Ireland – Stability Programme Update

December 2006

Foreword

This document updates Ireland's Stability Programme. It includes macroeconomic projections up to 2009 and takes account of the measures adopted in Budget 2007.

This Update has been prepared in conjunction with Budget 2007 and is being presented to Dáil Éireann on Budget Day, 6 December 2006. As such, it also provides an update of the economic background to Budget 2007.

The document has been prepared in accordance with Council Regulation (EC) No. 1055/2005 amending regulation 1466/97, which sets out the rules covering the content of Stability Programmes, and conforms to the revised Opinion on the content and format of Stability and Convergence Programmes agreed by the Economic and Financial Committee of the EU in September 2005.

Contents

List of Tables, Charts and Boxes

Tables[1]

Charts

Boxes

[1] Indicators in bold in the tables are a requirement of the guidelines for the format and content of Stability and Convergence Programmes.

Chapter 1 - Overall Policy Framework and Objectives

The Government's economic and budgetary objective is to promote competitiveness and ensure that the economy continues to grow at a sustainable rate, thereby facilitating full employment, enhanced living standards and a more equitable society. The policy strategy to achieve these objectives includes the following main elements:

1. Improving equity and opportunity;
2. Fostering employment and economic growth;
3. Helping families and those on low incomes;
4. Enhancing public services and value for money;
5. Maintaining high levels of infrastructural investment to secure future economic growth;
6. Pursuing prudent fiscal policies to ensure the flexibility required to respond effectively to any budgetary pressures that may arise in the future.

The Government considers that a stable macroeconomic environment and, in particular, a commitment to sound public finances and improving the economy's competitiveness, provides the basis for achievement of its economic and social policy objectives. Of particular importance is the need to ensure that public expenditure grows broadly in line with available resources and, within this, to increase the level of investment needed to tackle the economy's infrastructure deficit. In a longer term context, the Government is determined that the public finances will remain well placed to meet anticipated fiscal pressures, including those arising from the ageing of the population.

1.1 Economic Outlook

There is a consensus among international economic forecasting institutions that, notwithstanding the current slowdown in the US economy, the short-term outlook for the global economy is generally positive. Nevertheless, there are some potential downside risks, including those related to exchange rate developments and volatile oil prices.

The prospects for the Irish economy over the period 2007 – 2009 are generally favourable, with an average growth rate (in both GDP and GNP terms) of 4.7% per annum projected over this period. Employment growth is forecast to average 2.4% per annum over the period, with unemployment remaining relatively low. Inflation should moderate and converge to the euro area average over the period.

1.2 Budgetary Stance

The projected budgetary position over the period 2007 – 2009 is for a General Government budget surplus of 1.2% of GDP in 2007 followed by surpluses of 0.9% in 2008 and 0.6% in 2009. The cyclically-adjusted budget balance, with a surplus of 1.8% of GDP in 2007 followed by surpluses of 1.7% in 2008 and 1.5% in 2009, respects the terms of the Stability and Growth Pact, and is consistent with a medium-term objective of keeping the budget close to balance. The debt-to-GDP ratio will be maintained at the second-lowest in the euro area, declining to around 22% over the forecast period. The market value of the assets of the National Pensions Reserve Fund is estimated to be in the region of 10% of GDP at the end of 2006.

Table 1 – General Government Balance and Prospective Debt Ratio

% of GDP	2006	2007	2008	2009
General Government Balance	2.3	1.2	0.9	0.6
Cyclically-Adjusted Balance	2.7	1.8	1.7	1.5
Debt Ratio (year end)	25.1	23.0	22.4	21.9

Source: Department of Finance

Chapter 2 – Economic Outlook

2.1 Summary

Available data point to another year of strong growth for the Irish economy in 2006.[2] GNP growth is estimated at 5.7%, with GDP growth being slightly lower at 5.4%. Against a generally favourable international economic background, the outlook for the Irish economy over the period 2007 – 2009 is broadly positive, although the rate of growth is likely to moderate somewhat.

Table 2 – Summary of Economic and Budgetary Indicators: 2001 – 2006

% volume change unless otherwise indicated	2001	2002	2003	2004	2005	2006
GNP	3.9	2.8	5.5	3.9	5.3	5.7
GDP	5.8	6.0	4.3	4.3	5.5	5.4
Private consumption	5.4	3.8	3.2	3.8	6.6	6.5
Government consumption	9.8	7.1	3.2	1.8	4.6	3.6
Gross domestic fixed capital formation	-0.2	3.5	5.7	7.4	12.8	6.8
Exports of goods and services	8.6	4.5	0.5	7.3	3.9	4.8
Imports of goods and services	7.2	2.4	-1.2	8.6	6.5	5.9
Current account (% GDP)	-0.6	-1.0	0.0	-0.6	-2.6	-3.4
Harmonised Index of Consumer Prices	4.0	4.7	4.0	2.3	2.2	2.7
Consumer Price Index (% change)	4.9	4.6	3.5	2.2	2.5	4.0
Unemployment (% of labour force)	3.9	4.4	4.6	4.4	4.3	4.4
Employment (% change)	3.1	1.8	1.9	3.0	4.7	4.4
Employment change ('000)	53	32	34	54	87	87
General Gov. Balance (% GDP) *	0.8	-0.4	0.2	1.4	1.0	2.3
General Gov. Debt (% GDP)	35.4	32.2	31.1	29.7	27.4	25.1

* Deficit (-) / Surplus (+).
Source: 2001-2005 CSO, except for public finance figures which are produced by the Department of Finance. 2006 figures are Department of Finance estimates.

