Ireland - Stability Programme

December 2001 Update

Foreword

This document updates Ireland's Stability Programme and includes macroeconomic projections to 2004. It takes account of the measures adopted in Budget 2002, the ongoing commitments in the National Agreement with the social partners - the Programme for Prosperity and Fairness (PPF) - and the National Development Plan 2000-2006 (NDP). There will be a general election in 2002 and the priorities of the post-election Government are not yet known. Accordingly, while the projections for 2003 and 2004 incorporate provisions for budgetary measures, these provisions must be seen as technical only.

This Update has been prepared in conjunction with Budget 2002 and is being presented to Dáil Éireann on Budget Day, 5 December 2001. As such it also provides an economic background to Budget 2002.

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

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Chapter 1 - Overall Policy Framework and Objectives

Economic Outlook

The international economic outlook has deteriorated significantly since the last Stability Programme Update in December 2000. The US and EU economies were already slowing before the September 11 terrorist attacks, which have added a dimension of uncertainty to the economic outlook. At the same time, the changing structure of the Irish economy over the last decade has increased our dependence on economic developments in the wider world. Thus, policy attention here has refocused towards accommodating ourselves to the international slowdown, and to positioning the country to take full advantage of a recovery in the pace of global economic activity when that comes. Irish economic growth next year will be significantly below potential, but should recover to its medium-term potential over the period to 2004.

Reflecting both international conditions and reduced potential for increases in labour supply, GDP is forecast to increase at an annual average rate of 5% over the three years 2002-2004 compared with estimated annual growth of 9¾% in 1999-2001. GNP growth, a more accurate reflection of national income in Ireland, is anticipated to average 4¼% over the forecast period.

Employment may increase by an average annual 1½% over 2002-2004 compared with 4½% over the last three years. Unemployment is expected to rise modestly from its present historically low level, to 4¾% next year, but to decline to 4½% by 2004. Consumer price inflation is forecast to decline to 4.2% next year, in part on the basis that external inflation seems likely to be subdued, and to 2¼% by 2004.

Policy Focus

The core objective of macroeconomic and budgetary strategy, against the background of a currently weak international economy and uncertainty about both the timing and pace of its recovery, is to ensure that Ireland is positioned to benefit fully from a pick-up in global economic activity when that emerges. The key priorities, in this context, are:

- firstly, sustaining confidence in the public finances;
- secondly, dealing with a weakening of Irish competitiveness on the cost front and more broadly, inter alia by adhering to the current agreement with the social partners, the PPF;
- thirdly, prioritising public spending towards programmes which improve the long-term capacity of the economy to benefit from improved conditions as they emerge; and
- fourthly, making further progress in structural reform.

Budgetary Stance

In this context, as summarised in Table 1 below, allocations to public investment are being sustained at a relatively high level within the framework of a planned General Government budgetary position which moves into moderate deficit over the period to 2004. The projected budgetary position respects the Stability and Growth Pact and underpins a prospective continuing low ratio of General Government Debt to GDP.

Table 1: Public investment, general government surpluses; prospective debt ratio (% of GDP)

% of GDP	2001	2002	2003	2004
Public Investment	4.4	4.6	4.6	4.6
General Government Surplus	1.4	0.7	-0.5	-0.6
Debt Ratio (year end)	35.8	33.7	33.8	34.1

Source: Department of Finance

The Government's budgetary measures and expenditure plans aim to sustain and enhance capacity for economic progress going forward, in particular by improving the level and quality of public services, developing infrastructure, encouraging investment and enterprise and doing so in a way that sustains fiscal policy.

Chapter 2 - Economic Outlook

2.1 Summary[1]

Real GDP growth this year is estimated at 6¾%, based on a sharp deceleration as the year progressed following the maintenance of growth in the early months of 2001.

As a result, the economy is likely to enter 2002 with little momentum. Demand in our major trading partners is likely to be considerably weaker than in recent years. The outlook, taking the budget measures into account, is for GDP growth close to 4% next year. However, assuming some pick-up in the external economy during the second half - in line with international forecasts - the pace of economic activity in Ireland is projected to pick up through the year, with growth reaching potential in 2003-04.

Employment growth next year is likely, therefore, to moderate and unemployment seems set to rise modestly, from its historically low level. Looking beyond next year, employment should expand somewhat more rapidly again, limiting the increase in unemployment - which should begin to decline once more in the later part of the projection period. Inflation should fall further - to 4.2% - through 2002, partly reflecting an easing of external inflationary pressures, with a further deceleration likely thereafter.

2.2 The Economy in 2001

Following a sustained, strong performance over the past seven years, the pace of economic expansion slowed markedly during 2001. While there was substantial year-on-year growth in the early months, this largely reflected the carry-over of very strong economic activity from last year. A wide range of indicators - tax receipts, trade, industrial production and survey-based indicators of output and expectations - suggest that a sharp slowdown then set in, and that intra-year growth since has been weak.

A slowdown from the very strong growth rates recorded since 1994 was bound to happen. A major reduction in unemployment has been achieved since then, there has been a significant rise in overall labour force participation and physical capacity constraints have become increasingly binding. Accordingly, as the year began, most commentators envisaged a slackening in the pace of expansion from recent exceptional levels, albeit on the benign scenario of a gradual moderation towards the economy's medium term potential growth rate - estimated to be around 5% per annum.

However, reflecting the impact of both domestic and external shocks, growth has decelerated more rapidly than anyone envisaged. On the domestic front, the restrictions put in place to guard against the risk of foot-and-mouth disease (FMD) adversely affected a number of sectors, most notably agri-food, tourism and related transport. At the same time, the international economic environment deteriorated significantly compared with earlier expectations.

[1] The analysis contained herein is based on data available up to end-November 2001. The forecasts are based on the technical assumption of unchanged interest rates and exchange rates. International trends over the forecast period are based on the European Commission Autumn 2001 forecasts.

