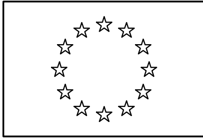

EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

Brussels, 28 January 2003
ECFIN/023/03-EN

2002 UPDATE OF THE STABILITY PROGRAMME OF IRELAND (2003-2005)

AN ASSESSMENT

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SUMMARY AND CONCLUSIONS

The new update of the Irish stability programme was presented in December, as customary together with the budget for the coming year. It broadly complies with the data requirements of the revised "code of conduct" on the content and format of stability and convergence programmes[1]. However, compliance would be strengthened by explaining the nature and significance of the large "contingency provisions" included in the public finance projections for the final two years of the programme. This makes it difficult to identify the true targets of the programme, thereby complicating the assessment of the adjustment planned in the medium term.

The economic policies as reflected in the planned measures in the programme update broadly comply with the Broad Economic Policy Guidelines for 2002. Specifically, the measures to improve the management and control of public expenditure, as outlined in the update, are in line with the Broad Economic Policy Guidelines but the recommendation to develop a norm-based framework to guide spending in the medium term has not been implemented.

Following the very large deterioration in the budget balance recorded in 2001, when the surplus ratio fell by about three percentage points of GDP to 1.6%, the estimated outcome for 2002, according to the latest budgetary data provided by the Irish Department of Finance, is a deficit of 0.1% of GDP. Although better than in recent estimates, including that submitted with the update itself, this result falls short, by about half a percent of GDP, of the objective in last year's programme, for which a large tax undershoot is mainly to blame[2]. This is in spite of an upward revision to the rate of GDP growth, which is now estimated at 4½% (from 3.9% in the previous update), and to the rate of inflation (measured by the GDP deflator), which has continued to exceed 5% (compared to 3.8% in the previous update). Following the exceptionally high growth recorded by the Irish economy in the second half of the 1990s, and notwithstanding the relative slowdown since 2001, the output gap, derived from an application of the agreed production function methodology to the data in the programme, is estimated to be still positive and significant. The corresponding cyclically-adjusted balance (which, after taking account of an approximately neutral impact of one-off measures, broadly coincides with the underlying balance) is estimated to have become significantly negative (about 1% of GDP), compared with the "close-to-balance" requirement of the Stability and Growth Pact. The fiscal stance implemented in 2002 is thus judged to have been significantly expansionary, in contrast with a specific budgetary recommendation for that year in the Broad Economic Policy Guidelines. The estimate of the output gap, however, presents unusual margins of uncertainty in the case of Ireland, due to the special features of the economy, particularly the very large contribution to overall productivity growth from a relatively restricted number of sectors, covering a small proportion of the workforce. General government debt is estimated to have been 34.1%

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[1] *Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes*, document EFC/ECFIN/404/01 - REV 1 of 27.06.2001 endorsed by the ECOFIN Council of 10.07.2001.

[2] For this assessment, the target in the previous update (+0.7% of GDP) has been adjusted to (i) include UMTS receipts of 0.2% of GDP and (ii) exclude a transfer from the Central Bank of 0.5% of GDP which had to be reclassified below the line.

of GDP in 2002, a more rapid reduction on the 2001 debt ratio than anticipated in the previous update (2.6 versus 2.1 percentage points of GDP).

The macroeconomic scenario in the programme envisages a return, by 2005, to growth around that generally accepted to be sustainable in the medium term, of around 5%. The potential growth rate derived with the agreed methodology initially exceeds, but, by the end of the programme, converges to this rate. In 2003 and 2004, the economy is expected to continue to grow at a lower rate, close to 4%. Inflation (measured by the GDP deflator) is assumed to decline gradually through the programme period to 2½% in the final year of the programme, but there is little improvement in 2003 on account of an indirect tax hike in the budget. The projected pace of the recovery is slower than in the Commission's pre-budget Autumn 2002 forecast.

The new programme further deepens and extends the downward shift in the projected path for the general government balance outlined in the previous programme. The headline balance is projected to continue to deteriorate in 2003 and 2004, with the deficit rising to 0.7% and 1.2% of GDP respectively and with the primary surplus falling to 0.9% and 0.3% of GDP; the deficit stabilises at 1.2% of GDP in the last year of the programme. The deterioration stems from the fact that the further significant decline in the revenue ratio well outweighs a modest drop in the expenditure ratio, which itself reverses recent trends thanks to restrained primary expenditure growth. While a persistently negative interest rate–growth rate differential ensures that the gross debt ratio, currently the second lowest in the EU, initially continues to decline, although at a reduced pace, a very small rise is projected in the last two years of the programme period. However, excluding the build-up of assets of the National Pension Reserve Fund, the debt ratio would be falling throughout the programme period.

The projected path of rising budget deficits in the programme needs to be qualified.

First, subject to the above-mentioned caveats about the measurement of the output gap, the relatively subdued pace of the projected recovery would imply that actual output growth falls short of potential growth. As a result, in spite of the ongoing deterioration in the nominal balances, the underlying deficit is estimated to have peaked in 2002 and to move closer to balance towards the end of the programme period. Specifically, a tightening of fiscal policy of about ½ percentage point of GDP is foreseen in 2003, when the budget implements a cut in capital expenditure, a marked reduction in the growth rate of current expenditure and an overall stabilisation of the tax burden. In any case, the targets in the programme respect the safety margin against breaching the 3% of GDP threshold for the deficit ratio.

Second, as in all previous stability programmes, the budgetary targets for the final two years incorporate "contingency provisions" against unforeseen developments; in the most recent update they amount to 0.4% of GDP in 2004 and 0.8% in 2005. While past experience suggests that such provisions might be used, the budgetary position would improve significantly if they were not.

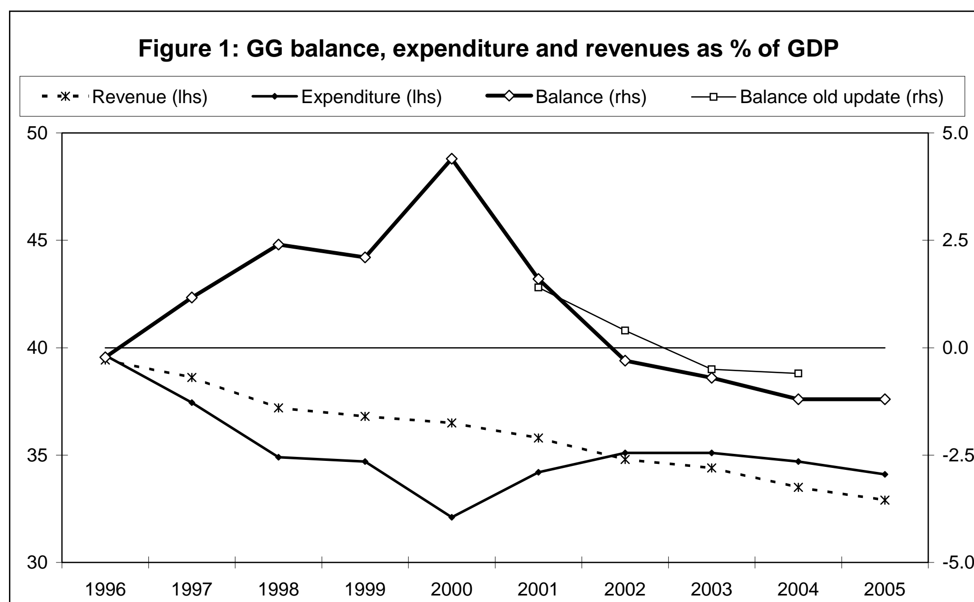
The low level of the primary surpluses projected in the programme reflects the impact of multi-annual measures, particularly the investment programme expected to peak with the National Development Plan 2000-2006. The programme targets imply an underlying deficit of around ½% of GDP in each year (including contingency provisions). Bearing also in mind the particularly low level of the debt ratio and the overall manageable profile of future age-related expenditure, the Commission considers that, in line with its Communication of 27 November 2002 on *strengthening the co-ordination of budgetary*

policies, running such a limited deficit in underlying terms may be considered fundamentally consistent with the Stability and Growth Pact.

