnership approach has underpinned the success of the Irish economy since 1987. Through a consensus-based approach to wage determination, covering both the public and private sectors, successive multi-annual agreements have sought to improve the competitiveness of the economy through moderation in pay increases in a framework in which fiscal and monetary policy are geared towards price stability. The agreements also cover areas of policy such as taxation reform and public services provision. In this integrated approach, actual pay increases are underpinned by government commitments regarding taxation reform, public services and social expenditure.

The Partnership approach has been remarkably successful in delivering relative industrial relations peace, strong economic growth, low inflation and reduced unemployment. For example, between 1994 and 1999 GDP growth averaged 9.3%, GDP per capita grew by 50% and inflation averaged 2%.

The latest agreement, called the Programme for Prosperity and Fairness (PPF), began in March 2000 and will last for 33 months. The Programme aims to further enhance living standards and reduce social exclusion on a basis that will prove sustainable over the longer term. The Programme focuses on the continued competitiveness of Ireland in a global economy and the need for a flexible, dynamic and well educated workforce.

The 2000 Broad Economic Policy Guidelines implicitly acknowledge that the wage increases in the Programme for Prosperity and Fairness were consistent with the maintenance of employment growth.

The PPF was underpinned by a commitment that there would be increases in net take home pay, from pay increases and tax reductions combined, of up to 25% or more. The Programme also included Government commitments in relation to public service provision and social inclusion.

The dynamic and flexible nature of the new Programme has already been tested by the recent increase in inflation. The Government and the other social partners moved quickly to deal with this issue within the framework of the new agreement.

## **2.3 Taxation Policy**

In Budget 2001 the Government has continued its wide-ranging reform of the income tax system - designed to improve equity, to better reward work and to encourage greater participation in the labour market. (The Government's tax reform strategy is outlined in more detail in Box 2.2). The Budget's significant tax changes are also designed to address unemployment and poverty traps and to improve the interaction of the tax and social security systems.

The tax reductions in the Budget deliver on the commitment of the Government under the PPF to reduce personal taxation in order to support a competitive pay evolution and, thereby, economic and social progress.

In this regard, it should be noted that the IMF Executive Board in its recent Article IV Examination of the Irish Economy stressed that " the commitment to further moderate tax cuts under the national wage agreement should be respected."<sup>1</sup>

In 2001 a reduction in the numbers in the various tax brackets, as shown in Table 8, will increase the reward from work to all taxpayers. The changes will remove 107,000 taxpayers from the top rate of tax and will completely remove 133,000 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.

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<sup>1</sup> Source : Public Information Notice for the 2000 Article IV Consultation

**Table 8 - Distribution of Income Tax Payers by Tax Band**

| Tax Year         | Exempt Cases |       | Marginal Band |      | Standard Band |       | Higher Band |       |
|------------------|--------------|-------|---------------|------|---------------|-------|-------------|-------|
|                  | No.          | %     | No.           | %    | No.           | %     | No.         | %     |
| <b>1997/1998</b> | 380,000      | 25.5  | 108,000       | 7.25 | 580,000       | 38.75 | 424,000     | 28.5  |
| <b>1998/1999</b> | 394,000      | 25    | 82,000        | 5.25 | 643,000       | 40.5  | 463,000     | 29.25 |
| <b>1999/2000</b> | 474,000      | 28.5  | 25,000        | 1.5  | 655,000       | 39.25 | 510,000     | 30.75 |
| <b>2000/2001</b> | 535,000      | 29.5  | 7,000         | 0.5  | 718,000       | 41    | 509,000     | 29    |
| <b>2001/2002</b> | 668,000      | 37.75 | 4,500         | 0.25 | 695,000       | 39    | 402,000     | 23    |

Source : Revenue Commissioners, (No.s rounded to the nearest '000)

### **Box 2.2 – Reforming the Irish Tax System**

The Government is implementing a wide-ranging reform of the income tax system designed to improve equity, while at the same time incentivising greater participation in the labour market. The three main elements involved are:

- reducing tax rates
- replacing tax allowances with tax credits
- widening the standard rate tax band

As regards tax rates, both the standard rate and the top rate have been reduced by a total of 8 percentage points over the past three years and will now be at 20% and 42% respectively in 2001/02. These changes are designed to reduce marginal tax rates and improve the incentive to work.

Tax credits are of equal value to all taxpayers regardless of income whereas the previous system of tax allowances gave greater benefits to those paying tax at the higher rate. Nearly all personal tax allowances have been converted to tax credits, with the initial tax credits being set at a level which leaves the position of higher-rate taxpayers generally unchanged and improves the position of those at the standard rate. This has resulted in a significant increase in the income level at which people enter the tax net, which is £144 (€183) in 2001/02, compared with £71 (€90) in 1997/98. In the PPF the social partners and the Government have agreed that, over time, all those earning the minimum wage will be removed from the tax net (currently £172 (€218) per week).