Table 2 - Economic and Budgetary Indicators: 1996-2000

	1996	1997	1998	1999	2000
%volume change (except where otherwise stated)					
GNP	7.4	9.4	7.9	8.2	10.4
GDP	7.8	10.8	8.6	10.8	11.5
Personal consumption	6.3	7.3	7.3	8.2	9.9
Public consumption	3.2	5.5	5.5	6.5	5.4
Fixed investment (including stocks)	15.7	20.3	17.1	4.5	9.8
Exports	12.2	17.4	21.4	15.7	17.8
Imports	12.5	16.8	25.8	11.9	16.6
Consumer prices (% change) ^	1.6	1.5	2.4	1.6	5.6
GDP deflator (% change)	2.2	4.1	5.9	4.2	4.3
Unemployment (% of labour force)	11.9	10.3	7.6	5.6	4.3
Employment (% change)	3.7	3.9	8.3	6.3	4.7
Employment change ('000)	47	51	115	95	77
General Gov. Balance (% GDP) *	-0.3	1.2	2.3	2.3	4.5
General Gov. Debt (% GDP)	74.2	65.1	54.8	49.3	38.6

^ Consumer Price Index.
* Deficit (-) / Surplus (+).
Labour market data for 1996 - 98 refer to April. For later years, full - year data are used.
Source: CSO and Department of Finance.

External Developments

2001 was a difficult year for the global economy. The slowdown in the US which began in the second half of 2000 gained momentum. Output in the US contracted at an annual rate of 1.1% in the third quarter of this year. The September terrorist attacks have affected confidence, and seem likely to accentuate the downturn. According to the European Commission, US growth this year will be just under 1%. As a major source of foreign direct investment into Ireland, developments in the US manufacturing sector are of particular importance from our perspective. That sector has performed poorly for some time, with the National Association of Purchasing Managers Index showing a contraction each month since August last year.

Slower growth in the US has spilled over into the wider global economy. The European Commission estimates that the EU as a whole will grow by 1.7% this year, just half as fast as last year. With economic conditions in Japan remaining weak, growth across the OECD in 2001 is now estimated at 1.0%, an extremely steep decline from last year's 3.7%.

Against this less favourable background, although there was strong double-digit year-on-year growth in the volume of Irish exports over January-August, export volumes have been broadly static since late last year. Import trends together with forward-looking indicators are not yet pointing to an improving performance, so that merchandise export growth for the year as a whole of 8¼% is forecast. The value of services exports in January-June was 26% higher than a year ago, but ongoing difficulties affecting tourism and the impact of a slowing global ICT sector on exports of computer-related services suggest a considerably weaker second-half outcome. The volume of exports of goods and services combined is estimated to rise by about 8¼%.

Domestic Demand

Available indicators point to a more moderate evolution of household expenditure this year than for some time. While the volume of retail sales excluding cars rose by 7.6% over the first nine months of the year this, nevertheless, is a slower pace of expansion than in 2000. The easing in employment growth as unemployment fell to historically low levels, combined with the measures taken to guard against the risk of foot-and-mouth disease which doubtless affected personal consumption through the second quarter, are part of the explanation. In addition, car sales have dropped off dramatically, falling by 27% to end-July. With confidence likely to be affected to some degree since the summer by high-profile threats to jobs or actual job-losses, an element of precautionary saving may be emerging. Taking these factors into account, private consumption is estimated to increase by about 6%.

Employment growth continued to moderate - reflecting the less plentiful labour supply now available but also, it would seem, an easing in the pace of investment as businesses responded to the more muted demand conditions prevailing both abroad and domestically. According to the Quarterly National Household Survey, total employment in the first three quarters was 51,000 (3.0%) higher than a year earlier, with an evident decelerating pace of growth. While some further easing seems likely in the final quarter, average employment growth for the year as a whole seems likely to be 2.8%. Unemployment reached a record low of 3.7% in the first half of 2001. The average for the year may be around 4%, however, as unemployment has begun to edge upwards since then.

Earnings statistics reveal an acceleration in wage increases in the early part of this year. Hourly earnings in the construction sector rose by 17.3%, year-on-year, in the second quarter. The corresponding increase in manufacturing was 9.8% while weekly earnings in the distribution and business services sector rose by 9.4%. Although relevant CSO data are not yet available, it is clear that public sector earnings also grew strongly. Trends in PAYE receipts suggest that earnings increases may have eased subsequently. It is estimated that non-agricultural earnings per capita will rise by more than 8% this year.

Available indicators point to a slowdown in the rate of investment growth. House completions in the first half were 4.8% higher than a year ago. However, Homebond registrations - a useful proxy for housing starts - were down considerably over the same period. This points to overall output significantly below last year's record 49,800 units. While the remainder of construction, assisted by higher public investment, is likely to record a further volume increase, trends in capital goods imports are consistent with an ongoing slowdown in machinery and equipment investment. Total investment is estimated to increase by about 5½%.

Final Demand and Imports

Taking these elements together, final demand seems likely to rise by about 7%, compared to 13¾% in 2000. Merchandise import volumes rose very modestly to end-August, and there was a clear decelerating trend which points to dampened expectations about future export and domestic demand growth. However, the most recent import figures also seem to reflect some destocking and, on the basis that this process will ease quickly, merchandise import growth for the year is forecast to approach 3¾%. While the value of services imports increased by 31% in the first half, the rate of growth should ease in line with the export patterns. The volume of imports of goods and services, accordingly, is estimated to rise by 7¼% in 2001. Balance of payments data for the first half of the year point to a substantial increase in net factor outflows and, with net transfers easing, the deficit on the current account of the balance of payments is forecast to increase to about 2% of GNP.

Gross National Product

In summary, therefore, GNP may expand by about 5¼%, with an expansion concentrated earlier in the year followed by a sharp deceleration and little or no growth in the second half. Although not too far below the estimates contained in the mid-year Economic Review and Outlook, this is more than 2 percentage points lower than forecast in last year's Stability Programme Update and reflects the adverse implications of the FMD threat in the spring together with the impact of a weaker-than-forecast international economy. GDP growth is estimated at 6¾%.

Table 3 – Economic and Budgetary Indicators 2001: Forecast and Estimated Outturn

	2001 Forecast	2001 Outturn
GNP (% volume change)	7.4	5.2
GDP (% volume change)	8.8	6.8
Consumer prices (% change)	4.5	4.9
Unemployment rate (% labour force)	3.2	4.0
Employment growth ('000)	60	47
Employment growth (%)	3.5	2.8
General Government Surplus (% GDP)	4.3	1.4
General Government Debt (% GDP)	33	35.8

Source: Department of Finance.