The update reviews the government's structural reform programme. In view of the substantial progress made in recent years, direct tax relief in 2003 is implemented on a relatively modest scale and is supplemented by some tax-base broadening measures. Regarding expenditure, current and capital allocations have been increased significantly in recent years to improve public services and to address infrastructural needs through the further implementation of the National Development Plan. The update also outlines a range of measures to improve the management and control of public expenditure.

With its low debt level and gradual build-up of assets in the National Pensions Reserve Fund, Ireland is in a relatively strong position to cope with the budgetary impact of ageing populations. Moreover, the budgetary impact of ageing populations will take place later than in other EU countries and as such there is a longer window of opportunity to put effective policies in place. Nonetheless, there is a risk of budget imbalances in the long run on the basis of current policies. A financing gap may emerge over time if age-related spending as a share of GDP approaches the average level for the EU and if the tax ratio is left unchanged. To ensure that public finances are on a sustainable footing, it is thus important to develop sustainable financing arrangements for social welfare expenditure and to avoid the perpetuation of underlying deficits. The deficit position envisaged in the update for the year 2005 does not seem to be ambitious enough a budget target in light of the projected budgetary impact of ageing populations.

1. INTRODUCTION



The new update of the Irish stability programme, covering the period 2003-2005, was released on 4 December 2002, together with the budget for 2003[3]. A revised outturn for the general government balance in 2002, based on the full-year Exchequer accounts, was published on 9 January 2003.

The new update confirms that the Irish government is committed to maintaining sound public finances and to respecting the Stability and Growth Pact, which is credited as providing the overall framework for budgetary policy. The accompanying graph shows that the budget balance fell by almost 5 percentage points of GDP between 2000 and 2002, when it became negative for the first time since 1996. The budgetary strategy adopted in the update seeks to stem this rapid deterioration by (i) turning the recent sharp rise in the expenditure ratio into a moderate downward path, while (ii)

[3] All budget documents, including the stability programme, can be downloaded from www.budget.gov.ie

allowing the downward trend in the revenue ratio to continue. In the process, the medium-term path of the public finances is allowed to shift downward compared to the previous update, while the debt ratio rises marginally.

As in previous programmes, the medium-term budgetary strategy is not well-defined. In line with past practice, the budgetary projections for the final two years cannot qualify as "hard targets", because they include technical provisions of a conditional size for future budgets as well as large contingency provisions against unforeseen developments[4].

The new update broadly complies with the data requirements laid down in the *Code of conduct*[5]. However, compliance would be strengthened by explaining the nature and significance of the contingency provisions. The deadline for submission (1 December) was missed by three days because the presentation of the budget, to which the stability programme serves as an economic background, took place on the first Wednesday of December, in line with the practice of the preceding 5 years[6].

2. IMPLEMENTATION OF THE PREVIOUS UPDATE

The previous update of the stability programme targeted a general government surplus for 2002 of 0.4% of GDP (adjusted)[7]. The new update estimates the provisional outturn to be a *deficit* of 0.3% of GDP, but in early January 2003, in the light of the better-than-expected actual outturn for the Exchequer cash accounts, the Department of Finance revised this to a deficit of just 0.1% of GDP[8]. Though well below target, this outcome is far better than predicted a few months earlier.

Table 1 provides a breakdown into revenue and expenditure categories (as a percentage of GDP). As shown in the last column, the deviation from the targeted balance ratio by 0.5 percentage points of GDP is due primarily to a lower than budgeted tax ratio, although there were some offsets from non-tax revenue. Higher than anticipated non-investment primary spending as a percentage of GDP was more than compensated by savings on interest payments and public investment, so that the total expenditure ratio came in below target.

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[4] The careful observer may note that, in spite of this, the targeted balance for 2003 in the new update - a deficit of 0.7% of GDP - is rather close to that envisaged in the previous update, which was a deficit of 0.5% of GDP (including technical and contingency provisions). This does not hold for the projected 2004 balance (see graph).

[5] With the exception of overall expenditure and revenue ratios in the long-term sustainability table, the tables provide not only the required but also the optional information indicated in the *Code*, as well as some useful supplementary information, for instance on stock-flow adjustments. UMTS receipts in the figures for 2002 are not treated in line with ESA95 rules. There are some minor deviations from the model tables supplied in the *Code*. In the table on budgetary developments to 2005, "other expenditure" is split into "social transfers in kind related to expenditure on products supplied to households via market producers" (ESA code D.6311+D.63121+D.63131) and "other expenditure". In the table on cyclical developments, there is no row for the cyclically-adjusted *primary* balance. The table on economic developments defines labour productivity in GNP rather than GDP terms, while the data in the long-term sustainability table also relate to GNP rather than GDP.

[6] There is no indication that in future this date will be brought forward, even though a 2001 report by the *Budget Day Working Group* favoured "moving to an earlier Budget date than at present for the years subsequent to 2002".

[7] See footnote 2.

[8] See *Monthly Economic Bulletin* of the Department of Finance, released on 9 January 2003.

Table 1. Implementation of 2002 budget: selected aggregates (% of GDP)[1]

	plan[2]	provisional outturn[3]	difference
General government balance	**0.4**	**-0.1** (-0.3)	**-0.5** (-0.7)
Revenues	**34.6**	**33.9** (33.9)	**-0.7** (-0.7)
- taxes and social security contributions	29.7	28.9 (29.0)	-0.8 (-0.7)
- other	4.9	5.0 (5.0)	+0.1 (+0.1)
Expenditure	**34.2**	**34.0** (34.2)	**-0.2** (+0.0)
- interest payments	1.7	1.4 (1.5)	-0.3 (-0.2)
- primary expenditure	32.5	32.6 (32.7)	+0.1 (+0.2)
** of which: gross fixed capital formation*	*4.6*	*4.4 (4.4)*	*-0.2 (-0.2)*
** of which: other*	*28.0*	*28.2 (28.3)*	*+0.3 (+0.4)*
General government debt	**33.7**	**34.1**	**+0.4**
Real GDP growth	**3.9**	**4.5**	**+0.6**
GDP deflator (% change)	3.8	5.0	+1.2
Real GNP growth	**3.5**	**1.8**	**-1.7**
GNP deflator (% change)	4.3	5.4	+1.1

Source: Budgets for 2002 and 2003; Monthly Economic Bulletin, January 2003; additional information supplied by the Department of Finance
Notes:
[1]To allow comparison, all aggregates taken from the "national accounts classification" of the 2002 and 2003 budgets, which is in line with ESA95 (apart from the treatment of UMTS receipts, for which adjustment has been made), but social security contributions, transfers and overall revenues and expenditure do not correspond to Commission Regulation (EC) No 1500/2000 of 10.7.2000
[2]Taken from the budget for 2002; plans adjusted as in footnote 2
[3]Budget aggregates taken from new outturn published on 9 January 2003 with additional information supplied by the Department of Finance; budget aggregates in parentheses and remaining numbers taken from the budget for 2003

The 0.8% of GDP tax undershoot derived from the Exchequer accounts follows a more dramatic shortfall in 2001 amounting to 1.7% of GDP. As noted in the current and previous updates of the stability programme, cyclical developments have undoubtedly played a role. Table 2 displays the implied elasticities from the budgets for 2001 and 2002 as compared to those that can be derived from (estimated) outturns[9]. According to the update, the Irish budget may be more responsive to GNP rather than GDP developments[10], so elasticities with respect to both aggregates are presented when available. This exercise admittedly ignores the impact on the total tax take of the composition of nominal growth (into expenditure categories; into volumes *versus* prices). Nevertheless, the large differences between planned and actual elasticities suggest that growth factors alone cannot explain the tax shortfalls and that difficulties have arisen in accurately costing tax packages and forecasting revenues[11].