As regards the widening of the standard rate band, since 1980 married couples had double the personal allowance and rate bands of single people, with full transferability between spouses. This frequently resulted in the second spouse facing high marginal tax rates on all income when taking up employment. It also resulted in the width of the tax bands being held down for cost reasons, bringing progressively more single people earning less than the average industrial wage into the top tax rate. In this context it was decided to widen the standard rate tax band over a period with the objective that each person should have his or her own non-transferable standard rate band. In Budget 2001 the standard band is being increased to £20,000 (€25,395) for single people and £40,000 (€50,790) for two-earner married couples (with a maximum transferable band of £29,000 between spouses), and £29,000 (€36,822) for one-earner married couples. The policy of widening of the standard rate band in this way was supported by the social partners in the PPF.

## **2.4 Expenditure Projections 2001 – 2003**

Public expenditure policy must strike a balance between the requirement not to add excessively to domestic inflationary pressures on the one hand, and on the other, to meet the public service and social inclusion commitments in the key Programme for Prosperity and Fairness as well as to maintain our cost competitiveness through necessary investment in public infrastructure.

Public expenditure policy priorities are also in line with the areas identified for Government action at the Lisbon European Council in March namely: employment, innovation and research, economic reform and social cohesion. Public expenditure policy for the period of this Programme is being formulated in the context of significant budgetary surpluses and a falling debt/GDP ratio.

The Government recognises the need not to threaten inflation by adding excessively to demand and agrees with the recommendation in the 2000 Broad Economic Policy Guidelines that public expenditure growth be restrained. The Government also recognises that public expenditure policy has a key contribution to make in containing inflation by underpinning the recent agreement with the Social Partners in relation to public service provision and social inclusion.

The expected trend in general government current expenditure as a percentage of GDP is given in Table 9. In terms of GNP, which is a far more satisfactory measure of Irish taxpayers' ability to support public spending, General Government Current Expenditure is estimated/projected at 30.8% in 2000, 30.5% in 2001, 29.5% in 2002 and 28.4% in 2003.

**Table 9 - Total Government Current Expenditure <sup>1</sup>**

|   | 2000 | 2001 | 2002 | 2003 |
|---|------|------|------|------|
| <b>as a percentage of GDP</b>                 |      |      |      |      |
| <b>General Government Current Expenditure</b> | 25.9 | 25.4 | 24.5 | 23.5 |
| <b>of which:</b>                              |      |      |      |      |
| - <i>Interest payments</i>                    | 2.0  | 1.8  | 1.4  | 1.2  |
| - <i>Goods and Services</i>                   | 12.3 | 12.1 | 12.2 | 12.0 |
| - <i>Other Transfers</i>                      | 11.5 | 11.5 | 10.9 | 10.4 |

[Preliminary National Accounts Assessment]

### **Infrastructural Investment**

The 2000 Broad Economic Policy Guidelines acknowledged that despite substantial investment in recent years, Ireland still has a significant infrastructural deficit. They therefore recommended that budgetary policy should aim to ensure that the objectives of the National Development Plan are accorded high priority, given the infrastructural needs of a strongly growing economy.

In response to the urgent need to remedy infrastructural deficits, thereby easing cost competitiveness pressures, capital expenditure will average 5.3% of GDP over the Programme period in line with the National Development Plan 2000-2006<sup>2</sup>. The bulk of this planned investment in roads, public sector transport and water and sewerage services is aimed at addressing existing bottlenecks and allowing for further economic growth in the years ahead.

<sup>1</sup>These apportionments for general government current expenditure by category are provisional.

<sup>2</sup> The National Development Plan was discussed in detail in last year's Stability Programme, section 3.14.

**Table 10: Capital Account**

|                                    | 2000 | 2001 | 2002 | 2003 |
|------------------------------------|------|------|------|------|
| <b>as a percentage of GDP</b>      |      |      |      |      |
| <b>Total Government Investment</b> | 5.1  | 5.4  | 5.5  | 4.9  |
| <b>Capital Resources</b>           | 2.4  | 2.6  | 1.7  | 1.1  |
| <b>Capital Deficit</b>             | 2.7  | 2.8  | 3.8  | 3.7  |

[Preliminary National Accounts Assessment]

The investment measures contained in Budget 2001 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 continuing reduction in EU funding, will respect the Stability and Growth Pact. With a view to maintaining investment efficiency, new approaches to public investment are underway including a series of Public Private Partnerships.