2.3 Prospects for 2002 and the Medium Term

The forecasts for the Irish economy over 2002-2004 in this Stability Programme Update are based on a relatively benign scenario in which the global economy picks up during the second half of next year. They incorporate the technical assumptions that interest and exchange rates stay at present levels and the expectation that Ireland, by maintaining its international competitiveness, remains positioned to take advantage of the anticipated pick-up in global economic activity.

External Outlook

The international economy is assumed to develop as forecast by the European Commission in its latest forecasts. While there is considerable uncertainty about the timing and extent of a recovery in global economic activity, the consensus view - which the Commission shares - is that activity will pick up in the second half of 2002, assisted by renewed growth in the US stemming in particular from the impetus of monetary easing and fiscal stimulus. The Commission's forecasts for GDP growth in key economies are set out in Table 4, below.

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

	2001	2002	2003
Germany	0.7	0.7	2.8
France	2.0	1.5	2.6
Italy	1.8	1.3	2.7
Euro area	1.6	1.3	2.9
UK	2.3	1.7	3.0
EU15	1.7	1.4	2.9
US	0.9	0.5	3.4
Japan	-0.6	-0.9	0.5

Source: European Commission 2001 Autumn forecasts

Compared with an estimated 11¼% expansion in 2000, the Commission forecasts that demand in Ireland's export markets will grow by 1.9% next year - the same rate as in 2001 - before recovering strongly in 2003. However, their assessment reflects a substantial slowing in capital goods imports by our main trading partners. Since our exports are less oriented to capital goods their assessment may overstate the downturn as it affects Ireland - but correspondingly overstate the prospective upturn going forward. Taking this into account, a moderate recovery in Irish export performance, essentially during the second half of next year, is implied in their forecasts, with the prospect that exports of goods and services could increase by 4¾% in 2002. While this pales in comparison with the rates of increase seen in recent years, as global recovery strengthens export prospects can be expected to brighten through 2003. There are, however, significant downside risks, discussed at the end of this section.

Domestic Demand

The immediate outlook for investment is less favourable than in recent years. Housing output is expected to slow further, with a negative carry-over from this year's slowdown not being fully offset by the housing-related budget measures. While infrastructural building activity will benefit from another increase in public investment as implementation of the National Development Plan continues, the remainder of construction demand is forecast to weaken in line with slower economic activity generally. Accordingly, total building and construction investment is forecast to fall in 2002 by more than 1%. Machinery and equipment investment is forecast to decline sharply, given prevailing international conditions. Total investment, therefore, is projected to decline by about 2½% next year. As with exports, the prospect is that a global strengthening will lead to more rapid investment growth in 2003 and beyond.

In line with the foregoing expectations, employment growth is projected to moderate further, and seems unlikely to absorb the increase in labour force numbers which is in prospect next year. Accordingly, unemployment is forecast to rise, albeit modestly. Slower overall demand growth should facilitate a closer alignment of earnings outcomes with the terms of the PPF. Those terms, allied to the measures in this year's Budget and to a further easing of inflation, point to continued improvement in real disposable incomes through next year. Allowing also for some up-tick in precautionary savings, personal consumption is projected to increase by 5¾% in 2002. On the basis that incomes growth will ease in line with competitive requirements, and notwithstanding a somewhat stronger employment performance and improving consumer confidence in response to the beneficial impact on Ireland of the forecast strengthening of the international economy, personal consumption growth may ease further through 2003 and thereafter.

Final Demand and Imports

Final demand is forecast to increase by about 4% in 2002. Import growth of 4¼% is forecast, in line with these developments. With net EU transfers declining appreciably, the current account of the balance of payments seems likely to record a deficit of the order of 2½% of GNP next year. As final demand picks up beyond 2002 import growth is likely to accelerate and, with net EU transfers easing further, a current account deficit of this magnitude may persist over the full forecast period.

GNP and Risks

Adding these elements together, GNP growth of 3½% is forecast for 2002. However, given the anticipated strengthening of international economic activity during the second half of next year, the prospect is that the Irish economy will gain momentum into 2003.

There are, however, significant downside risks to these forecasts. In particular, the anticipated acceleration in global economic activity may not come as quickly, or prove as strong, as forecast. The stronger pace of cost growth here than in many competitor-countries, which poses a particular competitiveness challenge when, as now, our exporters face greater competition for the fewer export opportunities available, constitutes a further risk. In addition, apart from its implications for exports, any loss in competitiveness - broadly defined - would make Ireland less attractive to increasingly mobile foreign direct investment. Furthermore a significant appreciation of the euro against sterling and/or the dollar, which would impede exports to non-euro markets, cannot be ruled out.

Table 5 - Growth and associated factors

	2000	2001	2002	2003	2004
GDP growth at constant market prices	11.5	6.8	3.9	5.8	5.3
GDP level at current market prices (€)	103,475	115,150	124,200	134,650	145,075
GDP deflator	4.3	4.2	3.8	2.5	2.3
HICP change	5.3	4.0	4.0	n.a.	n.a.
CPI Change	5.6	4.9	4.2	2.8	2.3
Employment growth	4.7	2.8	1.4	1.6	1.5
Labour productivity growth [2]	5.4	2.4	2.3	3.3	3.1
% Volume Change					
Private consumption expenditure	9.9	6.1	5.7	5.0	4.8
Government consumption expenditure	5.4	7.0	5.1	2.1	2.8
Gross fixed capital formation	7.0	5.4	-2.6	2.0	3.3
Change in stocks as a % of GDP	0.6	-0.2	0.1	0.3	0.2
Exports of goods and services	17.8	8.2	4.7	7.9	7.1
Imports of goods and services	16.6	7.2	4.3	6.5	6.4
Contribution to GDP Growth					
Final domestic demand	7.3	5.1	2.8	3.2	3.4
Change in stocks	0.6	-0.2	0.1	0.3	0.2
External balance of goods and services	3.4	1.9	1.0	2.2	1.7