Table 2. Implied tax elasticities 2001-2002: actual versus planned

	2001		2002	
Tax elasticity	**GNP**	**GDP**	**GNP**	**GDP**

[9] The Department of Finance has calculated that, over the period 1989-1997, the elasticity of tax revenues with respect to nominal GDP ranged from 0.7 to 1.5, with an average of 1 (see *Report of the Tax Forecasting Methodology Group*, November 1998).

[10] In 2002, the gap between both is expected to have become unusually large given a surge in profit outflows.

[11] The update notes that the tax-intensity of economic growth has declined as growth has slowed. A recent report confirms that the cost of the personal income tax package for 2001 was underestimated by 0.2% of GDP. See summary of Revenue and Department of Finance responses to the C&AG in the *2001 Annual Report of the Comptroller and Auditor General*, September 2002, Section 4.10.

Planned (from budget)	n.a.	0.84	1.08	1.09
Actual (from (estimated) outturn)	0.31	0.28	0.67	0.50
Source: Budgets for 2002 and 2003; National accounts for 2001				

The budgetary projections in the previous update showed that the stance of fiscal policy was planned to be broadly neutral. Looking at the updated cyclically-adjusted balances in Table 6 below, and notwithstanding the qualifications surrounding the estimates of the output gap, the fiscal stance in 2002 must be judged as expansionary rather than broadly neutral as recommended in the BEPGs for 2002. The cyclically-adjusted balance turned sharply negative in 2002, to around 1% of GDP according to the production function method.

General government debt is estimated to have been 34.1% of GDP in 2002, or 0.4 percentage points of GDP higher than envisaged in the previous update. However, if one takes into account the upward revision of the 2001 base by almost one percentage point, the pace of debt ratio reduction accomplished in 2002 is actually faster than anticipated in the previous update (2.6 pp of GDP compared to a planned 2.1 pp), thanks to higher than expected nominal growth.

3. MACROECONOMIC ASSESSMENT

3.1. External economic assumptions

The macro-economic projections in the new update are based on the technical assumption of unchanged interest and exchange rates from end-November 2002 and on the Commission's autumn 2002 forecast for the other external assumptions. Accordingly, there are no differences in the external outlook, apart from interest rates, between the Commission's forecast and that of the Irish authorities, in the years for which the forecasts can be compared[12].

3.2. Macroeconomic developments

Table 3 compares the Commission's (pre-budget) autumn 2002 forecast with the macro-economic projections of the stability programme.

Regarding 2002, estimated real GDP growth in the update is well above that in the Commission's autumn 2002 forecasts and this looks more plausible particularly in view of new data. In terms of GNP growth, which arguably is a better measure of the strength of the economy on account of a surge in profit outflows during 2002, both forecasts predict a similar expansion, of just below 2% in 2002. For 2003 and beyond, a broadly similar macro-economic scenario, of a gradual pick-up towards the sustainable GDP growth rate in the medium term (generally accepted to be around 5%), underlies both forecasts. However, a significant difference is that the recovery to such a growth rate is predicted to take a year longer in the new update. Also, the update expects the recovery to rely more on the external side. For 2003, the official forecast is weaker than the Commission's, which is plausible in view of the contractionary effect of the budget for 2003 (see below). Even so, given that the same external assumptions underlie both sets

[12] The final year of the Commission forecast is 2004 and that in the stability programme is 2005. The external assumptions for 2005 in the update are obtained by extrapolating the assumptions for 2004.

of forecasts, the stability programme can be said to take a cautious view of the pace of the upturn. The update emphasises several downward risks, emanating from (i) the uncertain timing of the international recovery and (ii) adverse competitiveness developments flowing from a sudden sharp appreciation of the euro or from a lack of responsiveness of wage expectations.

Table 3. Macro-economic developments and forecasts, 2002-2005

	2002		2003		2004		2005	
	COM	**SP**	**COM**	**SP**	**COM**	**SP**	**COM**	**SP**
Real GDP (% change)	3.3	4.5	4.2	3.5	5.2	4.1	-	5.0
Real GNP (% change)	1.9	1.8	3.7	2.2	4.8	2.9	-	3.8
Contributions to GDP growth:								
- Final domestic demand	3.0	2.5	3.6	1.3	4.1	2.1	-	2.6
- Change in stocks	0.0	0.2	-0.1	0.2	-0.1	0.2	-	0.2
- External balance on g&s	0.4	1.8	0.7	1.9	1.1	1.7	-	2.2
Employment (% change)	1.3	1.0	1.4	0.6	1.9	1.3	-	1.6
HICP inflation (%)	4.8	4.7	3.8	4.2	3.1	3.0	-	2.1
GDP deflator (% change)	5.5	4.9	3.7	3.5	3.6	3.3	-	2.6
	COM	**SP**[3]	**COM**	**SP**[3]	**COM**	**SP**[3]	**COM**	**SP**[3]
Potential growth[1]	7.0	6.8	6.5	6.0	6.3	5.8	5.8	5.5
Output gap[1,2]	0.8	2.0	-1.4	-0.4	-2.4	-2.0	-	-2.5

Source: COM: Commission services autumn 2002 forecast (pre-budget); SP: December 2002 update of the stability programme and DG ECFIN calculations
Notes:
[1]based on the production function method for calculating potential output growth
[2]in percent of potential GDP
[3]ECFIN calculations on the basis of the figures in the December 2002 update of the stability programme

Applying the commonly agreed production function method[13] to the update's macro-economic outlook produces estimates of potential growth that are lower than in the Commission's autumn 2002 forecast, especially in 2003-2004, when the difference is 0.5 percentage points. Both labour and capital make a smaller contribution to potential output growth in the update - the former due to a higher implied NAIRU, the latter to a weaker outlook for investment. The calculated output gap, hugely positive in 2001 (over 4 pp - see Table 6), turns negative in 2003 and deteriorates sharply towards the end of the programme period.

Driven by sustained inflationary pressure from the domestic side, headline inflation remained the highest in the euro area all through 2002. From this perspective, the timing of the indirect tax increases in the budget for 2003 is unfortunate. The authorities expect the impact on the CPI to be similar to that of the indirect tax hike in the previous budget (*viz.* +0.85 pp for 2003 after +0.9 pp in 2002). Adding this estimate to the Commission's pre-budget forecast yields somewhat higher HICP inflation in 2003 than the new update, and a far smaller improvement on 2002. For 2004, both forecasts are close, with inflation falling to around 3%, and by 2005, the update envisages Irish inflation of around 2%.

[13] As endorsed by the ECOFIN Council on 12.7.2002.

4. BUDGETARY TARGETS AND MEDIUM-TERM PATH OF THE PUBLIC FINANCES

4.1. Programme overview

The budgetary undershoots of 2001 and 2002 have led to a downward shift of the medium-term path for the public finances. The deficit is projected to average 1% of GDP over the period 2003-2005. As in the previous update, the projections close the programme period with a deficit, even though, by then, the economy is forecast to have recovered to the medium-term sustainable growth rate. The new update reaches a low of 1.2% of GDP in 2004-2005, a doubling of the deficit ratio projected for 2004 in the previous programme.

As usual, however, the projected balances for the final two years of the programme cannot be regarded as "hard targets" for two reasons. Firstly, they incorporate increasingly large *contingency provisions*. In contrast with the previous update, however, they are more of the "usual" size, *viz.* 0.4% of GDP in 2004 and 0.8% in 2005 (see Table 4)[14]. In the budgetary projections presented in the update, the contingency provisions have been assigned 50:50 to receipts and expenditure, on a pro-rata basis across all headings. Secondly, the projections for the final two years include *technical provisions* for unspecified future budget measures, the size of which is subject to review "in light of emerging economic conditions". The new update provides for hypothetical budgets at a full-year cost of 0.7% of GDP in both years[15].