2.2 The Economy in 2006

GNP growth in 2006 is estimated at 5.7%, with GDP growth estimated at 5.4%. As regards the headline figures, a number of important developments should be noted. Firstly, growth is being mainly driven by domestic demand, with little contribution from net exports. This, in turn, partly reflects the general deterioration in competitiveness in recent years, which has resulted in a relatively modest rate of export growth. Secondly, employment growth has been very strong once again this year; when combined with the output figures, this suggests a relatively low rate of labour productivity growth. This is partly explained by the sectoral composition of output growth, which has been concentrated in relatively labour-intensive sectors such as construction and services.

External Developments

Global growth is robust, despite high oil prices in the first half of the year and world GDP is now estimated to grow at more than 5% this year. The US economy is slowing but growth in other regions, in particular emerging Asia, is set to remain strong.

Growth in the United States has started to ease back this year but GDP is still forecast to grow at 3.4% in 2006. A combination of higher energy prices, increases in interest rates and a faltering housing market are beginning to effect domestic demand. Japan's recovery is becoming increasingly broad-

[2] The analysis here is based on data available up to end-November 2006, and on the European Commission's assumptions regarding the external environment that are set out in Annex 1.

based, with GDP rising by 3.0% in the first half of 2006. Growth in the rest of Asia is also strong and real GDP is expected to increase by 8.4% in 2006. China's growth projections have been adjusted upwards by almost 1% to 10.4% based on growing exports and an acceleration in investment spending. The euro area has experienced considerable economic expansion in the first half of 2006 and output growth is expected to reach 2.6% in 2006. Growth in the UK has rebounded this year and economic activity is expected to grow by 2.7% in 2006.

Domestic Demand

Available data point to fairly solid growth in consumer spending this year. For instance, the volume of personal consumption in the first half of 2006 was 6.5% higher than in the same period of last year according to quarterly national accounts data. Retail sales data point to a continuation of strong spending growth in the third quarter; excluding cars, the volume of retail sales was 6.5% higher year-on-year in the third quarter. This relatively strong spending growth reflects strong disposable income growth, which, in turn, is mainly due to the continued expansion in employment and increases in per capita earnings. Over the second half of the year, the maturing of the Special Savings Incentive Accounts (SSIA) scheme is expected to provide some further impetus to consumption, although the main impact is likely to be in 2007. For 2006 as a whole, personal consumption is expected to increase by 6.5%.

In the first half of 2006, government consumption was just over 4% higher in volume terms than in the same period of 2005. For 2006 as a whole, an increase of 3.6% is expected.

The volume of investment spending rose by 2.6% year-on-year in the first half of the year. Building and construction spending remained strong, supported by a further increase in residential construction. On the other hand, spending on machinery and equipment was particularly weak, with a negative annual growth rate recorded in the first half. However, growth rates in this component can be volatile. The prospects for the second half of the year are for an acceleration in the rate of investment spending, supported by continued strong new housing output, and a pick up in the rate of spending on machinery and equipment. For 2006 as a whole, therefore, total investment growth is forecast to be 6.8%.

Exports of Goods and Services

Quarterly national accounts data show that the volume of exports in the first half of the year was 5.9% higher than in the same period of last year. Within this component, there have been diverging trends for merchandise and services exports. In volume terms, exports of goods rose at an annual average rate of just 0.3% in the first six months of the year, while the value of goods exports in the first three quarters of the year was just 2.7% higher than in the same period of last year. On the other hand, balance of payments data show that the value of services exports was 18.9% higher year-on-year in the first half of this year. Exports of computer and business services were particularly strong in the first half of the year. In terms of developments for the year as a whole, and allowing for likely price trends, it is estimated that the volume of exports of goods and services will rise by around 4.8% this year.

Final Demand and Imports

Quarterly national accounts data show that the annual growth rate of imports of goods and services has exceeded that of exports in each quarter since the first quarter of 2004. This pattern has continued this year, with the data showing that import growth averaged 7.1% in the first half of the year (as outlined above, the equivalent figure for exports was 5.9%). In volume terms, merchandise imports rose at an annual average rate of 5.3% in the first six months of the year, while in the first nine months of the year the value of merchandise imports was 5.6% higher than in the same period of last year. Services imports rose by 15.3% year-on-year in the first half, with particularly strong growth recorded in the insurance and business services components. For the year as a whole, final demand is projected to rise by around 5.6% in 2006 in volume terms, with imports projected to rise by 5.9%.

Balance of Payments
In the first half of this year, a deficit of €3.8 billion was recorded in the current account of the balance of payments. This compares with a deficit of €3.1 billion in the same period of last year. The deterioration in the current account balance over this period reflects a decline in the merchandise trade surplus and is indicative of the general loss in competitiveness in recent years. For the year as a whole, a current account deficit of 3.4% of GDP (4.0% of GNP) is forecast. If this was to materialise, it would be the largest deficit since the current methodology for compiling balance of payments statistics was introduced in 1998.

Employment and Earnings
Total employment rose by 87,000 (4.5%) year-on-year in the first three quarters of 2006, and by the second quarter the level of employment exceeded 2 million for the first time in the history of the State. As has been the case in recent years, employment increases in the construction and services sectors were particularly strong, with annual increases of 9.2% and 5.3%, respectively, in the first three quarters of the year.