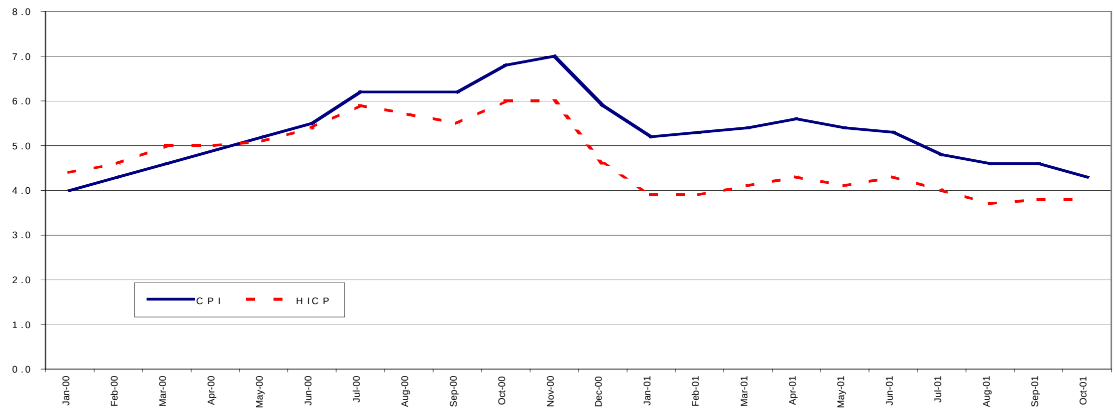
Source : Department of Finance

2.4 Inflation

Developments in 2001

Inflation, as measured by annual changes in the Consumer Price Index (CPI), has followed a broadly downward trend this year to 4.3% in October (3.8% on the European HICP measure), after reaching a recent peak of 7% in November 2000 (HICP: 6%). The peak reflected a number of temporary factors that pushed up inflation last year. The rate of decline was somewhat slower than originally expected, however, because of an unanticipated sharp rise in food prices combined with higher oil prices and some limited euro weakness earlier this year, and continuing services sector inflation. The latter development is a consequence, inter alia, of the significant rate of earnings increases discussed above.

Figure 1: Inflation 2000 – 2001 (October), %



Source: CSO.

Reflecting these developments, the forecast for CPI inflation in 2001 was revised upwards to 5.0% in the mid-year Economic Review and Outlook publication. This forecast, as always, was based on the technical assumption of unchanged interest and exchange rates. Since then, euro area wholesale interest rates have fallen by 1¼ percentage points and oil prices have softened, helping to reduce the

[2] Growth of GNP at constant prices per person employed

annual rate of inflation. But services sector inflation has continued rising, to 6.4% year-on-year in October. The CPI average for the year as a whole is now likely to come in at 4.9%, a decline of 0.7 percentage points from that recorded in 2000. On the European HICP measure, inflation may average 4.0%. While this represents a significant reduction from last year, Ireland's HICP-measured inflation remains well above the norm in the euro area.

Prospects for 2002

The outlook is for a further moderation in CPI inflation next year, for several reasons. Weaker global demand in the first half of next year is likely to lead to a decline in external inflation. The forecast easing of employment growth and the more moderate pace of demand growth should prompt some easing in services sector inflation. Provided that exchange rates remain unchanged there should be no further pressures from that source, and present expectations are that oil prices, on average, will be lower going forward than they have been this year. Finally, this year's sharp increase in some food-stuff prices seems unlikely to be repeated in 2002. Taking into account the 0.9% impact of the budgetary measures CPI inflation is forecast to average 4.2% next year but, given the ongoing strength of services sector price increases, average inflation measured on the HICP basis is forecast to remain close to 4%.

Independent Forecasts

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

Table 6 – Comparison of Macroeconomic Forecasts for Ireland in 2002

Annual % change	GDP	GNP	CPI	Employment
Department of Finance (Budget 2002)	3.9	3.5	4.2	1.4
European Commission (Autumn 2001)	3.3	n.a.	3.3*	0.8
Central Bank of Ireland (Autumn 2001)^	5.0	4.5	3.5	2.0
ESRI (October 2001)	3.4	2.6	3.1	1.4
OECD (November 2001)	3.7	2.9	n.a.	n.a.

*HICP

^Compiled prior to the terrorist attacks in the US

Chapter 3 - General Government Balance and Debt

3.1 Summary

The Government's economic and budgetary strategy is geared towards ensuring that, when the international economy recovers, Ireland will be well-positioned to benefit fully from that recovery. In sum, it aims to sustain confidence in the public finances, to support Irish competitiveness and to prioritise key infrastructural investment.

Reflecting the downturn in the domestic and international economies, the outlook is for a General Government budgetary surplus of 0.7% GDP in 2002 followed by deficits of 0.5% of GDP in 2003 and 0.6% of GDP in 2004, respecting the terms of the Stability and Growth Pact. The debt/GDP ratio is expected to decline from an anticipated end-2001 level of 35.8% to 34.1% of GDP by end-2004 - which is significantly above the target set in last year's Stability Programme Update and reflects slower growth than anticipated and associated weaker budgetary outturns.

3.2 Policy Strategy

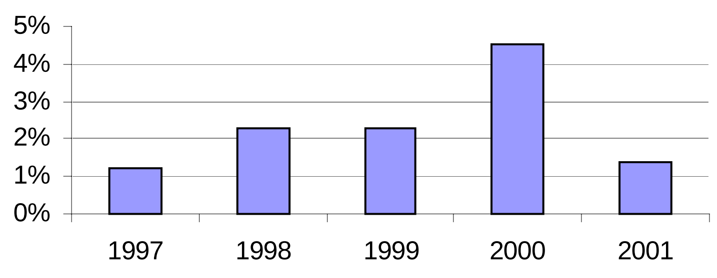
The core objective of macroeconomic and budgetary policy, against the background of a currently weak international economy and uncertainty about both the timing and pace of its recovery, is to ensure that Ireland is positioned to benefit fully from a pick-up in global economic activity when that emerges. The key priorities in this context are:

- firstly, sustaining confidence in the public finances;
- secondly, dealing with a weakening of Irish competitiveness on the cost front and more broadly, inter alia by adhering to the current agreement with the social partners, the PPF;
- thirdly, prioritising public spending towards programmes which improve the long-term capacity of the economy to benefit from improved conditions as they emerge; and
- fourthly, making further progress in economic structural reform.