Table 4. Size of contingency provisions in successive stability programmes

Stability programme covering year *t* to year *t+2*	**Contingency provision in year *t+1*** (as % of GDP)	**Contingency provision in year *t+2*** (as % of GDP)
Original programme, 1999-2001	0.4	0.8
Dec 1999 update, 2000-2002	0.9	1.7
Dec 2000 update, 2001-2003	0.4	0.8
Dec 2001 update, 2002-2004	0.8	1.1
Dec 2002 update, 2003-2005	0.4	0.8

Source: Stability programme and its four updates to date

Bearing in mind these qualifications, Table 5 presents the evolution of selected budgetary aggregates as a percentage of GDP until 2005, thereby offering an overview of the composition of the planned adjustment. The last column calculates the change in the ratios between 2002 and 2005. The recent decline in the budget ratio is projected to continue, albeit at a reduced pace; the primary balance falls by almost 1 pp of GDP. This results from allowing the trend decline in the revenue ratio to proceed, while taking action on the spending side to turn the recent steep increase in the expenditure ratio into a modest gradual decline.

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[14] The contingencies in the 2000-2002 programme were relatively large to take account of the implications for public sector pay of the current national agreement, the *Programme for Prosperity and Fairness* (PPF), which was being negotiated at the time of the presentation of the budget/stability programme update. Regarding the huge provisions in the 2002-2004 update, the authorities referred to the greater degree of uncertainty surrounding the economic outlook.

[15] These technical provisions cover only taxation and *current* spending measures. In the update's budgetary projections, they have been allocated to various tax and expenditure components.

Table 5. Composition of the adjustment in public finances (% of GDP)

	2001	2002[1]	2003	2004	2005	2005-2002
Revenue	**35.8**	**34.8**	**34.4**	**33.5**	**32.9**	**-1.9**
of which:						
- Taxes and social security contributions	31.4	30.4	30.5	29.9	29.6	-0.8
- Other (residual)	4.3	4.4	4.0	3.6	3.4	-1.0
Expenditure	**34.2**	**35.1**	**35.1**	**34.7**	**34.1**	**-1.0**
of which:						
- Primary expenditure	32.6	33.6	33.5	33.2	32.6	-1.0
of which:						
Gross fixed capital formation	4.3	4.4	4.1	4.1	4.0	-0.4
Consumption and transfers	23.3	24.5	24.9	24.8	24.5	0.0
Other (residual)	5.0	4.6	4.5	4.3	4.0	-0.6
- Interest payments	1.6	1.5	1.6	1.5	1.5	0.0
Budget balance	**1.6**	**-0.3** (-0.1)	**-0.7**	**-1.2**	**-1.2**	**-0.9** (-1.1)
Primary balance	**3.1**	**1.2**	**0.9**	**0.3**	**0.4**	**-0.8**

Source: December 2002 update of the stability programme; Monthly Economic Bulletin, January 2003
Notes:
[1]Data adjusted to reflect correct treatment of UMTS receipts; revised outturn in parentheses

The steady decline in the revenue ratio since the mid-1990s is projected to continue. The drop of almost 2 pp of GDP over the programme period is spread more or less equally over the tax burden (defined as the sum of taxes and social security contributions as a percentage of GDP) and the non-tax revenue ratio. The fall in the tax burden occurs after 2003, while the reduction in other revenues as a percentage of GDP is more gradual over time. After jumping by about three percentage points between 2000 and 2002 (see Figure 1 above), the expenditure ratio is projected to decline by 1 percentage point of GDP by 2005, which occurs after 2003.

Table 6 presents the output gap and cyclically-adjusted balance (CAB), with potential output derived from applying the commonly agreed production function method to the macro-economic scenario in the update[16]. It has to be borne in mind that Irish cyclically-adjusted budget balances must be interpreted with more than the usual degree of caution, because of the difficulty in obtaining plausible estimates of Irish potential growth after the exceptional boom of the late nineties[17].

[16] The update itself calculates output gaps taking the estimated output gap for 2001 and the potential growth rates from the Commission's autumn 2002 forecast (itself calculated in accordance with the agreed production function method) as given, instead of applying this method to the macro-economic scenario of the programme, as in the table. This "approximation" produces an improvement in the CAB from -1.0% in 2002 to 0.1% in 2005. Table 6 does not show the figures from the Commission's autumn 2002 forecasts, because they were prepared in advance of the budget. For the 2002 situation, the revised outturn published in early January is used throughout. With the estimate of trend output based on the HP-filter (as a back-up method), the CAB shows a similar improvement over the period 2002-2005 to that in Table 6 (+0.5pp). However, the CAB-levels are rather different (-1.6% of trend output in 2002 improving to -1.1% by 2005), reflecting a slower reduction of the positive output gap.

[17] The production function methodology (as well as the HP-filter method) is unable adequately to capture the transition from double-digit growth in the late nineties to the current "medium-term sustainable growth rate" commonly estimated at around 5%. The uncertainty regarding the estimate of the output gap is related to the very large contribution to overall productivity growth from a relatively restricted number of sectors, covering a small proportion of the workforce. Another reason for caution is that the alternative numbers are centred around GDP, whereas GNP developments may be more relevant in an Irish context.

The cyclically-adjusted numbers show a marked deterioration from around balance in 2001 to a sizeable deficit in 2002, pointing to an expansionary stance in 2002, which is not in line with the BEPGs for 2002. Between 2002 and the end of the period, however, the CAB is expected to improve by around ½ pp of GDP, which is front-loaded in 2003. In 2003 and beyond, the structural deficit is thus around ½ pp of GDP. The CABs never exceed 1% of GDP, which respects the "safety margin" (estimated at 1.3% of GDP) against breaching the 3% of GDP threshold.

Table 6. Output gap and cyclically-adjusted balances[3]

	Budgetary targets[1]	Output gap[2]	Cyclically-adjusted balance (CAB)[1]	Change in CAB	Cyclically-adjusted primary balance (CAPB)[1]	Change in CAPB
2001	1.6	4.3	0.2	-	1.8	-
2002	-0.3	2.0	-1.0	-1.2	0.4	-1.4
2003	-0.7	-0.4	-0.6	0.4	1.0	0.6
2004	-1.2	-2.0	-0.6	0.0	0.9	-0.1
2005	-1.2	-2.5	-0.4	0.2	1.1	+0.2
2005-2002	-0.9			0.6		0.7

Source: December 2002 update of the stability programme and ECFIN calculations
Notes:
[1]as % of GDP
[2]as % of potential GDP
[3]2002: excluding UMTS receipts of 0.2% of GDP and using revised outturn from Monthly Economic Bulletin

In general, the CAB does not always correspond to the "underlying" balance because of one-offs measures (apart from UMTS receipts which are always filtered out in Commission calculations of CABs). Regarding the comparison between 2002 and 2003, a one-off from the ongoing investigation into bogus non-resident accounts in 2002 (almost 0.1% of GDP) is matched by a new temporary levy on financial institutions (also almost 0.1% of GDP), which is payable over the 2003-2005 period. The remaining one-offs relate to 2003 and offset one another[18]. The underlying balances in 2002-2005 are thus some 0.1% of GDP lower than the CABs presented in Table 6. It is important to note that this calculation of the underlying balance abstracts from some other non-permanent measures because they affect the balance during a five-to-seven year period[19].

In sum, the update projects a widening of the nominal deficit from an estimated 0.1% of GDP in 2002 to 0.7% in 2003 and 1.2% in 2004-2005. The budgetary targets for the final two years incorporate increasingly large contingency provisions; excluding them would significantly improve the budgetary position for 2004-2005. Subject to the caveats about the measurement of the output gap, the cyclically-adjusted deficit is estimated to have peaked in 2002 and to move closer to balance towards the end of the programme period, in spite of the ongoing deterioration in the nominal balances. Specifically, a tightening of fiscal policy of about ½ percentage point of GDP is foreseen in 2003 (see below). The

[18] On the one hand, there is a gain of 0.2% of GDP from advancing the date of payment of capital gains tax; on the other, the cost of paying the back-dated element of the "benchmarking" awards for the period December 2001-December 2002, also about 0.2% of GDP (see Section 4.2 below).