Over the same period, the labour force expanded at an annual rate of 94,000 (4.6%), mainly reflecting higher female participation rates and continued net inward migration. Non-Irish nationals now account for around 10% of the labour force. The average unemployment rate was 4.4% for the first three quarters of this year.

Available data point to a continuation of favourable labour market trends over the remainder of the year, with total employment forecast to rise by 87,000 (4.4%) for 2006 as a whole. With the labour force also projected to rise by 4.4%, the unemployment rate is expected to average 4.4% this year, compared to an EU average of 8.0%.

Earnings data point to a slight easing in the rate of wage inflation in some sectors this year. In the construction sector, where the strongest increases have been recorded in recent years, hourly earnings rose at an annual rate of 1.8% in first half of the year. In the industrial sector, hourly earnings rose at an annual rate of 4.1% and weekly earnings by 3.3% over the same period. In the business and distribution services sector, weekly earnings rose by 5.4% year-on-year over the first two quarters; in the financial sector the equivalent rate of increase was 5.8%, while in the public sector weekly earnings rose by 5.3% in the twelve months to June 2006. With labour supply growth expected to feed through into more moderate wage increases, non-agricultural earnings per capita are forecast to rise by 4.7% this year.

Gross Domestic Product and Gross National Product
In overall terms, GDP is projected to rise by 5.4% in volume terms in 2006. In the first half of the year, GNP growth averaged 7.9%, significantly higher than the GDP growth rate. However, GNP figures are particularly volatile on a quarterly basis, as they are affected by both profit outflows and inflows. Allowing for this volatility, the growth rate of GNP is now likely to be higher than GDP, although the gap is not expected to be as large as indicated by the data for the first half of the year. In overall terms, therefore, GNP volume growth of 5.7% is now expected.

Inflation
In terms of euro area comparisons, the appropriate measure of inflation is the Harmonised Index of Consumer Prices (HICP). HICP inflation averaged 2.7% in the first ten months of the year, 0.5% higher than the euro area equivalent over the period, mainly reflecting higher services sector inflation in Ireland. For the year as a whole, HICP inflation is expected to average 2.7% in 2006.

After averaging 2.5% in 2005, the annual rate of inflation, as measured by the Consumer Price Index (CPI), has picked up this year. The main difference between the HICP and the CPI is the inclusion of mortgage interest repayments in the CPI. The acceleration in the rate of increase in the CPI is mainly attributable to the impact of higher mortgage interest repayments which, in turn, reflects increases in wholesale rates. In addition, a higher level of oil prices had an adverse impact on the rate of inflation in the first half of the year. CPI inflation averaged 3.8% in the first ten months of the year and is expected to average 4.0% for the year as a whole.

Table 3 – Economic Indicators 2006: Budget Forecast and Estimated Outturn

	2006 Forecast (December 2005)	2006 Estimate (December 2006)
GNP (% volume change)	4.6	5.7
GDP (% volume change)	4.8	5.4
Consumer prices - HICP (% change)	2.0	2.7
Consumer prices - CPI (% change)	2.7	4.0
Unemployment rate (% labour force)	4.3	4.4
Employment growth ('000)	60	87
Employment growth (%)	3.1	4.4

Source: Department of Finance

2.3 Macroeconomic Projections 2007 – 2009

Overview

The prospects for the international economy over the forecasting horizon appear to be reasonably favourable, with international economic organisations generally projecting continued solid growth in most regions. While this broadly benign international background will provide support to the exporting sector in Ireland, the adverse trends in cost competitiveness experienced in recent years is expected to restrain the rate of export growth.

In terms of likely developments in domestic demand, the maturing of the SSIA scheme will provide some impetus to consumption and investment spending in 2007. Thereafter, the prospects are for more moderate domestic demand growth, as the effect of the SSIA's begins to fade. It is also assumed that new housing output will be on a slight downward trend over the forecast horizon. In these circumstances, GDP growth is expected to be 5.3% next year, before slowing to 4.6% in 2008 and to 4.1% in 2009.

The forecasts in this Update are based on the EU Commission's technical assumptions regarding key external variables and developments in our main trading partners (see Annex 1). As a small, globally-integrated economy, Ireland is exposed to international economic developments. In this context, there are a number of clearly identifiable risks and vulnerabilities attached to global developments, including:

- the potential for further dollar depreciation, given the magnitude of the US current account deficit;[3]
- the possibility that the slowdown in the US housing market triggers a sharper than expected fall in overall economic activity in the US, with potential spill-over effects to other regions;
- notwithstanding some easing in recent months, oil prices remain relatively high and the possibility of further increases cannot be ruled out;
- rising interest rates could ultimately slow the pace of growth in many of our trading partners.

Risks and vulnerabilities exist on the domestic front also. A further deterioration in competitiveness could materialise through, for example, relatively high price or wage inflation. In addition, the construction sector accounts for a very high proportion of overall economic activity, with around one in eight workers directly employed in this sector, a much greater concentration than in the EU generally. Developments in this sector, therefore, will exert an important influence on the economy as a whole.

[3] The US current account deficit is estimated to be 6.4% of US GDP in 2006.