3.3 Actual Balances and implications of forthcoming budget

The exceptional 11.5% increase in GDP in 2000 supported a record General Government surplus of 4.5% of GDP last year. Essentially reflecting the global economic slowdown and unanticipated adverse domestic developments, the surplus in 2001 is estimated at 1.4% of GDP which broadly compares with the average surplus over the period 1997-1999.

Figure 2 : General Government Balance



A General Government Surplus of 0.7% is projected for 2002 while deficits of 0.5% and 0.6% are anticipated for 2003 and 2004.

There will be a general election in 2002 and the priorities of the post-election Government are not yet known. Accordingly, while the projections for 2003 and 2004 incorporate provisions for budgetary measures, these provisions must be seen as technical only.

The debt/GDP ratio is expected to fall to 34.1% by 2004 from a likely 35.8% at end-2001. Not less than 1% of GNP will continue to be set aside annually for the pre-funding of pension liabilities. This prefunding does not affect the General Government Balance.

In response to the urgent infrastructural needs of the economy, capital expenditure will average 5% of GDP over the Programme period, in line with the National Development Plan.

Budget 2002 tax changes will increase the reward from work of all taxpayers and remove over 79,000 taxpayers from the tax net altogether. These measures will also support further increases in labour force participation.

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

Table 7 - General government budgetary developments[3]

% of GDP	2000	2001	2002	2003	2004
General government	4.5	1.4	0.7	-0.5	-0.6
Central government	4.1	0.8	0.8	-0.9	-1.2
State government	n.a.	n.a.	n.a.	n.a.	n.a.
Local government	0.1	0.1	0.1	0.0	0.0
Social security funds	0.4	0.5	-0.2	0.4	0.6
Total receipts	35.7	34.8	35.1	33.7	33.6
Total expenditures	31.1	33.4	34.4	34.2	34.3
Budget balance	4.5	1.4	0.7	-0.5	-0.6
Net interest payments	2.1	1.6	1.7	1.8	1.7
Primary balance	6.6	3.0	2.3	1.3	1.1
Taxes	26.5	25.1	25.2	25.3	25.2
Social contributions	4.2	4.3	4.3	4.3	4.4
Interest income	1.1	1.3	1.8	1.4	1.4
Other	3.9	4.0	3.8	2.7	2.7
Total receipts	35.7	34.8	35.1	33.7	33.6
Collective consumption	4.7	4.5	4.8	4.7	4.7
Social transfers in kind	1.3	1.2	1.3	1.3	1.3
Social transfers other than in kind	8.2	7.8	8.2	8.1	8.2
Interest payments	2.1	1.6	1.7	1.8	1.7
Subsidies	0.8	1.2	0.8	0.8	0.8
Gross fixed capital formation	3.7	4.4	4.6	4.6	4.6
Other	10.4	12.5	13.1	12.9	13
Total expenditures	31.1	33.4	34.4	34.2	34.3

Source: Department of Finance

3.4 Structural balance and fiscal stance

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

However, estimates of the 'structural budget balance' and other such measures of the appropriateness of budgetary stance require to be treated with caution. The European Commission itself has indicated that "calculations of the output gap are subject to a particularly large margin of error in Ireland" [4]. The uncertainty relating to estimates of how far Ireland's economy is above or below its trend growth position (i.e. the estimated output gap) necessarily attaches to the related estimates of the Cyclically-Adjusted Budget Balance, and thus to inferences to be drawn from such analysis about the budgetary stance. Against this background, actual general government balances (and debt ratios) may convey the more critical information about the appropriateness of policy.

Notwithstanding the foregoing reservation, estimates of the cyclically-adjusted balance have been prepared and are presented below. The estimates are based on the projections described in this Stability Programme Update, and use a methodology similar to that of the European Commission.

[3] Preliminary National Accounts Assessment
[4] Public Finances in EMU, July 2001, Page 122

Calculated on this basis, as indicated in the table, the cyclically-adjusted balance points to a contractionary fiscal stance in 2002. However, on the basis of the technical assumptions underpinning the budgetary position going forward (which include contingency provisions of 0.8% and 1.1% of GDP for 2003 and 2004, respectively), the methodology points to a loosening over the period of this Stability Programme update as a whole - with the cyclically-adjusted balance estimated to fall from -0.2% of GDP this year to -0.9% in 2004.

Table 8 - Cyclical developments

% of GDP	2000	2001	2002	2003	2004
GDP growth at constant prices	11.5	6.8	3.9	5.8	5.3
Actual balance	4.5	1.4	0.7	-0.5	-0.6
Trend GDP growth	7.7	7.4	7.1	6.8	6.5
Output gap	6.8	6.1	3.0	2.0	0.9
Cyclically-adjusted balance	2.8	-0.2	-0.1	-1.0	-0.9
Change in Cyclically adjusted GGB	-0.5	-3.0	+0.1	-0.9	+0.1

Source : Department of Finance

3.5 Debt levels and developments

The General Government Debt/GDP outturn at end-2001, while declining from the end-2000 level, will be somewhat above the target set in last year's Stability Programme Update. This reflects the slowdown in the Irish and world economies evident since earlier in the year. Over the Programme period as a whole, the debt level is expected to remain low, but to fall only marginally from 35.8% at end-2001 to 34.1% by end-2004.

Table 9 - General government debt developments

% of GDP	2000	2001	2002	2003	2004
Gross debt level	38.6	35.8	33.7	33.8	34.1
Change in gross debt	-10.7	-2.8	-2.1	0.0	0.4
--Primary balance	-6.6	-3.0	-2.3	-1.3	-1.1
--Interest payments	2.1	1.6	1.7	1.8	1.7
--Nominal GDP growth	-6.9	-3.9	-2.6	-2.6	-2.4
--Other factors influencing the debt ratio	0.7	2.5	1.1	2.1	2.2
Of which: Privatisation receipts		-0.5			
p.m. implicit interest rate on debt	5.4	4.6	5.0	5.3	5.0

Source : Department of Finance

3.6 Balance by sub-sectors of general government

The balance by sub sectors of general government is set out in detail in Table 7. In Ireland Central Government accounts for around 90% of total Government expenditure, Ireland does not have a federal or state government system while Local Government and the Social Insurance Fund account for the balance. Ireland's Social Insurance Fund will have a large surplus at end-2001, and this is expected to grow further over the Programme period.