[19] In particular, the special savings incentive scheme (2001-2007) comes at an annual cost of around 0.4% of GDP, whereas the gradual advancement of the date of payment of corporation tax (2002-2006) improves the balance by around 0.7% of GDP annually. The net impact on the public finances over the programme period is thus positive. See also Section 5 below.

cyclically-adjusted deficit is around ½% of GDP in each year of the period 2003-2005, which is in line with the close-to-balance requirement of the Stability and Growth Pact. Furthermore, the targets in each year of the programme respect the safety margin against breaching the 3% of GDP threshold for the deficit ratio.

4.2. Public finances in 2003

For 2003, the government targets a budget deficit of 0.7% of GDP. In nominal terms, this is 0.6 percentage points worse than in 2002, but the CAB-estimates indicate that the fiscal stance has a contractionary bias (see Table 5 and Table 6 above).

On the revenue side, the budget for 2003 increases the tax take by 0.9% of GDP compared to a no-policy change scenario[20], two-thirds of which comes from increases in indirect taxes and stamp duties. A one-off boost to revenues results from bringing forward the date of payment of capital gains tax (0.2% of GDP), while the personal tax system is only partially indexed[21]. As shown in Table 5 above, the net impact of these measures is a near-stabilisation of the tax ratio between 2002 and 2003[22]. The fall of the overall revenue ratio is more pronounced, owing to a fall in non-tax revenue as a percentage of GDP (particularly declining transfers from the rest of the world).

On the expenditure side, a 1% cut in nominal capital spending (which translates into a very significant real cut in view of high construction inflation) makes room for increased current spending. Even so, the budget plans a marked reduction in the growth rate of current discretionary expenditure, to 8% for 2003 from 15% in 2002 and 22% in 2001[23]. The main measures regarding current spending are a relatively modest social welfare package[24] and a rise in the public sector pay and pensions bill by 11%, which includes a provision of 0.4% of GDP for the back-dated element of the benchmarking awards[25]. The expenditure ratio remains unchanged between 2002 and 2003, thereby halting the upward trend observed in the preceding two years.

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[20] This scenario already included the impact of the final phase of the reduction of the standard rate of corporation tax, to 12.5% by 1 January 2003.

[21] At a cost of just 0.1% of GDP, which, roughly speaking, represents about one-third of the cost of a full indexation. This compares to full-year costs of the personal income tax packages in the 2002 and 2001 budgets of 0.5% and 1.1% of GDP respectively.

[22] Given these revenue-enhancing measures, one would expect the tax burden to increase by more than 0.1 pp of GDP. However, the no-policy change projections for 2003, which are available for cash concepts, display a very low tax elasticity (0.5 to nominal GDP), which improves to 1.1 post-budget.

[23] The spending envelopes for 2003 are built around a reduction in the "existing level of service" basis by 0.6% of GDP. See also Section 6.

[24] At a full-year cost of 0.4% of GDP, this is more modest than in the 2001 and 2002 budgets (full-year costs of 0.7% and 0.9% of GDP respectively). The final instalment of a three-year programme, begun in the 2001 budget, to significantly increase child benefit payments is now to be completed by 2005 rather than 2003.

[25] The benchmarking process was set up in mid-2000 to adjust pay levels in the public sector by reference to comparable jobs in the private sector. The benchmarking body's report of mid-2002 recommended pay increases by grade leading to an 8.9% rise in public sector pay costs (carrying a full-year cost estimated at 0.8% of GDP). That a quarter of the resulting awards would be backdated to December 2001 (provision for which is now made in the 2003 budget), had been decided in December 2000. The benchmarking body recommended making the phased implementation of the remaining 75% conditional on agreement on modernisation and flexibility.

4.3. Targets and adjustment in 2004-2005

As shown in Table 5 above, the headline budget balance is projected to deteriorate further in 2004-2005, by 0.5 pp of GDP, to -1.2% of GDP. According to the cyclically-adjusted balances in Table 6, this corresponds to a broadly neutral fiscal policy. If the contingency provisions were not used, however, the stance would be restrictive.

From Table 5, the tax burden drops quickly after 2003 (-0.9 pp), which is due to (i) the delayed effect of tax reductions; (ii) the one-off nature of the boost to revenues in 2002 from advancing capital gains tax; and (iii) the impact of the contingency provisions. Partly offsetting this, however, is the effect from scaling back several forms of tax relief, which was announced in the budget for 2003 and will take some years to generate its full effect on revenues (see Section 7 below). The expenditure ratio declines by 1 pp after 2003. This is mainly due to the growth rate of current discretionary spending (excluding contingency provisions) being restrained further, to a planned 6% in 2004 and 5% in 2005 (from 8% in 2003), well below nominal growth. By contrast, after the cut in 2003, discretionary capital spending is allowed to keep pace with nominal GNP growth.

If the contingency provisions are excluded, the fall in the revenue ratio between 2003 and 2005 (by 1.1 pp of GDP) would be more than offset by a decline of the expenditure ratio (by 1.4 pp), resulting in an improvement rather than a deterioration of the nominal balance.

4.4. Risks to the budgetary targets

Apart from the possibility that the contingency provisions may not have to be exhausted, the budgetary targets in the stability programme are subject to a number of risks.

Firstly, in the absence of a new national agreement and of an agreed timetable for implementing the remaining 75% of the benchmarking awards, the evolution of the *public sector pay bill* is particularly uncertain. Following the breakdown of earlier talks on a new agreement, the government launched a proposal for a new agreement in mid-January 2003, which led to a re-opening of negotiations. For the public sector, the proposal provides for a six-month pay pause, followed by general pay rises of 3% from 1.1.2004; 2% from 1.7.2004 and 2% from 1.12.2004 as well as for the full implementation of the remaining benchmarking awards: 50% from 1.1.2004 and 25% from 1.6.2005. The acceptance of this proposal would imply a strong rise in the public sector bill in 2004 (which, however, would be partly offset by higher tax revenues). The required gross increase (tentatively estimated at 0.7% of GDP) would exceed the envelope allocated to public service pay initiatives in the 2004 budget projections (0.5% of GDP). The situation for 2005 is more difficult to assess because the draft proposal runs until end-2004 (for the general pay rises).

A second risk relates to the *special savings incentive scheme*, which is estimated to cost around 0.4% of GDP in each year. While the number of participants going forward can only fall, any further increase in the average monthly amount saved would put additional pressure on government revenues[26]; the maximum exposure is some 0.6% of GDP[27].

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[26] The 25% Exchequer contribution to the special savings incentive accounts is treated as a tax credit in national accounts, thereby lowering personal income tax receipts.

Finally, an immediate *cap on public sector employment* was announced in the new budget (to be followed by an actual cut of 1½% by 2005) but, as the Department of Finance has clarified, the numbers in the stability programme do not reflect this. From this angle, there is thus scope for a better outturn.

4.5. Sensitivity analysis

Like the previous update, the new programme reports that a one percentage point deviation from the expected GDP growth rate is estimated to modify the budget ratio by ½ percentage point and that half this impact is expected from a 1 pp change in the interest rate assumption. The cumulative impact of a sustained 0.5 pp deviation from the growth target over the 2003-2005 period would thus entail a budget ratio that is ¾ pp of GDP off the target of -1.2% of GDP in 2005.

The cyclically-adjusted balances are also likely to be altered by such a deviation from expected growth, because persistently higher/lower growth can be expected to affect potential output. Commission simulations of the resulting CABs under the assumptions of (i) a sustained 0.5 pp deviation from the growth targets in the update over the 2003-2005 period; (ii) trend output based on the HP-filter[28] and (iii) no policy response (notably, the level of primary expenditure is as in the central scenario[29]), reveal that, by 2005, the CAB is 0.4 pp of GDP above/below the central scenario. This represents a tentative estimate of the additional adjustment necessary to achieve the nominal targets in the programme (in the case of a growth shortfall) and of the lower required adjustment (in case of higher than expected growth).