**Table 11: Total Government Current Resources**

|   | 2000 | 2001 | 2002 | 2003 |
|---|------|------|------|------|
| <b>as a percentage of GDP</b>               |      |      |      |      |
| <b>General Government Current Resources</b> | 33.3 | 32.5 | 32.5 | 32.7 |
| <b>of which:</b>                            |      |      |      |      |
| -Central Government Taxes                   |      |      | 26.6 |      |
| -Social Security Receipts                   | 27.2 | 26.6 | 4.3  | 26.8 |
| - Miscellaneous Current Receipts            |      |      | 1.7  |      |

[Preliminary National Accounts Assessment]

## **2.5 Budgetary Projections 2000-2003**

The projected General Government balance for the period to 2003 is shown in Table 12. An average annual surplus of 4.2% of GDP is forecast for the three years 2001-2003.

The budgetary stance represents a responsible and realistic approach in the context of Ireland's strong fiscal position and is in comfortable compliance with Ireland's obligations under the Stability and Growth Pact.

It represents a considered balance between the need to avoid adding to domestic inflation, while underpinning the Programme for Prosperity and Fairness - the cornerstone of economic policy - and adequately addressing infrastructural constraints as envisaged in the National Development Plan.

It should be noted that:

- the Government plans to run significant General Government surpluses each year of the up-dated Stability Programme despite a decline in net EU receipts by the Irish Exchequer from 0.6% of GDP in 1999 to an estimated -0.3% of GDP in 2003;
- there will be a further substantial reduction in the debt to GDP ratio, to 24% by 2003; and
- Ireland will continue to set aside further substantial sums of not less than 1% of GNP annually, to pre-fund pensions liabilities (the National Pensions Reserve Fund already has assets of almost £5.05 billion (€6.4 billion) or 7.4% of GNP).

**Table 12 - Budgetary Projections: 2001- 2003**

|   | 2000 | 2001 | 2002 | 2003 |
|---|------|------|------|------|
| <b>as a percentage of GDP</b>               |      |      |      |      |
| <b>Current Account Surplus</b>              | 7.4  | 7.0  | 8.0  | 9.2  |
| <b>Capital Account Deficit</b> <sup>1</sup> | 2.7  | 2.8  | 3.8  | 3.7  |
| <b>Contingency</b> <sup>2</sup>             | 0.0  | 0.0  | -0.4 | -0.8 |
| <b>General Government Surplus</b>           | 4.7  | 4.3  | 3.8  | 4.6  |
| <b>- of which Primary Surplus</b>           | 6.7  | 6.1  | 5.4  | 6.0  |
| <b>General Government Debt</b>              | 39   | 33   | 28   | 24   |

ESA95 Basis [Preliminary National Accounts Assessment]

The 2000 Broad Economic Policy Guidelines recommended that “given the extent of overheating in the economy” the Government should “gear the Budget for 2001” to ensuring economic stability. The Government’s budgetary policy framework for 2001-2003 is in line with this recommendation.

These budgetary projections take account of an increase in the deficit on the capital account from 2.7% of GDP in 2000 to 3.7% in 2003 reflecting increased public sector investment as a result of the roll out of the National Development Plan.

They also incorporate a contingency provision against possible future developments which could adversely affect the budgetary position amounting to 0.4% of GDP in 2002 and 0.8% in 2003.

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<sup>1</sup> 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.

<sup>2</sup> This is a provision made against factors that may impact on the Budget but cannot be quantified at this stage.

### **Box 2.3 Public Finance Impact of Third Generation Mobile Phone Licences**

The impact on the public finances of the sale of third generation mobile phone licences is not yet clear; it will depend on the level of fees set for them in 2001. The budgetary arithmetic included in this Update does not incorporate possible 3G-related revenue.

In July, the Director of Telecoms Regulation launched a consultation process which proposed that the competition for the award of licences for third generation (3G) mobile telephony services will be by way of a comparative selection process. The Director also proposed the award of four licences including one reserved for a new entrant to the market.

The level of fees for 3G licences will be established later taking account of developments in 3G competitions elsewhere in Europe. The consent of the Minister for Finance is required in relation to the proposed fees, and this will be sought at the appropriate time.

It is anticipated that the licensing process should be completed by around May 2001.

## **2.6 Disposal of State Assets**

A number of State asset disposals are expected next year. If the proceeds of these disposals are used for pensions prefunding they will have no impact on the budgetary outturn.