Chapter 4 – Sensitivity Analysis and Comparison with Previous Updates

4.1 Summary

This Chapter briefly outlines the impact on the underlying budget balance of different possible economic scenarios. It is estimated that a 1% change in the growth rate would change the General Government Balance by about a ½% of GDP. In addition it is estimated that a 1% increase in interest rates could reduce growth by about ½% in the short-run. As a result, a 1% change in interest rates could change the General Government Balance by around ¼%.

4.2 Alternative scenarios and risks

The economic forecasts included in this updated Stability Programme represent the Department of Finance's assessment of Ireland's future growth prospects. The forecasts are based on the technical assumption of unchanged interest and exchange rates, and international developments based on the European Commission's latest forecasts. As with any forecasts, they are subject to some margin of uncertainty. In particular, it is difficult to determine at this stage how deep and protracted the current global economic slowdown will be.

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 desirable in the interests of economic or budgetary sustainability or if required in terms of the Stability and Growth Pact.

4.3 Sensitivity of budgetary projections to different scenarios and assumptions

In line with estimates for previous years, it is calculated that a 1% impact on growth rate would change the General Government Balance by about 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 10 - Impact on the Budget Balance of 1% Change in Rate of Growth Per Annum

	2002	2003	2004
Baseline GDP Growth	3.9	5.8	5.3
GGBalance (% GDP) (including contingency)	0.7	-0.5	-0.6
Cumulative impact of 1% change in growth per annum on GGBalance	up to 0.5%	up to 1.0%	up to 1.5%
GGBalance Range (%GDP)	1.2 to 0.2	0.5 to –1.5	0.9 to –2.1

Source: Department of Finance

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, revenue receipts and expenditure.

The impact on economic activity is highly uncertain. Higher interest rates would reduce the 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.

Estimates by the Economic and Social Research Institute suggest that a 1% increase in interest rates could reduce growth by as much as ½% in the short-run. As a result, a 1% change in interest rates could change the General Government Balance by around ¼% of GDP. It would also directly affect debt servicing costs but, as the debt burden declines, these effects are becoming more and more marginal relative to the impact on growth and Government revenues.

4.4 Comparison with previous update

Table 11 compares this Stability Programme Update with the updated programme for 2000. Growth in 2000 was very strong at 11.5% of GDP, higher than anticipated in last year's Stability Programme

Update, reflecting the strength of both domestic and external demand. In this update, the forecast GDP increase for 2001 has been revised downward by 2% compared with last year's Update, largely reflecting the slowdown in the US and euro area economies. The GDP growth rates for 2002 and 2003 have also been revised, consistent with the global economic slowdown persisting into 2002 and a gradual recovery during the second half of that year.

The General Government Balance in 2000 emerged 0.2% below the level anticipated in last year's Update. The forecast outturn for 2001 has been revised downward, primarily because tax revenues have risen much more slowly than envisaged as economic activity eased in response to the international slowdown. With the 'output gap' (however accurate its measurement) clearly much lower going forward than would have been the case had GDP growth been as strong as forecast in last year's Update, forecast General Government budgetary positions for 2002 and 2003 have also been revised downward. The General Government debt ratio, already far below the 'Maastricht' threshold, is set to remain low over the period to 2004, when it may be around 34.1% of GDP.

Table 11 - Divergence from previous update

% of GDP	2000	2001	2002	2003	2004
GDP growth					
previous update	10.7	8.8	6.3	5.7	---
latest update	11.5	6.8	3.9	5.8	5.3
Difference	0.8	-2.0	-2.4	0.1	---
Actual budget balance					
previous update	4.7	4.3	3.8	4.6	---
latest update	4.5	1.4	0.7	-0.5	-0.6
Difference	-0.2	-2.9	-3.1	-5.1	---
Gross debt levels					
previous update	39	33	28	24	---
latest update	39	35.8	33.7	33.8	34.1
Difference	0	2.8	5.7	9.8	---

Source: Department of Finance

Chapter 5 - Quality of Public Finances

5.1 Summary

In Budget 2002 the Government has continued its wide-ranging reform of the income tax system. The changes will remove 57,000 taxpayers from the top rate of tax and will completely remove over 79,000 from the tax net. Since 1997, the Government has removed over 380,000 people from the tax net.

In terms of GNP, General Government Expenditure is projected at 40% in 2001, 41% in 2002, 41% in 2003 and 42% in 2004. In response to the urgent need to remedy infrastructural deficits, thereby easing cost competitiveness pressures, capital expenditure will average 5% of GDP over the Programme period in line with the National Development Plan.

5.2 Policy Strategy

Following the Lisbon and Stockholm European Councils, greater emphasis is now being put on the "quality" of public finances, with respect to both Government revenue and expenditure.

Improving the quality of public finances involves seeking to ensure that tax and benefit systems provide appropriate incentives to save, work and invest. It also encompasses measures to shift the composition of public spending towards investment in human and physical capital, steps to enhance the efficiency of public services, measures to ensure the long run sustainability of public finances as a result of demographic ageing, and actions to improve the working of product markets [5].

As noted in the 2001 Broad Economic Policy Guidelines (BEPGs), Ireland's "public finances are sound and the recent decision to make an annual contribution of 1% of GNP to the National Pensions Reserve Fund until at least 2055 further enhances their long-term sustainability".

The Government's primary objective in this area over the last four years has been to reform the tax and benefit systems so as to incentivise participation in the labour force and to work towards removing those on low incomes from the tax net.

There have been very important supply-enhancing components to budgetary strategy in recent years which have sought to tackle infrastructural bottlenecks, by means of the €60 billion National Development Plan over the period 2000-2006, and to increase labour supply by direct tax relief, reform of the tax and benefit system and a range of active labour market measures and initiatives to improve the educational and skills levels of the work force.

5.3 General Government Revenue

In Budget 2002 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[6]. The Budget's 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 more than deliver on the commitment of the Government under the PPF to reduce personal taxation in order to support a competitive pay evolution which sustains competitiveness and, thereby, economic and social progress.