4.6. Debt ratio

Thanks to high nominal growth and sizeable surpluses, the Irish debt ratio fell quickly in the mid-nineties and, at 39% of GDP, became the second lowest in the EU in 2000. A further reduction, to 34%, took place in 2001-2002. The new update foresees a small rise in the debt ratio, to just under 35% by 2005.

Table 7 shows that the primary balance and the interaction between the average interest rate and GDP growth both continue to contribute to lowering the debt ratio, albeit to a lesser extent than in the recent past. In the final two years of the programme period, this is more than offset by stock-flow adjustments. As detailed in the update, the sizeable stock-flow adjustments largely reflects the impact of the National Pensions Reserve Fund, which was set up to pre-fund future pensions liabilities and receives 1% of GNP annually from general government resources. Without the accumulation of non-government assets in this fund, the debt ratio would be falling throughout the period[30].

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[27] When the scheme closed to new entrants at the end of April 2002, there were 1.17 million accountholders, who can each save up to €254 per month. This yields a maximum Exchequer contribution of almost €900 million (0.25*12*€254*1.17 million) or around 0.6% of GDP.

[28] In the absence of a fully-specified macro-economic scenario that would underlie such deviations, it is obviously impossible to derive new estimates of potential growth from the production function method.

[29] The effect of lower/higher growth on revenues is captured by using the conventional sensitivity parameters adopted in cyclical adjustment procedures.

[30] On the remaining stock-flow (SF) adjustment, the update specifically mentions (i) the Social Insurance Fund, which benefits from an Exchequer subvention if required but has been in surplus since 1997; and (ii) the increase in local authorities' debt (accounting for 0.4 to 0.6pp annually), which is partly for social

Table 7. Decomposition of changes in the government debt ratio (% of GDP)

	2001	2002	2003	2004	2005
Government debt ratio	**36.7**	**34.1**	**34.0**	**34.5**	**34.9**
Total change in government debt ratio	-2.6	-2.6	-0.1	+0.5	+0.4
of which:					
Contribution of primary balance	-3.1	-1.2	-0.9	-0.3	-0.4
Contribution of interest and nominal GDP growth	-2.4	-1.8	-0.8	-0.9	-1.0
Contribution of stock-flow adjustment	+2.9	+0.4	+1.6	+1.7	+1.8
due to the National Pensions Reserve Fund	*1.1*	*1.0*	*1.0*	*1.0*	*1.0*
=> remaining stock-flow adjustment	+1.8	-0.6	+0.6	+0.7	+0.8

Note: calculations based on the budget constraint equation

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} + \frac{SF_t}{Y_t}$$

where t is a time subscript; *D, PD, Y* and *SF* are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth

Source: ECFIN calculations on figures provided in the stability programme update

5. THE SUSTAINABILITY OF PUBLIC FINANCES

The update contains a section on the sustainability of public finances and refers to the EPC projections for public expenditures on pensions, health care and long-term care which show an overall increase in age-related spending of some 7 percentage points of GNP between 2000 and 2050. It also summarises the results of the latest actuarial review of the Social Insurance Fund[31].

For such an assessment, it is first necessary to consider whether current budget policies can ensure continued compliance with the Stability and Growth Pact in the light of the budgetary implications of ageing populations (see Annex 2). While Ireland is in a relatively good position to meet the budgetary costs associated with an ageing population, the risk of emerging budgetary imbalances on the basis of current policies cannot be excluded. This risk would occur if age-related spending increases in line with projections (although from a low starting position and at a somewhat later stage than in other EU countries) and if the tax ratio is assumed to be unchanged over the projection period.

However, a quantitative assessment of the sustainability of public finances based on the budgetary targets at the end point of the programme needs to be interpreted with caution. This is because these targets are affected by several "temporary" schemes and measures, the most significant of which is increased public investment under the National Development Plan 2000-2006 (see Table 8). Consequently, the primary balance should be significantly higher once these schemes will have ended, thus contributing to a faster pace of debt reduction which can help offset the projected increases in age-related expenditure.

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housing purposes to be lent on to households in the form of local authority mortgages. The negative remaining SF adjustment in 2002 partly reflects the transfer from the Central Bank (0.5% of GDP).

[31] As none of these projections assigns a role to the National Pensions Reserve Fund (see below), carrying out a comprehensive review, allowing for the contribution of this fund to relieving the pensions burden from 2026, appears indispensable to enable a full assessment of long-term sustainability.

A second issue is whether the budgetary strategy outlined in the programme is compatible with improving the sustainability of public finances. One of the main elements in Ireland's strategy to prepare for an ageing population[32] is the continued annual contribution of 1% of GNP to the National Pensions Reserve Fund to partially pre-fund public pensions[33]. However, a deficit position, as envisaged by the update for the year 2005, does not seem to be ambitious enough a budget target in light of the projected budgetary impact of ageing. To ensure that public finances are on a sustainable footing, it is important to avoid the perpetuation of underlying deficits.

Table 8. Main temporary schemes and measures

Measure	Period affected	Impact on 2005 balance[1]
Lowering the balance:		
- increased public investment, *cf.* National Development Plan 2000-2006	2000-at least 2006	-1.7[2]
- special savings incentive scheme	2001-2007	-0.4
Improving the balance:		
- gradual advancement of payment of corporation tax	2002-2006	+0.7
- special levy on financial institutions	2003-2005	+0.1
SUM		**-1.3**
Possibly improving the balance further:		
- non-use of the contingency provision	2005	-0.8
- announced decline in public sector employment[3]	2003-2005	-0.1/-0.2

Notes:
[1]% of GDP
[2]Tentatively derived as the difference between the planned GFCF ratio in Ireland in 2005 (4.0%) and the average ratio in the EU over the period 1996-2001 (2.3%)
[3]Announced in the 2003 budget but not yet reflected in the stability programme targets

Finally, it is necessary to consider the type and scale of the budgetary challenges that will emerge in coming years to ensure sustainable public finances. As the starting level of age-related spending as a share of GDP in Ireland is much lower than in other EU countries and the impact of ageing populations will take hold somewhat later given the relatively high fertility rate, Ireland is in a relatively strong position to meet the budgetary challenges posed by ageing populations. However, a financing gap may emerge over time if age-related spending as a share of GDP approaches the average level for the EU and if the tax ratio remains constant. The low debt ratio, the much-reduced tax burden and the growing National Pensions Reserve Fund nonetheless suggest that the policy measures required to ensure sustainability should be of manageable proportions. The most recent actuarial review assessing the long-run viability of the social security system shows that current contribution rates have to be increased significantly (+ 56%) if pension rates are to grow in line with earnings and the Social Insurance Fund is to break even to 2056.

[32] Referring to the National Strategy Report on the Pension System of September 2002, the update mentions (i) realising further increases in participation rates and (ii) maintaining unemployment rates at the current low levels as further elements of the "ageing" strategy.

[33] At the end of 2002, the Fund's assets represented over 7% of GNP. The annual contribution of 1% of GNP has to be made until at least 2055, while drawdowns are to begin in 2026.

6. STRUCTURAL MEASURES AND OTHER REFORMS WITH LIKELY BUDGETARY IMPACT

The update reviews the progress in the government's structural reform programme, which focuses on lowering the tax burden, broadening the tax base, improving public services and addressing infrastructural needs through the further implementation of the National Development Plan. The update also outlines a range of measures to improve the management and control of public expenditure.

The update reviews the significant direct tax relief already accomplished in recent years. Tax reductions on a more limited scale in the budget for 2003 are targeted at the lower-paid, to enhance labour force participation, and at enterprise through the confirmation of the final reduction of the standard rate of corporation tax from January 2003. The update does not contain measures to further lower the tax burden (but includes "technical provisions" for future budgets which might). At the same time, the budget for 2003 announced several measures to broaden the tax base, which will have their full effect on revenues in a few years' time[34].