## **2.7 Effect on General Government Balance of Pensions Prefunding**

Payments to pensions pre-funding do not have an impact on the General Government Balance. It had been anticipated, when last year's Stability Programme December 1999 Update was being prepared, that two funds would be established one of which would be outside the Government sector. Accordingly, it was then anticipated that prefunding payments would reduce the General Government Balance by 2.2% of GDP in 2000 and by 0.3% of GDP thereafter. It is now the case that only one fund, the National Pensions Reserve Fund, is being established. Payments to this Reserve Fund do not have an impact on the General Government Balance, as it is treated as part of the General Government sector.

An amount of £3.015 billion was set aside for pensions prefunding in 1999. This together with a further £1.85 billion set aside this year gives a total projected value for the Fund, including interest, at end-2000 of £5.05 billion (€6.4 billion) or 7.4% of GNP.

The bulk of this funding (about £3.6 billion) was financed from the proceeds of the sale of shares in Eircom (formerly Telecom Eireann) in 1999 and 2000 and the balance is financed from a minimum annual contribution of 1% of GNP. (The public finance implications of population ageing are discussed in more detail in Chapter 3).

## **2.8 Sensitivity to Lower Growth**

The economic and budgetary 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 I. 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.

## **Chapter 3 - Structural Reform Initiatives**

### **Summary**

This Chapter sets out the key structural challenges facing the economy and discusses the Government's responses to them.

Policies designed to increase labour supply such as active labour measures, upskilling and migration are outlined, as are policies to boost competition in product and capital markets.

Measures to 'cool' the housing market and address the economy's infrastructural deficit - through the National Development Plan 2000-2006 - are also described.

Finally the Government's long term policy for addressing the public finance implications of population ageing by means of a National Pensions Reserve Fund is discussed.

### **3.1 Introduction**

As the current phase of rapid economic convergence towards the living standards of the more prosperous EU Member States continues, Ireland is facing a new set of challenges many of which might best be termed 'the problems of success'. These challenges include :

In the short term...

- Supporting further gains in labour force participation and in skill levels as the economy approaches full employment;
- Bringing supply and demand into equilibrium in a housing market which has a rapidly increasing population in the 'home owning' age cohorts;

In the short to medium term...

- Tackling the economy's infrastructural deficit;
- Strengthening competition in product and capital markets;

In the medium to longer term...

- Responding to the public finance implications of an ageing population over the next fifty years.

A summary of the Government's policy responses to each of the challenges listed is set out below.

### **3.2 Boosting Labour Supply and Skills Levels**

Ireland's 2000 National Employment Action Plan (EAP) focuses on measures to alleviate labour shortages, as they now constitute one of the major challenges facing the economy. Policies are set out in detail in the EAP but summaries of some of the key measures are outlined below.

#### **Passive to Active Labour Market Measures for the Unemployed**

The preventive strategy implemented under Ireland's Employment Action Plan (EAP) represents a new dimension in the delivery of labour market supports. This strategy is aimed at engaging with both young and adult unemployed at an early stage of unemployment with a view to supporting their return to employment and preventing their drift into long-term unemployment. This on-going preventive approach commenced for young unemployed (under 25) in 1998, and adult unemployed in the age range 25 to 34, in 1999. It was extended during 2000 to include adults aged 35-54. In addition to this phased roll-out of the preventive strategy, the trigger point for early intervention with adult unemployed was brought forward, from 12 months to 9 months, during 2000.



This EAP-type approach was also extended to the long-term unemployed, on a pilot basis, initially in one urban and one rural location. It is being extended over time to further areas of the country.

This approach is complemented with a substantial range and scale of active labour market programmes to assist the long-term unemployed and other disadvantaged groups re-integrate into the labour market. The FAS (National Training Agency) Action Plan for the Long-Term Unemployed aims at increasing the proportion of long-term unemployed participating in FAS skills training programmes to 25% during the year 2000, compared to last year's target of 20%.

### **Improvement in Educational and Skills Level of Labour Force**

Under the National Development Plan, almost IR£10 billion (€12.7 billion) will be invested in policies to increase employability, adaptability, encourage entrepreneurship and promote equal opportunity (the four pillars of the EAP).

Based on recommendations of an Expert Group on Future Skills Needs, the Government in 1999 approved funding to support 5,400 extra third level places for the electronics and software sectors; 1,500 extra places on ICT postgraduate conversion courses and 730 new places in information technology skills courses. A new National Training Fund to provide increased resources for upskilling is also being established.