In 2002, a reduction in the numbers in the various tax brackets will increase the reward from work to all taxpayers. The changes will remove 57,000 taxpayers from the top rate of tax and will completely remove over 79,000 from the tax net. Since 1997, the Government has removed over 380,000 people in total from the tax net.

5.4 General Government Expenditure

[5] European Commission: Public Finances in EMU, July 2001, Page 69

[6] The Government's tax reform strategy was discussed in detail in last year's Stability Programme Update, Box 2.2 – Reforming the Irish Tax System, Page E.21

Against a background of strong economic growth in recent years, the Government has been able to make considerable progress in addressing key infrastructural needs and improving critical public services. These priorities are reflected in its approach to multi-annual planning as set out in the NDP and PPF.

Table 12 shows the evolution of government expenditure as a percentage of GNP over the period 1995-2004.

Table 12: Evolution of Irish Government Expenditure as a percentage of GNP

% of GNP	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
General Government Expenditure	45	44	42	39	40	37	40	41	41	42

Source: Department of Finance

In the shorter term, and in the current worsening economic conditions, the Government is committed to effectively managing competing demands for increased public expenditure, while continuing to deliver on its key priorities. In 2002, service improvements, based on the published Estimates and Budget changes, have been targeted at priority areas:

- An additional €875 million (16%) in net current spending for health services. The challenge for the health service, through the new Health Strategy, will be to create a new focus on resource efficiency and service delivery;

- An additional €429 million (10%) in net current spending for education and science. The Government regards education as a key investment priority in order to ensure Ireland's continued economic and social progress into the medium and longer terms; and

- An additional €130 million for Overseas Development Assistance (ODA). The additional resources will bring Ireland's overall ODA contribution to €462 million in 2002, equivalent to 0.45% of GNP, and reflects Ireland's commitment to increase ODA towards the UN target of 0.7% by 2007.

This allocation of resources to priority areas has been achieved by making reductions in the allocations to other areas.

The expected trend in General Government Expenditure as a percentage of GDP is given in Table 7. In terms of GNP, General Government Expenditure is projected at 40% in 2001, 41% in 2002, 41% in 2003 and 42% in 2004.

The Minister for Finance has indicated that, in the future, Ireland should move to a unified tax and expenditure Budget system in which all tax and spending decisions are announced on Budget day.

5.5 Infrastructural Investment

The Irish economy has embarked upon a unique phase of substantial public investment programmes, under the National Development Plan. Indeed, the 2001 Broad Economic Policy Guidelines called on Ireland to "Continue to accord high priority to the National Development Plan especially to infrastructure, human capital investment and R&D".

In response to the urgent need to remedy infrastructural deficits, thereby easing cost competitiveness pressures, capital expenditure will average 5% of GDP over the Programme period in line with the NDP[7]. 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.

[7] The National Development Plan was discussed in detail in the Stability Programme Update published in December 1999, section 3.14.

Net capital expenditure has increased by over 160% between 1997 and 2001. In 2002, on the basis of the published Estimates and Budget changes, consistent with the commitment to infrastructure provision and, notwithstanding the tight budgetary situation prevailing, the Government has sought to target additional resources to key priority areas:

- Health: a 30% increase;
- Education: an 8% increase;
- Roads and Transport: a 9% increase; and
- Housing: a 26% increase.

The investment measures contained in the Estimates, Budget 2002 and in the NDP represent a prudent use of available resources to support sustained economic progress into the future. Their financing, despite an expected continuing reduction in EU funding, will respect the Stability and Growth Pact. With a view to maintaining investment efficiency, new approaches to public investment are underway, including a series of Public Private Partnerships.

Chapter 6 - Sustainability of Public Finances

6.1 Long term budgetary prospects, including the implications of ageing

The EU Economic Policy Committee (EPC) report "Budgetary Challenges Posed by Ageing Populations: The Impact on Public Spending of Pensions, Health and Long-Term Care for the Elderly and Possible Indicators of the Long-Term Sustainability of Public Finances"[8] contains projections for public spending on pensions and health/long-term care out to 2050 in all Member States, including Ireland. The projections are based on a commonly agreed set of assumptions, and a common methodological approach. The aim was to estimate the purely demographic effects on spending in the areas mentioned, abstracting from any policy changes.

The Report projects that demographic changes will lead to an increase in public spending on pensions in Ireland from 4.6% of GNP in 2000 to 9.0% in 2050. The corresponding projected increase in public spending on health care is from 6.6% of GNP in 2000 to 9.1% in 2050.

The long-term budgetary implications of ageing had been addressed in Ireland prior to the EPC Report and so one policy response pre-dates that Report. In 1999, the Government established the National Pensions Reserve Fund with a view to partially pre-funding the Exchequer's future pensions liabilities. Each year 1% of GNP is being placed in the Fund, which has also been assigned the major part of the proceeds of the Telecom Éireann flotation. Reserves accumulated cannot be drawn down until after 2025. The assets in the Fund currently amount to about 8% of GNP.

[8] The Report was finalised in October 2001. It is available on the European Commission's website.

Chapter 7 - Horizontal Issues Affecting Public Finances

7.1 Summary

This Chapter sets out a number of reform measures in relation to the public finances that have taken place over the last year. These include a new savings incentive scheme designed to promote savings among the general public and a tax recovery scheme designed to collect the taxes due on underlying income which had been concealed in bogus non-resident accounts. The current position with regard to the sale of the last remaining state bank, the awarding of UMTS licenses and the Aer Lingus survival plan are also discussed.

7.2 Budgetary implications of structural reforms

The Irish Government continues to regard structural reform as vital to ensuring efficient resource allocation, innovation and economic dynamism, all of which are key factors determining national competitiveness and standards of living.

The Government's continued commitment to the structural reform agenda in 2001 can perhaps best be seen in Ireland's request to participate in an OECD Regulatory Reform Peer Review Programme, which analysed progress with regard to economic reform across a range of sectors. The results of the Review were published in April 2001. In the report, the OECD notes that the structural reform process in Ireland has "gathered speed over the 1990's and is moving forward on a broad front".