Box 1: Revisions compared to Pre-Budget Outlook

The Department of Finance published its *Pre-Budget Outlook* (PBO) in mid-October. This new publication, which is part of the reform of the budgetary process announced by the Minister for Finance in the 2006 Budget, contained macro-economic and budgetary projections covering the period 2006 – 2008.

The macro-economic and budgetary forecasts included in this *Stability Programme Update* (SPU) differ from those in the PBO for a number of reasons. Firstly, policy decisions regarding spending and taxation announced in the Estimates and in the Budget will affect the economy as well as the public finances. Secondly, the PBO projections were based on data and other information available up to end-September, while those in the SPU are based on published data up to end-November. Finally, account is also taken of the Commission's assumptions for key exogenous variables which were published in November along with the Autumn economic forecasts.

External Outlook

The EU Commission's Autumn forecasts predict that EU growth will exceed potential this year. Estimates for GDP growth in both the euro area and the EU25 have been revised upwards from the Spring forecasts, to reflect the strong acceleration of activity in the first half of 2006. Output is being driven mainly by strong domestic demand, particularly business investment, supported by a small positive contribution from the external sector. In the UK, growth is expected to moderate slightly to around 2½% in 2007 and 2008. Modest growth will persist in the US until midway through 2008. In the second half of 2008, the economy is forecast to return to quarterly GDP growth (in annualised terms) of 3%-3⅓%, close to long-term potential. On the external side, the slowing of the US economy, a weakening dollar allied to a possible disorderly unwinding of global imbalances and potential oil price volatility are the most salient risks to the outlook. However, the Commission anticipates that growth should remain close to potential over the forecast horizon. Below, in Table 4, are the forecasts for GDP growth in Ireland's main trading partners. Based on these forecasts the Commission estimate that Ireland's export markets will grow by 6.4% next year before slowing to 6.1% in 2008.

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

	2005	2006	2007	2008
Euro area	1.4	2.6	2.1	2.2
Germany	0.9	2.4	1.2	2.0
France	1.2	2.2	2.3	2.1
Italy	0.0	1.7	1.4	1.4
UK	1.9	2.7	2.6	2.4
EU25	1.7	2.8	2.4	2.4
US	3.2	3.4	2.3	2.8
Japan	2.6	2.7	2.3	2.1

Source: European Commission 2006 Autumn Forecasts.

Domestic Demand

Personal consumption growth is expected to accelerate next year vis-à-vis this year. In part, this reflects the projection for further relatively strong growth in earnings and employment. In addition, around two-thirds of the SSIAs mature next year. While there are strong grounds to assume that a large portion of these funds will be diverted into alternative savings products or used to run down debt,[4] it is likely, nevertheless, that the ending of the scheme will provide some additional impetus to personal consumption expenditure next year. In overall terms, personal consumption is forecast to increase by 7.3% for next year. A deceleration to 4.8% is projected for 2008 as the impact of the

[4] See Annex 1, Pre-Budget Outlook, Department of Finance, October 2006.

SSIA scheme on consumption begins to fade, while a further moderation is expected in 2009 as the rate of earnings and employment growth eases.

In volume terms, government expenditure is assumed to increase at an average rate of 3.5% per annum over the period 2007 – 2009.

The rate of growth in investment spending is forecast to moderate over the forecast horizon. Next year, new housing output is likely to be lower than this year's level. On the other hand, it is assumed that at least some portion of the SSIA funds will be used to finance home improvement. In later years, however, housing output is projected to continue its gradual decline towards more sustainable levels, while the impetus to home improvement is expected to fade. While other investment, including public investment, is expected to remain strong, overall building and construction investment growth is forecast to slow over the forecast period. Taking into account likely developments in machinery and equipment spending, total investment is forecast to increase by 5.4% in real terms in 2007, slowing to 3.8% the following year and to 2.5% in 2009.

Exports of Goods and Services

Notwithstanding the reasonably favourable economic environment in most of our major trading partners, no significant acceleration in the rate of export growth is expected over the forecast horizon. This assessment is based on the general deterioration in cost competitiveness in recent years. Next year, exports of goods and services are forecast to rise by 4.9%, with an average growth rate of 4.5% envisaged for the following two years. It is also expected that the gradual shift from merchandise to services exports will continue over the forecast horizon.

Final Demand and Imports

Final demand is forecast to increase by 5.7% in 2007 before slowing to 4.5% in 2008 and to 4.0% in 2009, partly due to the unwinding of the SSIA impact on consumption. Imports of goods and services are forecast to expand by 6.2% in 2007, in part due to the assumption that a large portion of SSIA-related expenditure is on imported goods. The rate of import growth is expected to average just over 4% per annum in the following two years, as the SSIA impetus to consumption fades.

Employment and Earnings

The labour market outlook remains broadly favourable, although some moderation in the rate of employment growth is expected, compared to the recent relatively high rates of increase. Total employment is forecast to rise by 3.5% in 2007, followed by growth of 2.1% in 2008 and 1.6% in 2009, with growth in each year being driven largely by the expanding services sector. Some improvement in labour productivity is expected over the forecast horizon, although growth rates are likely to remain below those recorded during the second half of the 1990s. The unemployment rate is expected to remain broadly stable over the forecast horizon. Growth in non-agricultural earnings per capita is likely to ease slightly.