The second report of the Expert Group, published in March 2000, recommended 1150 additional third level places for the pharmaceutical, chemical, food and biotechnology sectors, to be introduced on a phased basis, and recommended initiatives to improve the availability of skills for research and for the construction sector

### **Migration**

Under Ireland's long-standing work permits system over 15,000 permits were issued in the first 11 months of this year, some 140% ahead of the number of permits issued over the same period in 1999. A new work visa system to facilitate the recruitment of suitably qualified people for designated sectors (such as IT, nursing and skilled construction) where skill shortages are particularly acute was introduced this year. The new visa scheme applies in respect of non EEA countries and will allow the prospective employee to apply to the Irish Embassy or Consulate in their home country and to have the work authorisation placed on their passport.

### **Female Participation**

While Ireland's female labour force participation has risen considerably over recent years – and participation rates among single women are as high as elsewhere – there is still some scope for further growth. Ireland's EAP and the PPF reaffirm the strong commitment set out in the National Development Plan and the Community Support Framework to equal opportunities between women and men. Accordingly, as well as steps to enhance incentives, recent Budgets contained measures to encourage an expanded supply of child care places to meet the growing need for such facilities. The NDP has allocated £250m (€317 million) towards childcare. Budget 2001 includes additional measures to support childcare provision and significant increases in child benefit.

## **3.3 Bringing Supply and Demand into Equilibrium in the Housing Market**

Recent house price increases have shown moderating trends compared with previous years. Inflation in the new house market peaked at 26% countrywide and 38% in Dublin in 1998. The latest year on year figures are slowing at 12% and 10% respectively. The main factors underpinning housing demand include demographic trends, such as growth in key household formation population age-groups (25-34 years), a decrease in average household size, reversal of earlier emigration trends and sustained economic growth.

The Government recognises that continued house price inflation can pose a threat to the wider economy and has introduced a number of measures in recent years to respond to the demand/supply imbalance.

The key objectives of the latest Government package launched in June 2000 are to:

- maximise housing output to meet the continuing strong demand for housing,

- curb short-term speculative demand,
- strengthen the position of first-time purchasers in the market,
- increase the supply of social and affordable housing, and
- improve the institutional arrangements to facilitate the delivery of housing related infrastructure and thereby increase overall housing supply.

These objectives were implemented through a comprehensive package of measures including:

- exemption from stamp duty for first-time buyers for second-hand houses up to £150,000 (€190,000) and reduced rates up to £300,000 (€381,000), combined with a higher stamp duty rate of 9% for all housing transactions for non-owner occupiers;
- introduction for three years of an anti-speculative tax of 2% per annum on investors purchasing residential properties for non-owner occupation – but exemptions will apply in certain cases;
- the use of Strategic Development Zones to ensure the early development of large-scale residential developments, with a levy of £3,000 (€3,800) per housing unit for land owners who do not develop the land in accordance with the planning scheme for the zone and within specified time frames;
- measures to increase the capacity of the construction industry, in particular to address shortages of professional and skilled workers;
- an additional 1,000 local authority housing units per annum from 2001 to 2006;

The National Development Plan has also included significant investment in housing and housing-related infrastructure and in water and sewerage services, roads and public transport.

### **3.4 Tackling the Economy's Infrastructural Deficit**

The 2000 Broad Economic Policy Guidelines recommended that Government should "ensure that the objectives of the National Development Plan are accorded high priority, given the necessity of meeting the infrastructural needs of a strongly growing economy, while at the same time achieving the stability objectives of fiscal policy".

The National Development Plan (NDP) with investment of £40.588 billion (€51.5 billion) in 1999 prices is a key policy commitment to the achievement of continuing sustainable economic growth, a more inclusive society and better regional balance in economic growth.

Just under £21 billion (€26.6 billion) will be spent in the main priority area of Economic and Social Infrastructure. The cost-effective and timely delivery of the Plan, and in particular the infrastructural investment, will be of key importance.

Solid progress was made this year in advancing implementation of the Plan. Agreement on the Community Support Framework for Ireland was reached with the European Commission in July. The Commission subsequently approved the Employment and Human Resources Development Operational Programme, the Economic and Social Infrastructure Operational Programme, the Productive Sector Operational Programme, the Borders, Midlands and West and the South and East Regional Operational Programmes.

Monitoring committees and a Cabinet Committee will ensure on an ongoing basis that any possible obstacles to the successful delivery of the Plan are fully addressed. There will be flexibility in the monitoring arrangements to switch resources if necessary. Indications are that Plan implementation will generally come close to target by year end.

### **3.5 Strengthening Competition in Product and Capital Markets**

The Irish Government regards structural reform of product and capital markets as vital in ensuring efficient resource allocation, innovation and economic dynamism, all of which are key factors determining national competitiveness and standards of living.

A detailed review of progress made during the year 2000 is set out in the *Progress Report on Reforming Product and Capital Markets* published by the Department of Finance in November. The key reforms undertaken include:

Continued liberalisation of the utilities' markets...