A detailed review of progress made in reforming product and capital markets during the year 2001, including details of the Government's response to the OECD Report on Regulatory Reform, is set out in the 2001 Progress Report on Reforming Product and Capital Markets published by the Department of Finance in mid November and submitted to the EU Economic Policy Committee as part of the Cardiff Process. Ireland's latest labour market strategy is set out in detail in the 2001 National Employment Action Plan published by the Department of Enterprise, Trade and Employment.

Last year's Stability Programme Update set out a range of medium term reform measures being undertaken in Ireland across product, capital and labour markets. This year, this Chapter sets out a number of reform measures in relation to the public finances that have taken place over the last year.

Special Savings Incentive Scheme

The principal objective of the new special savings incentive scheme is to encourage substantial regular savings by all. The proposal is a real incentive for people to 'lock away' some of their disposable income for a five-year period.

The basic structure of the scheme is that individuals save an amount between €12.70 (£10) and €253.95 (£200) every month for a first year, and between €0 and €253.95 (£200) for the remaining four years, commencing in any month between May 2001 and April 2002 inclusive.

Up to the end of September 2001 a total of €163.42 million (£128.7 million) had been subscribed, of which €50.41 million (£39.7 million) was lodged in September. The latter figure implies a minimum of around 195,000 subscribers, but probably significantly more (full details will be not be available before March, 2002). The cost of the scheme to the Exchequer to September is €40.63 million (£32 million). The cost of the scheme in a full year is likely to be at least €126.97 million (£100 million).

The main features of the scheme are as follows:

- For every amount saved in the scheme, the Exchequer will contribute to the individual saver's account an additional 25% of that amount by way of a tax credit (25% top up is equivalent to a tax credit of 20% on gross, i.e. standard rate of tax).
- Income or gains from the savings invested will be taxed at 23% and this will be deducted by the participating financial institutions at the end of the five years.
- The scheme commenced on 1 May 2001 and accounts must be opened before 30 April 2002 to benefit. The Exchequer contribution will apply for a five-year period only.

- Every individual who is resident in the State, and is 18 years of age or over, can save in one of these accounts.

- The maximum amount that an individual can lodge to an account in any one month in the first year will be €253.95 (£200), and the minimum amount which must be saved by an individual in any one month will be €12.70 (£10). After the first year an individual may save any amount in a month up to €253.95 (£200) over the remaining 4 year period.

- Special saving incentive accounts will be managed, on behalf of an individual saver, by a range of bodies such as banks, building societies, credit unions, life assurance companies and fund managers and the Government will not be operating or guaranteeing the accounts or the return under them.

- It will be possible for an individual to transfer a special savings incentive account from one investment manager to another during the five years.

- An account can comprise investments in deposits, quoted shares, Government securities, collective funds or life assurance products, as determined by the accounts manager.

- To obtain the maximum benefit from the savings scheme, the savings must be left for the full term of five years. Where that is the case, tax at 23% will apply only to the difference between the total value of the assets at that point in the account less the amounts invested together with the Exchequer contribution.

- However, if there is an earlier withdrawal from an account (other than on death), the full amount withdrawn (both the savings and investment return) will incur tax at 23%.

Tax Recovery Scheme
The Revenue Commissioners announced a Statement of Practice on 2 May 2001 on "Underlying Tax" on Funds Deposited in Bogus Non-Resident Accounts. The Statement of Practice was aimed at collecting in full, in an efficient and pragmatic manner, the taxes due on underlying income concealed in bogus non-resident accounts, which were the subject of one of the recommendations in the Final report by the Dáil Committee of Public Accounts into Deposit Interest Retention Tax (D.I.R.T).

Under the terms of that Statement, the Revenue Commissioners indicated that they were setting a deadline of 15 November 2001 for bogus non-resident account holders to make a voluntary disclosure and to pay the tax along with interest and penalties. For those cases that met the November deadline the Statement indicated that the following arrangements would apply:

- Exposure to interest and penalties would be capped at 100% of the tax, in other words account-holders would have to pay the tax and up to the same amount again in interest and penalties. Under the normal regime operated by Revenue much higher interest and penalties could arise.

- Revenue would not take steps to initiate the prosecution of related tax evasion offences through the courts.

- The names of the individuals concerned would not be published.

These arrangements will not be available in certain circumstances outlined in the Statement i.e. cases already the subject of investigations. The Revenue Commissioners also announced that those cases that did not make the required disclosure and payment by 15 November would be identified using the Finance Act 1999 powers of access to information and records of financial institutions, that full interest and penalties would be charged in those cases and the names published and that suitable cases would be considered for prosecution.

The Revenue Commissioners announced on 19 November 2001 that provisional figures indicate the total of €223.5m (£176m) was paid by 3,500 account holders in respect of an estimated 6,500 accounts.

UMTS Licenses

The Director of Telecommunications Regulation in Ireland has decided that four UMTS (3G) mobile phone licences are to be offered for allocation by the 'beauty contest' method. Discussions are continuing between the Office of the Director of Telecommunications Regulation and the Minister for Finance in relation to the fee to be charged. The objective is to complete the process of allocating the licenses by the end of the year. Given that the level of fee has yet to be determined, it is not possible to provide an estimate of the proceeds at this stage.

Sale of State Banks
The following is the current position with regard to banks in State ownership as 2001 began:

- the sale of ICC Bank plc to Bank of Scotland was completed in February 2001;
- the sale of TSB Bank to Irish Life and Permanent plc was completed in April 2001; and
- the Board of the remaining State-owned Bank, ACC Bank plc, commenced a sale process in early 2001 which is expected to conclude by the end of the year.

Aer Lingus
Following the catastrophic impact of the events of September 11 on aviation, the position of Aer Lingus, the State-owned airline, has altered substantially. The company has completed a Survival Plan that sets out to build a robust, flexible business model to ensure long-term viability. The new model will be capable of competing successfully in a fundamentally changed market place, taking account of a 25% reduction in its scale of operation. Its focus will be to retain the premier business service together with a simplified economy and leisure product. The Government decided in principle that provided the Survival Plan is rapidly agreed and implemented in all its essential aspects, the Government will facilitate private sector interests and the staff of the airline making an investment in Aer Lingus in order to provide a source of funding to support the Survival Plan. This should not impact on the General Government Balance.