Gross Domestic Product and Gross National Product

In overall terms, therefore, both GNP and GDP are forecast to increase by 5.3% next year. Growth is expected to moderate thereafter, with average GDP growth of 4.4% (GNP of 4.3%) per annum over the period 2008 – 2009. This relatively benign projection is based on the assumption that the economy is not subjected to any significant shocks over this period.

Inflation

Inflation is expected to moderate over the course of 2007, partly due to the impact of higher oil prices falling out of the annual comparison. HICP inflation is forecast to be 2.6% in 2007, 2.0% in 2008 and 1.7% in 2009. These projections assume that SSIA-related expenditure has a limited effect on consumer prices, which in turn reflects the assumption that expenditure is concentrated on 'large' items (such as cars, foreign holidays, etc) most of which are imported.

CPI inflation is forecast to be 4.1% in 2007, 2.4% in 2008 and 2.0% in 2009.

Table 5 – Macroeconomic Prospects

% change (unless otherwise indicated)	2006	2007	2008	2009
GNP growth at constant market prices	5.7	5.3	4.6	4.0
GNP at current market prices (€m)	148,875	161,550	174,125	186,075
GDP growth at constant market prices	5.4	5.3	4.6	4.1
GDP at current market prices (€m)	175,625	189,900	204,375	218,300
Components of real GDP				
Private consumption expenditure	6.5	7.3	4.8	4.1
Government consumption expenditure	3.6	3.7	3.5	3.4
Gross domestic fixed capital formation	6.8	5.4	3.8	2.5
Exports of goods and services	4.8	4.9	4.6	4.5
Imports of goods and services	5.9	6.2	4.3	3.9
External Trade				
Current account (% GDP)	-3.4	-4.3	-4.0	-3.5
Price Developments				
HICP	2.7	2.6	2.0	1.7
CPI	4.0	4.1	2.4	2.0
Labour Market				
Unemployment (% of labour force)	4.4	4.4	4.5	4.6
Employment	4.4	3.5	2.1	1.6
Labour productivity (GDP/person employed)	0.8	1.7	2.5	2.5

Note: Tables 1a, 1b, 1c and 1d as set out in the guidelines are enclosed at Annex 2 (pages 38-39)
Source: Department of Finance

2.4 Range of Forecasts

The following table compares the Department of Finance 2007 forecasts with those of other organisations. In making comparisons, it should be borne in mind that the assumptions underpinning the forecasts may be different.

Table 6 – Comparison of Macroeconomic Forecasts for Ireland in 2007

Institution	Publication	GDP	GNP	HICP	Employment
		Annual % change			
Department of Finance	*Budget 2007*	5.3	5.3	2.6	3.5
Central Bank of Ireland	*Bulletin No.4, Oct 2006*	5½	5½	2¾	3¾
ESRI	*QEC Autumn 2006*	5.0	4.9	n.a.	3.5
European Commission	*Autumn 2006 Economic Forecasts*	5.3	n.a.	2.7	3.0
IMF	*Article IV Staff Report, Aug 2006*	5.4	5.4	2.5	n.a.
OECD	*Outlook No. 80, Nov 2006*	5.1	n.a.	2.8	2.6

Source: Department of Finance and institutions cited

Chapter 3 – General Government Balance and Debt

3.1 Summary

The Government's budgetary strategy is based on the objective of continued budgetary sustainability both in the medium-term and the longer term.

The public finance position is sound. The debt/GDP ratio is projected to be about 22% at end-2009, considerably less than half the present EU average debt level of around 63% of GDP, and among the lowest in the euro area.

The outlook is for a General Government budget surplus of 1.2% of GDP in 2007 followed by surpluses of 0.9% in 2008 and 0.6% in 2009. These projected balances include the cost of infrastructural investment which at around 5% of GNP is running well ahead of the EU average over the period.

The underlying (cyclically-adjusted) budget balance respects the terms of the Stability and Growth Pact.

3.2 Policy Strategy

The Government Programme states that the Stability and Growth Pact "provides the overall framework" for budgetary policy.

The strategy for achieving the Government's key objectives with regard to budgetary and economic policy includes:

1. Improving equity and opportunity;
2. Fostering employment and economic growth;
3. Helping families and those on low incomes;
4. Enhancing public services and value for money;
5. Maintaining high levels of infrastructural investment to secure future economic growth;
6. Pursuing prudent fiscal policies to ensure the flexibility required to respond effectively to any budgetary pressures that may arise in the future.

The formulation of medium-term budgetary policy is in accordance with the requirements of the revised Stability and Growth Pact. It facilitates confidence, investment and growth, and thereby supports the Government objectives for employment, competitiveness, prosperity and balanced economic development. In particular, the growth of public expenditure must be kept broadly in line with the underlying growth in resources, ensuring budgetary sustainability in the medium to long-term. The Government is determined that Ireland's public finances will remain in a good position to address emerging budgetary pressures over the longer term, including the budgetary consequences of an ageing population.

3.3 Budget Balance

A surplus of 2.3% of GDP on the General Government Balance is currently projected in 2006, compared with a planned deficit of -0.6% for 2006 at the time of last year's Budget.

The bulk of the improvement in the forecast outturn GGB for 2006 compared with the Budget estimate can be explained by the following factors:

- An excess in tax receipts of €3,800 million or 2.2% of GDP, due mainly to a surplus in stamp duty and capital taxes;

- An improvement in the net surplus of the Social Security sector of €300 million or 0.2% of GDP;
- A positive estimated accrual adjustment to PAYE Income Tax and employer/employee PRSI receipts of 0.1% of GDP;
- Expenditure savings of €540 million or 0.3% of GDP.