- 30% of the electricity market was opened up to competition in February 2000.
- The Government launched a consultation paper on public transport in September 2000 in line with recommendations in the 2000 Broad Economic Policy Guidelines. It sets out a number of reforms including the phased introduction of a fully franchised Dublin bus market.
- In late 1999, the Government decided to proceed with the privatisation of Aer Lingus, the state airline, and work to that effect has been ongoing in 2000.

Investment in R&D and in measures to support the transition to a knowledge economy...

- The National Development Plan 2000-2006 provides for spending of £1.95 billion (€2.47 billion) to support R&D. As part of this strategy, the Government established the independent Science Foundation Ireland in June 2000 to administer a Technology Foresight Fund of £560 million (€711 million).

Measures to promote competition and improve regulation in Irish capital markets...

- The Government has announced that it will introduce new legislation reforming competition and mergers rules, giving a greater role to the Competition Authority; and that the Authority will also enforce Articles 81 and 82 of the Treaty when this power is devolved to member states.
- The Government is in the process of disposing of the state-owned banks.

### **3.6 Responding to the Public Finance Implications of an Ageing Population**

In common with other industrialised countries, Ireland is set to experience a significant ageing of its population over the coming decades. The resulting increased dependency ratio will give rise to serious budgetary issues. In particular, it will put severe strain on the capacity of future Governments to continue to fund social welfare and public service pension liabilities on the present "pay-as-you-go" basis.

Ireland's demographics<sup>1</sup> are slightly more favourable than other European countries but the longer-term trend towards an older population is similar to that in other countries. Almost uniquely in the industrialised world, Ireland's elderly dependency ratio will actually decline a little over the next few years. At present Ireland has - and will continue to have for most of this decade - about five people of working age for each person over 65. However the position will begin to change at the end of the decade. By 2016 it is projected that there will be about four persons of working age to support each pensioner. By mid-century it is projected that there will be only two people of working age for every pensioner. In other words, Ireland's elderly dependency ratio is set to rise from about 20% today to about 25% by 2016 and to about 50% by 2050.

It is projected that ageing of the population will affect pension costs as follows:

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<sup>1</sup> Source: Population and social welfare pension projections are based on an update in October 2000 by Mercers Ltd. of an actuarial review of social welfare pensions carried out in September 1997 by the Irish Pensions Trust (now part of Mercers Ltd.). The update takes account of demographic and economic changes as well as changes in pension rates and contribution levels since the original study.

- the current Exchequer cost of public service and social welfare pensions is 4.7% of GNP;
- by 2026 the Exchequer cost of broadly maintaining the real level of this pension provision will rise to 8.1% of GNP;
- by 2056 this cost will have risen to 12.4% of GNP.

In order to address this situation the Government has decided to move from the traditional reliance on 'pay-as-you-go' in the public sector and to introduce partial pre-funding of our future pension liabilities. This will involve the establishment of a National Pensions Reserve Fund early in 2001. Once the Reserve Fund is established, a statutory minimum of 1% of GNP will be set aside and invested each year to part-fund the cost of future pensions. The assets of the Fund will be drawn down by future Ministers of Finance commencing in 2025. The size of these drawdowns will increase in line with the growth in the percentage of over 65s in the population. In this way the Fund - over a very long time period - will help to smooth the Exchequer burden arising from our additional pension commitments.

The legislation establishing the Fund will also allow the Government to make additional contributions to the Fund. For example, the Government has already set aside the net proceeds of the sale of the former Telecom Eireann for pension prefunding.

## Appendix I - Sensitivity Analysis

The economic forecasts included in this updated Stability Programme represent the Department of Finance's assessment of Ireland's future growth prospects. These are based on the following assumptions:

- unchanged interest and exchange rates
- unchanged commodity prices
- the continuation of reasonable growth in the world economy as forecast by the European Commission's Autumn 2000 Assessment
- a gradual loss in Ireland's competitiveness as growth in earnings continues to exceed those of our main trading partners

It is assumed that the Irish economy achieves a "soft-landing" from the current period of rapid growth. Of course, 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 possible economic scenarios.**

A number of points should be borne in mind when examining these results. Firstly, the estimates should be seen as indicative and are subject to considerable uncertainty. Secondly, 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.

### **Alternative Scenarios**

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

In line with estimates for previous years, it is estimated that a 1% impact on the growth rate would change the General Government Balance by about a ½% of 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.