As a major supply-side measure, Ireland runs a programme of public investment, the National Development Plan 2000-2006 (NDP). Over the period 2000-2002, Ireland's public investment thus averaged 4.2% of GDP, compared to 2.3% in EU-15. Faced with much tighter finances than in the recent past, the government opted to proceed with the implementation of the NDP at a slightly lower level of 4.0% of GDP. Even though spending to end-2002 on the NDP is above target, implementation is now expected to take longer than originally envisaged.

Legislation to establish a new National Development Finance Agency (NDFA) was passed at the end of 2002. It will provide advice to government units about the evaluation of financial risks and costs and of financing methods of public investment projects (including public private partnerships). Furthermore, "in certain circumstances", the NDFA will be able to raise finance for public investment projects, for which it may also set up special purpose companies. NDFA financing will be backed by a government guarantee, but the special purpose companies it might establish will not. Whether the financing operations of the NDFA might impact on the general government balance, is at present unclear; the authorities acknowledge that Eurostat has the final say on this.

The update confirms several measures to improve the monitoring and planning of expenditure that were announced at the end of 2002 for implementation from 2003. These include (i) improvements in the assessment of expenditure overrun risks and the introduction of contingencies to cater for unforeseen pressures, with special attention for demand-led schemes; (ii) revised arrangements for managing capital spending; and (iii) the provision of incentives for departments that produce savings. Also, to facilitate monitoring by outsiders, intra-year spending (and tax) profiles will be published from 2003. Further, an Independent Estimates Review Committee was set up in the course of 2002 to help prepare the spending plans for 2003, resulting in a 0.6% of GDP cut in the "existing level of service" basis; a similar review will be carried out early in 2003 regarding the spending targets for 2004-2005. These measures are in line with the Broad Economic Policy Guidelines for 2002, which recommended improving expenditure

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[34] The write-off period for investments in plant & machinery, hotels and holiday cottages will be extended. Further, a range of tax incentive schemes in the property and film sectors, the termination date of which is being harmonised to 31 December 2004, will not be renewed. In a similar vein, from 2004, benefits in kind granted to employees will be subject to social security contributions.

control. However, they would be further strengthened by the formulation of a "norm-based framework to guide spending in the medium-term", also requested in the BEPGs. This could link to and clarify the multi-annual spending projections in the stability programme and the technical and contingency provisions they incorporate. Taken together, there is thus partial compliance with the BEPGs for 2002 on the planning and control of expenditure.

7. OVERALL ASSESSMENT OF COMPLIANCE WITH THE SGP

The programme projects a deterioration in the nominal deficit from 0.1% of GDP in 2003 to 1.2% in 2004-2005; however, the 2004-2005 targets include large contingency provisions (0.4% and 0.8% of GDP respectively) against unforeseen developments. In spite of this widening of the nominal deficit, the cyclically-adjusted balance improves over the programme period, which is front-loaded in 2003 with a fiscal tightening of ½% of GDP. In 2003 and beyond, the cyclically-adjusted deficit is thus around ½% of GDP, which is in line with the close-to-balance requirement of the Stability and Growth Pact. Furthermore, the targets in each year of the programme respect the safety margin against breaching the 3% of GDP threshold for the deficit ratio.

According to the Commission Communication on *strengthening the co-ordination of budgetary policies* of 27 November 2002, a small deviation from the 'close to balance or in surplus' requirement of a longer-term nature could be envisaged, to cater for the inter-temporal budgetary impact of large structural reforms, for Member States where debt levels are well below the 60% of GDP reference value, and when public finances are on a sustainable footing. In this respect, the low level of the primary surpluses projected in the Irish programme partly reflects the implementation of the investment programme of the National Development Plan 2000-2006. Bearing also in mind the particularly low level of the Irish debt ratio and the overall manageable profile of future age-related expenditure, running a limited deficit in underlying terms, such as those implied by the programme, can be regarded as fundamentally consistent with the Stability and Growth Pact.

ANNEX 1: Summary tables from the 2002 updated stability programme

Table A.0: Basic assumptions

	2002	2003	2004	2005
Short-term interest rate [35] (annual average)	3.4	3.3	3.3	3.3
Long-term interest rate [31] (annual average)	4.8	4.7	5.2	5.2
USA: short-term (3-month money market)				
USA: long term (10-year government bonds)				
US$/€exchange rate (annual average) [31]	0.94	1.00	1.00	1.00
World excluding EU, GDP growth	2.9	3.9	4.2	4.2
USA GDP growth	2.3	2.3	2.8	
Japan GDP growth	-0.6	1.2	1.4	
EU-15 GDP growth	1.0	2.0	2.6	2.6
Growth relevant foreign markets	1.4	5.6	6.3	6.3
World import volumes, excluding EU	3.1	6.6	7.3	7.3
World import prices (manufactured goods in USD)				
Oil prices (Brent USD/barrel)	24.8	24.3	24.3	24.3
Non-oil commodities prices (in USD)				

Table A.1: Growth and associated factors

	2001	2002	2003	2004	2005
GDP growth at constant market prices (7+8+9)	5.7	4.5	3.5	4.1	5.0
GDP *level* at current market prices (€bn.)		125,600	134,600	144,600	155,800
GDP deflator	5.2	4.9	3.5	3.3	2.6
HICP change		4.7	4.2	3.0	2.1
CPI change	4.9	4.7	4.8	3.5	2.6
Employment growth	2.9	1.0	0.6	1.3	1.6
Labour productivity growth [36]		0.9	1.7	1.7	2.4
Sources of growth: percentage changes at constant prices					
1. Private consumption expenditure	5.1	2.8	2.9	3.6	4.0
2. Government consumption expenditure	10.8	8.9	0.6	0.5	0.3
3. Gross fixed capital formation		-0.3	-0.7	1.5	3.1
4. Changes in inventories and net acquisition of valuables as a % of GDP					
5. Exports of goods and services	6.7	4.6	5.0	6.1	6.8
6. Imports of goods and services	6.1	3.3	3.6	5.2	5.6
Contribution to GDP growth					
7. Final domestic demand		2.5	1.3	2.1	2.6
8. Change in inventories and net acquisition of valuables		0.2	0.2	0.2	0.2
9. External balance of G&S		1.8	1.9	1.7	2.2

[35] Purely technical assumption

[36] Growth of GNP at market constant prices per person employed

Table A.2: General government budgetary developments

In % of GDP	2001	2002	2003	2004	2005
Net lending by sub-sectors					
General government	1.6	-0.3	-0.7	-1.2	-1.2
Central government	1.1	0	-0.7	-1.4	-1.4
State government					
Local government	-0.1	-0.1	-0.2	-0.2	-0.2
Social security funds	0.6	-0.2	0.2	0.3	0.5
General government					
Total receipts	35.8	35.0	34.4	33.5	32.9
Total expenditures	34.2	35.3	35.1	34.7	34.1
Budget balance	1.6	-0.3	-0.7	-1.2	-1.2
Net interest payments	0.2	0.2	0.3	0.4	0.4
Primary balance	3.1	1.2	0.9	0.3	0.4
Components of revenues					
Taxes	25.3	24.5	24.6	24.0	23.8
Social contributions	6.1	6.1	5.9	5.9	5.8
Interest income	1.4	1.3	1.3	1.1	1.1
Other	2.9	3.1	2.7	2.5	2.3
Total receipts	35.8	35.0	34.4	33.5	32.9
Components of expenditures					
Collective consumption	5.5	5.8	6.0	5.9	5.7
Social transfers in kind	9.2	9.6	9.8	9.7	9.5
Social transfers other than in kind	8.6	9.1	9.1	9.2	9.3
Interest payments	1.6	1.5	1.6	1.5	1.5
Subsidies	1.1	0.9	0.8	0.8	0.7
Gross fixed capital formation	4.3	4.4	4.1	4.1	4
Other	3.9	3.9	3.7	3.5	3.3
Total expenditures	34.2	35.3	35.1	34.7	34.1