A General Government surplus of 1.2% of GDP is planned for 2007, followed by surpluses of 0.9% in 2008 and 0.6% in 2009. Ireland is expected to continue to have the second-lowest debt-to-GDP ratio in the euro area, with the ratio declining to around 22% over the forecast period.

In response to the infrastructural needs of the economy, public investment including PPP capital funded by annual payments from the Exchequer, will average around 5.0% of GNP over the period 2007 – 2009, up from 4.7% in the last update. A medium-term investment strategy will be set out in the National Development Plan 2007 – 2013, which will be published in January 2007. Ireland's investment in infrastructure is currently running well ahead of the EU average.

More detailed information in relation to Government expenditure and revenue issues is set out in Chapter 5.

At least 1% of GNP will continue to be set aside annually in the National Pensions Reserve Fund for the pre-funding of part of future pension liabilities, building up assets to help address costs associated with ageing in future decades. This pre-funding does not affect the General Government Balance, but does add to the General Government Debt.

Table 7 – General Government Budgetary Prospects

	2005	2005	2006	2007	2008	2009
	€m	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net Lending by sub-sector						
General government	1,745	1.1	2.3	1.2	0.9	0.6
Central government	966	0.6	2.0	1.0	0.7	0.5
State government	n/a	n/a	n/a	n/a	n/a	n/a
Local government	185	0.1	-0.1	-0.1	-0.1	-0.1
Social security funds	594	0.4	0.4	0.3	0.3	0.2
General government						
Total Revenue	56,737	35.2	36.8	36.6	36.0	35.5
Total Expenditure	54,992	34.1	34.6	35.4	35.1	35.0
Net lending/borrowing	1,745	1.1	2.3	1.2	0.9	0.6
Interest expenditure	1,657	1.0	1.0	1.1	1.0	1.0
of which **FISIM**[5]	-19	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
Primary balance	3,402	2.1	3.3	2.3	1.8	1.6
Selected components of revenue						
Total taxes	41,485	25.7	27.3	27.2	26.8	26.5
Taxes on production and imports	21,492	13.3	14.0	14.1	14.0	13.9
Current taxes on income, wealth etc.	19,743	12.3	13.1	12.9	12.6	12.4
Capital taxes (Capital Acquisitions Tax)	250	0.2	0.2	0.2	0.2	0.2
Social contributions	9,969	6.2	6.3	6.3	6.3	6.2
Property Income (interest & dividends)	1,724	1.1	1.0	1.0	1.0	0.9
Other	3,559	2.2	2.1	2.1	1.9	1.9
Total Revenue	56,737	35.2	36.8	36.6	36.0	35.5
Tax Burden[6]	51,890	*32.2*	*33.9*	*33.7*	*33.3*	*33.0*
Selected components of expenditure						
Collective consumption	8,693	5.4	5.4	5.3	5.3	5.3
Total social transfers	32,256	20.0	19.9	20.4	20.4	20.4
Social transfers in kind[7]	16,863	10.5	10.4	10.3	10.3	10.3
Social transfers other than in kind	15,393	9.6	9.5	10.1	10.0	10.0
Interest Expenditure	1,657	1.0	1.0	1.1	1.0	1.0
Subsidies	925	0.6	0.6	0.6	0.6	0.6
Gross fixed capital formation	5,186	3.2	3.6	3.8	3.8	3.8
Other	6,275	3.9	4.1	4.1	4.0	3.9
Total Expenditure	54,992	34.1	34.6	35.4	35.1	35.0

Source: Department of Finance. Figures may be affected by rounding.

[5] Financial Intermediation Services Indirectly Measured (FISIM) measures the value added by financial institutions.
[6] Total Taxes plus Social Contributions plus taxes paid directly to EU.
[7] Equal to ESA95 category Individual Consumption (P31) rather than ESA95 category Social Transfers in Kind (D63).

3.4 Cyclically-Adjusted Budget Balance and Fiscal Stance

It is generally accepted that some government revenues and expenditures will be sensitive to the position of the economy in the economic cycle. Thus, the cyclical position of the economy will have an impact on the actual budget balance. The Cyclically-Adjusted Budget Balance (CABB) removes the impact of the economic cycle on the budget balance in order to give an insight into the underlying fiscal position. It is calculated by subtracting the cyclically-induced component from the actual budget balance. Changes in the CABB from one year to the next can give an indication of discretionary changes in fiscal policy.

In practice, however, the CABB is unobservable and must be estimated. This estimation involves calculations of the cyclical position of the economy (i.e. the output gap) as well as the elasticity of the budget balance to changes in GDP. For most countries, estimates of potential output (and hence the output gap) are subject to uncertainty and Ireland is no different. Indeed, given the openness of the Irish economy, as well as considerable structural change in recent years, it is likely that estimates of the output gap for Ireland are even more uncertain than for other countries.[8]

Notwithstanding these caveats, estimates of the cyclically-adjusted budget balance are presented in Table 8. The estimates are based on the macro-economic and budgetary forecasts set out elsewhere in this Stability Programme Update. Estimates of potential output (and the resulting output gap) are based on the production function methodology employed by the EU Commission. The elasticity of the budget balance to changes in GDP is estimated to be 0.4. Estimates of the cyclically adjusted primary balance (i.e. excluding national debt interest payments) are also shown.