**Table 13 - Impact on the Budget Balance of 1% Change in the Rate of Growth Per Annum**

|  | 2001       | 2002       | 2003       |
|--|------------|------------|------------|
| Baseline GDP Growth  | 8.8        | 6.3        | 5.7        |
| GGSurplus (% GDP)<br>(including contingency)                             | 4.3        | 3.8        | 4.6        |
| Cumulative impact of<br>1% change in growth<br>per annum on<br>GGSurplus | up to 0.5% | up to 1.0% | up to 1.5% |
| GGSurplus Range<br>(%GDP)  | 3.8 to 4.8 | 2.8 to 4.8 | 3.1 to 6.1 |

#### **- Impact of changes in Interest Rates compared with central projection**

Interest rate changes would impact on economic activity and revenue receipts.

The impact on economic growth is highly uncertain. The size of the impact clearly depends on future expectations. If a given interest rate change is considered to be temporary it will have less of an impact than changes that are considered to be longer-lasting.

The level of indebtedness in the economy is also important. Clearly, a more indebted economy would suffer a greater impact from higher interest rates. According to ESRI estimates personal debt as a % of personal disposable income has increased from 43 % in 1990 to 64 % in the first half of 2000. However, the

Government debt burden has fallen even more over this period, reducing the economy's overall exposure to higher borrowing costs.

Previous estimates by the Economic and Social Research Institute suggest that a one per cent change in interest rates could affect growth by as much as a half a per cent in the short-run. These estimates seem reasonable. Accordingly a one per cent change in interest rates could affect the General Government Balance by as little as one quarter of a per cent. It would also directly affect debt servicing costs but these are marginal when compared with the greater impact on growth and Government revenues.

## **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.

It is however questionable whether attempts to measure the structural budget balance are useful in an economy changing as quickly as Ireland has done in the 1990s. 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 for Ireland for the reasons set out below :

**First**, with large structural changes having taken place, it is difficult to establish that there is currently an identifiable Irish economic 'cycle'.

**Second**, it is currently difficult to reliably establish what is the sustainable trend rate of economic growth in Ireland, because of shifts in productivity, labour force participation and migration patterns.

**Third**, there is a large degree of uncertainty regarding trend growth estimates generally.

**Fourth**, there is a weak correlation between measures of the output gap and inflation in Ireland given the importance of external factors in determining price developments.

**Fifth**, 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.

**Sixth**, the CABB does not take into account the impact of changes in EU funding on national budgets.

Estimations of the 'structural budget balance' and other such measures of the appropriateness of budgetary stance accordingly require to be treated with caution. Much more important in terms of evaluating the appropriateness of policy are the 'real' measures of the general government surplus and the general government debt level.

### **Estimates of Cyclically-Adjusted Budget Balances and Output Gaps**

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

As indicated in the table, calculated on this basis, the cyclically-adjusted balance has risen by more than 3% of GDP since 1997, suggesting that fiscal policy has been contractionary over the past three years. The methodology points to a similar tightening over the period of this Stability Programme update as a whole - with the cyclically-adjusted balance estimated to rise from 3½% of GDP this year to 4% in 2003.

Indeed, given the methodology employed, this estimated fiscal tightening understates the full impact of budgetary policy on economic activity in Ireland, as it does not take account of the effective withdrawal of 0.6% of GDP via a reduction in net EU transfers to Ireland over the period. [The Y2000 GGSurplus assumes that Ireland receives net EU transfers - Structural, Cohesion and similar receipts, less contributions to the EU Budget - of 0.3% of GDP this year: the Y2003 GGSurplus is based upon a net *outflow* equivalent to 0.3% of GDP as, by then, it is anticipated that the Irish Exchequer's contribution to the EU Budget will considerably exceed its receipts therefrom]

**Table 14 - Cyclically Adjusted Budget Balance <sup>1</sup>**

|             | <b>Actual Growth rate %</b> | <b>Trend Growth rate %</b> | <b>Output Gap (% trend GDP)</b> | <b>Actual GGB (% of GDP)</b> | <b>Cyclically adjusted GGB (% trend GDP)</b> | <b>GGB Change [+=tightening] %</b> |
|-------------|-----------------------------|----------------------------|---------------------------------|------------------------------|--|------------------------------------|
| <b>1997</b> | 10.7                        | 7.8                        | -0.1                            | 0.3                          | 0.3  | 0.3                                |
| <b>1998</b> | 8.6                         | 8.0                        | 0.4                             | 1.7                          | 1.6  | 1.3                                |
| <b>1999</b> | 9.8                         | 8.1                        | 2.0                             | 3.9                          | 3.4  | 1.8                                |
| <b>2000</b> | 10.7                        | 8.1                        | 4.5                             | 4.7                          | 3.6  | 0.1                                |
| <b>2001</b> | 8.8                         | 7.9                        | 5.4                             | 4.3                          | 2.9  | -0.7                               |
| <b>2002</b> | 6.3                         | 7.7                        | 4.0                             | 3.8                          | 2.7  | -0.2                               |
| <b>2003</b> | 5.7                         | 7.4                        | 2.4                             | 4.6                          | 4.0  | 1.3                                |

ESA 95 basis

<sup>1</sup> To maintain comparability, the above 1999 General Government Surplus of 3.9% does not take account of discharging future pensions liabilities associated with some of the employees and former employees of An Post and Eircom (formerly the state owned telecoms company) at a cost of 1.8% of GDP.