Table A.3: General government debt developments

In % of GDP	2001	2002	2003	2004	2005
Gross debt level	36.7	34.1	34	34.5	34.9
Change in gross debt	-2.6	-2.6	-0.1	0.5	0.4
Contribution to change in gross debt					
Primary balance	-3.1	-1.2	-0.9	-0.3	-0.4
Interest payments	1.6	*1.5*	1.6	1.5	1.5
Impact of nominal GDP growth	-4.0	-3.2	-2.3	-2.4	-2.5
Other factors influencing the debt ratio	2.9	0.3	1.5	1.7	1.8
Of which: Privatisation receipts	-0.6	-0.1			
p.m. implicit interest rate on debt	4.4	4.4	4.8	4.6	4.5

Table A.4: Cyclical developments

In % of GDP	2001	2002	2003	2004	2005
GDP growth at constant prices	5.7	4.5	3.5	4.1	5.0
Actual balance	1.6	-0.3	-0.7	-1.2	-1.2
Interest payments	1.6	1.5	1.6	1.5	1.5
Potential GDP growth	7.5	7.0	6.5	6.3	5.8
Output gap	4.4	2.0	-0.9	-2.9	-3.7
Cyclical budgetary component					
Cyclically-adjusted balance	0.1	-1.0	-0.4	-0.2	0.1
Cyclically-adjusted primary balance					

Table A.5: Divergence from previous update

In % of GDP	2001	2002	2003	2004	2005
GDP growth **Previous update**	6.8	3.9	5.8	5.3	--
latest update	5.7	4.5	3.5	4.1	5.0
Difference	-1.1	0.6	-2.3	-1.2	--
Actual budget balance **Previous update**	1.4	0.7	-0.5	-0.6	--
latest update	1.6	-0.3	-0.7	-1.2	-1.2
Difference	0.2	-1.0	-0.2	-0.6	--
Gross debt levels **Previous update**	35.8	33.7	33.8	34.1	--
latest update	36.7	34.1	34.0	34.5	34.9
Difference	0.9	0.4	0.2	0.4	--

Table A.6: Long-term sustainability of public finances

In % of GNP	2000	2005	2010	2020	2030	2040	2050
Total expenditure							
Old age pensions [37]	4.6	4.5	5.0	6.7	7.6	8.3	9.0
Health care (including care for elderly)	6.6	7.1	7.2	7.7	8.2	8.7	9.1
Interest payments							
Assumptions							
Labour productivity growth		3.2	2.7	1.8	1.8	1.8	1.8
Real GNP growth		4.7	3.5	2.1	2.2	1.9	1.8
Participation rates males (aged 20-64)	87.9	87.5	87.1	86.3	85.7	84.9	85.6
Participation rates females (aged 20-64)	56.7	56.3	56.4	56.7	61.3	65.6	73.3
Total participation rates (aged 20-64)	72.3	72.0	71.7	71.6	73.6	75.4	79.5
Unemployment rate		5.0	5.0	5.0	5.0	5.0	5.0

[37] Old age and seniority

ANNEX 2: Sustainability of public finances: a quantitative assessment

This is the second assessment of the sustainability of Irish public finances as part of the Stability and Growth Pact. The quantitative indicators are similar to those used last year, but have been adjusted in line with the recommendations of the Ageing Working Group to the EPC[38].

The Irish stability programme contains a section assessing the sustainability of public finances and includes the EPC budgetary projections for public expenditures on pensions, health care and long term care. The projections for age-related spending in the Irish stability programmes are presented as a share of GNP. It is assumed that a constant gap of 17% is maintained between GNP and GDP over the projection period. This implies that age-related spending is projected to increase by 5.6% of GDP between 2005 to 2050.

The table below presents debt and budget balance developments according to two different scenarios, a "programme scenario" and a "2002 situation scenario". The "programme scenario" is calculated on the following basis:

- the projections for age-related expenditure come from the stability programme;
- government revenues are held constant at the ratio projected for 2005;
- the starting point for gross debt and the primary surplus are the 2005 levels reported in the programme.

The "2002 situation scenario" is based on the budgetary data for 2002 in the programme and assumes that no budgetary adjustment occurs during the time frame of the stability programme. In other words, the primary balance remains unchanged at its 2002 level until 2005. This allows one to gauge the impact on the sustainability of public finances of the proposed change in the underlying budget position during the programme.

According to the quantitative indicators, there is a risk of budgetary imbalances that are not in compliance with SGP requirements on the basis of current policies. Such a conclusion may appear surprising given the vast improvement in public finances in Ireland over the past decade and in particular the very fast reduction in the public debt ratio. The results can be explained by a variety of factors.

First, Ireland is projected to be in a deficit position at the end point of its programme, although this includes an annual contribution of 1% of GNP to a pension reserve fund. As such, the pace of debt reduction in coming years is likely to be limited: combined with the low initial debt level, there is limited scope for savings on the interest burden to offset the projected increase in spending on pensions and health care.

Secondly, age-related spending is projected to increase significantly in coming decades, by some 6 percentage points of GDP, similar to the increase projected for many other

[38] 'How the sustainability of public finances was assessed using the 2001 updates of stability and convergence programmes: recommendations for improvements in future years', Note from the AWG to the EPC, EPC/ECFIN/396-02 of 23 July 2002.

Member States. It should, however, be noted that the starting level of age-related spending as a share of GDP in Ireland is much lower than in other EU countries and that the impact of ageing populations will take hold somewhat later given the relatively high fertility rate. However, unless accompanied by increases in tax revenues, an increase in age-related spending of this magnitude will inevitably lead to growing budgetary imbalances. This is in line with the conclusions of the latest Actuarial Review of Social Welfare Pensions which concludes that contribution rates would have to increase by some 56% to ensure that the Social Insurance Fund breaks even over the full period up to 2056. Overall, Ireland with its relatively low tax ratio and debt levels, together with the substantial degree of pre-funding of pensions, is in a relatively strong position to meet the budgetary costs of ageing population. Moreover, the Irish authorities should benefit from the somewhat longer window of opportunity to address the apparent financing gap.

Quantitative indicators on the sustainability of public finances

Main assumptions - baseline scenario (as % GDP)	2005	2010	2020	2030	2040	2050	changes
Total age-related spending	9,9	10,5	12,4	13,5	14,5	15,5	5,6
Pensions	3,8	4,3	5,7	6,5	7,1	7,7	3,9
Health care	6,1	6,2	6,7	7,0	7,4	7,8	1,7
Other age related expenditures	0,0	0,0	0,0	0,0	0,0	0,0	0,0
*Total non age-related spending**	22,7						
*Total revenues**	32,9						

* constant

Results (as % GDP)	2005	2010	2020	2030	2040	2050	changes
Programme scenario							
Debt	34,9	33,3	49,3	84,8	140,1	219,9	185,0
Net borrowing	-1,2	-2,0	-4,7	-7,6	-11,6	-16,9	-15,7
2002 situation scenario							
Debt	28,2	22,5	28,5	52,0	92,1	152,8	124,6
Net borrowing	-0,1	-0,6	-2,7	-5,0	-8,2	-12,4	-12,3

Tax gaps	T1*	T2**	T3***
Programme scenario	3,4	2,9	5,1
2002 situation scenario	2,4	1,8	4,0

* it expresses the constant difference between projected revenues and the revenues required to reach in 2050 the same debt to GDP ratio as the close to balance position holds for the whole projection period. P.m. debt to GDP at the end of the period: 4.7%

** it expresses the constant difference between projected revenues and the revenues required to reach in 2050 a debt to GDP ratio equals to 40%.

*** It indicates the change in tax revenues as a share of GDP that guarantees the respect of the interteporal budget constraint of the government, i.e., that equates the actualized flow of revenues and expenses over an infinite horizon.

Source: EPC, and 2002 Updated stability programme of Ireland. Commission calculations