Table 8 – Cyclical Developments

% of GDP	2005	2006	2007	2008	2009
GDP growth (%)	5.5	5.4	5.3	4.6	4.1
Actual balance	1.1	2.3	1.2	0.9	0.6
Interest expenditure	1.0	1.0	1.1	1.0	1.0
Potential GDP growth (%)	6.1	6.2	5.7	5.1	4.5
- contribution of labour	1.9	2.1	1.8	1.3	0.7
- contribution of capital	2.1	2.1	2.1	2.0	1.9
- contribution of total factor productivity	2.1	1.9	1.8	1.8	1.8
Output gap (% potential output)	-0.4	-1.1	-1.5	-2.0	-2.4
Cyclical budgetary component	-0.1	-0.4	-0.6	-0.8	-0.9
Cyclically adjusted balance	1.2	2.7	1.8	1.7	1.5
Change in CABB		1.5	-0.9	-0.1	-0.2
Cyclically adjusted primary balance	2.2	3.7	2.9	2.7	2.5
Change in CAPB		1.5	-0.8	-0.2	-0.2
Source: Department of Finance					

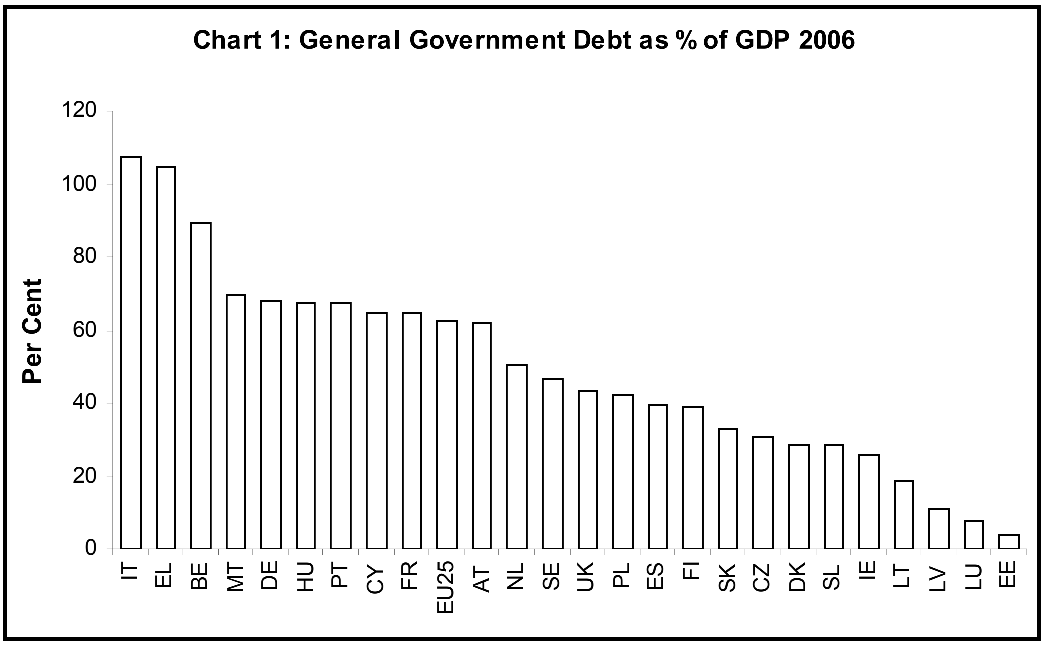
Note: figures may not be equal to totals due to rounding.

[8] See Stability Programme Update 2003 for an elaboration of some of the difficulties in calculating the output gap in an Irish context.

3.5 Debt Level and Developments

As indicated by Chart 1 below, Ireland has one of the lowest debt/GDP ratios in the EU25.

Over the Programme period, the gross debt level is expected to decline to around 22% of GDP.



Source: European Commission Autumn Forecasts 2006; Irish data: Department of Finance (estimates)

When account is taken of the build-up of assets in the National Pensions Reserve Fund (NPRF), the debt-to-GDP ratio, net of those assets, is estimated to be around 15% at end-2006.

Table 9 – General Government Debt Developments

% of GDP	**2005**	**2006**	**2007**	**2008**	**2009**
Gross debt	27.4	25.1	23.0	22.4	21.9
Change in gross debt ratio	-2.3	-2.3	-2.1	-0.6	-0.5
Contributions to change in gross debt ratio					
Primary balance	2.1	3.3	2.3	1.8	1.6
Interest expenditure (incl. FISIM)	1.0	1.0	1.1	1.0	1.0
Stock-flow adjustment	1.3	2.2	1.0	1.8	1.5
Nominal GDP	-2.5	-2.3	-1.9	-1.6	-1.4
Net Receipts of Social Security Funds	1.2	1.5	1.4	1.4	1.3
Other factors influencing the debt ratio:					
Privatisation receipts	n.a.	-0.1	n.a.	n.a.	n.a.
Increase in local authorities debt	0.1	0.1	0.1	0.1	0.1
p.m. implicit interest rate on debt	3.8	4.0	4.6	4.5	4.7

Source: Department of Finance

3.6 Budgetary Implications of Major Structural Reforms

As outlined earlier in Section 1.2, the underlying (structural) budget balance respects the terms of the Stability and Growth Pact, and is consistent with a medium-term objective of keeping the budget close to balance over the 2007 – 2009 period. It is therefore compliant with the medium-term objective as outlined in Council regulation 1055/2005 amending regulation 1466/1997.