### Appendix III - Policy Responses to Broad Economic Policy Guidelines (BEPGs) 2000

Each of the country specific recommendations concerning Ireland, contained in the 2000 Broad Economic Policy Guidelines, is set out below alongside relevant policy responses from Government.

| <b>Budgetary Policy</b>   |  |
|---|--|
| <b>BEPG 2000 Recommendation</b>   | <b>Government Policy Responses</b>   |
| Budgetary policy should aim to be ready, already in 2000, to use budgetary policy to ensure economic stability given the extent of overheating in the economy; gear the budget for 2001 to this objective.  | The Government remains committed to running substantial Budget surpluses for each year of the updated Stability Programme.   |
| Restrain the growth in real public consumption from the 4.3% estimated in 1999 to 2.7% in 2002 as shown in the [1999] updated stability programme.  | The Government recognises the need not to exacerbate inflationary pressures, and in this context fully agrees with the recommendation that public expenditure growth should be restrained. The increases in public expenditure in this Programme underpin adherence to the new agreement with the Social Partners and in this way contribute to constraining inflation.  |
| Ensure that the objectives of the National Development Plan are accorded high priority, given the necessity of meeting the infrastructural needs of a strongly growing economy, while at the same time achieving the stability objectives of fiscal policy.   | Solid progress was made in 2000 in advancing the Plan. Agreement on the Community Support Framework was reached with the EU Commission in July. The Committees to monitor implementation of the NDP held their first meetings. Expenditure on Roads was one area ahead of the financial provision proposed as the year proceeded.  |
| <b>Product and Capital Markets</b>  |  |
| <b>BEPG 2000 Recommendation</b>   | <b>Government Policy Responses</b>   |
| Give the Competition Authority the power to enforce Articles 81 and 82 of the EC Treaty; permit a real strengthening of competition policy in the reform of competition law to be drawn up this year and do not restrict it to procedural matters.  | The Government has announced that it will introduce new legislation reforming competition and mergers rules, giving a greater role to the Competition Authority and that the Authority will also enforce Articles 81 and 82 of the Treaty when this power is devolved to member states.  |
| Take measures to liberalise further the transport sector; in particular introduce competition into urban bus transport and into the railways, e.g. by franchising.  | The Government launched a consultation paper on public transport in September 2000 in line with recommendations in the 2000 BEPGs. It sets out a number of suggested reforms including the phased introduction of a fully franchised Dublin bus market and the break up of the state rail company into independent infrastructure and operating companies - with the option that the operating company be privatised.  |
| Make further efforts in particular to develop start-up and early-stage venture capital.   | The Irish Venture Capital Market has made considerable progress during the past few years. Ireland is ranked fifth among seventeen OECD countries in terms of the overall amount spent on venture capital as a % of GDP, with cumulative venture capital raised totalling 1.09% of GDP in 1997. Overall performance by Government and EU supported funds to 31 December 1999 since 1996 has been 121 investments in 72 companies totalling £37.9 million (€48.1m). |
| <b>Labour Markets</b>   |  |
| <b>BEPG 2000 Recommendation</b>   | <b>Government Policy Responses</b>   |
| Monitor wage developments so as to ensure that they are at most consistent with the recently concluded national pay and partnership agreement, the Programme for Prosperity and Fairness, as the minimum necessary basis for the maintenance of employment growth.  | Against the background both of the current social partnership agreement, the Programme for Prosperity and Fairness and the need for vigilance in relation to inflationary pressures, the Government favours wage developments consistent with maintaining competitiveness and economic growth.   |
| Adopt a comprehensive strategy to increase the participation of women in the labour market, including the removal of tax-benefit disincentives, and put in place measures which facilitate the reconciliation of work and family life; pursue, in particular, flexible leave schemes and a sustained effort to increase the supply of care for children and other dependants. | Budget 2000 contained measures to enhance incentives to work especially for married women, and to encourage an expanded supply of childcare places to meet the growing need for such facilities. Y2001 expenditure plans contain provision aimed at further expanding child-care supply. Budget 2001 includes additional measures to support childcare provision and significant increases in child benefit.   |