Chapter 4 – Sensitivity Analysis and Comparison with Previous Updates

4.1 Summary

This Chapter briefly outlines the impact of different economic scenarios on the budgetary balance. In general terms, it is estimated that a 1% change in the growth rate of the economy would change the General Government Balance (GGB) by about 0.4 percentage points of GDP in the short-run. However, this is only a general rule, as the magnitude of the impact on the GGB will vary according to the cause of the change in growth.

4.2 Alternative Scenarios and Risks

A number of points should be borne in mind when examining the results of the sensitivity analysis set out below. First, 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 over the period of the Programme. In reality such a response would occur if desirable in the interests of economic or budgetary sustainability, or if required under the terms of the Stability and Growth Pact. Finally, it should be noted that the results differ depending on the type of economic scenario applied in the model simulation.

4.3 Sensitivity of Budgetary Projections to Different Scenarios and Assumptions

Two alternative causes of a 1% change in economic growth are modelled using the HERMES model[9]. The results of these scenarios are presented in Table 10.

Table 10 – Impact on the Budget Balance of 1% Change in the Rate of Growth

	2007	**2008**	**2009**
Baseline GDP Growth (%)	5.3	4.6	4.1
GGB (% GDP) (including contingency)	1.2	0.9	0.6
1% change in the rate of growth due to a change in interest rates			
Cumulative impact of 1% change in growth on GGB (% GDP)	Up to 0.2 pp	Up to 0.4 pp	Up to 0.4 pp
GGB Range (%GDP)	1.0 to 1.4	0.5 to 1.3	0.2 to 1.0
1% change in the rate of growth due to a change in world growth			
Cumulative impact of 1% change in growth on GGB (% GDP)	Up to 0.1 pp	Up to 0.2 pp	Up to 0.3 pp
GGB Range (%GDP)	1.1 to 1.3	0.7 to 1.1	0.3 to 0.9

Source: Department of Finance

These estimates suggest that a 1% lower growth rate caused by higher interest rates would lead to a deterioration in the GGB of about 0.4 percentage points of GDP in the short-run. This result is broadly symmetrical in that higher growth resulting from lower interest rates would improve the GGB by a similar magnitude. The impact on the GGB in the first year is relatively small. However, as higher interest rates feed through into industrial costs, the magnitude rises to 0.4 percentage points of GDP (relative to the baseline) in the second year and remains at that level in the third year.

A change in world demand conditions would also have an impact on the growth rate of the Irish economy and hence on the public finances. Estimates suggest that a 1% increase in domestic growth resulting from stronger world output would improve the GGB by about 0.3 percentage points of GDP

9 The HERMES model has been developed by the Economic and Social Research Institute.

in the short-run. The impact in the first year is small (0.1 percentage points of GDP relative to the baseline) as the private sector is assumed to react slowly to the unexpected stronger world demand. The magnitude of the effect increases to around 0.2 percentage points of GDP in the second year and to 0.3 percentage points of GDP in the third year as the private sector adjusts. It should be noted that these results are somewhat smaller than quoted in previous Stability Programme Updates. This reflects the fact that the manufacturing sector accounts for a relatively smaller part of output now compared to the past (due for instance to the growing importance of less import-intensive sectors such as construction and parts of services).

4.4 Comparison with Previous Update

Table 11 compares this Stability Programme Update with the Programme of December 2005. GDP growth in 2006 is now estimated at 5.4%, compared to a forecast of 4.8% in last year's Stability Programme Update. GDP forecasts for 2007 and 2008 have also been revised. GNP growth in 2006 is now estimated to be 5.7%, compared to a forecast of 4.6% in last year's Update.

The General Government Balance in 2006 is now projected at 2.3% of GDP, compared with -0.6% anticipated in the last Update.

Table 11 – Divergence from the Previous Update

	2005	**2006**	**2007**	**2008**	**2009**
Real GDP growth (%)					
previous update	4.6	4.8	5.0	4.8	-
latest update	5.5	5.4	5.3	4.6	4.1
Difference	0.9	0.6	0.3	-0.2	-
General Government balance					
(% of GDP)					
previous update	0.3	-0.6	-0.8	-0.8	-
latest update	1.1	2.3	1.2	0.9	0.6
Difference	0.8	2.9	2.0	1.6	-
General Government Gross Debt					
(% of GDP)					
previous update	28.0	28.0	28.2	28.3	-
latest update	27.4	25.1	23.0	22.4	21.9
Difference	-0.6	-2.9	-5.2	-5.9	-

Source: Department of Finance

Chapter 5 – Quality of Public Finances

5.1 Policy Strategy

The objectives set out by Government include sustaining a strong economy, supporting employment promoting improved productivity and competitiveness and building a caring society. In pursuit of these objectives funding has been provided to:

- Underpin incentives to reward effort and enterprise, consolidating the progress made in recent years;
- Raise the share of national resources devoted to public investment.
- Improve a broad range of key day-to-day public services including:
  - Education, to improve the current and long-term skills base;
  - Measures to improve research and development;
  - Health services;
  - Childcare;
  - Payment rates for those in receipt of social welfare payments and pensions; and
  - Official Development Assistance spending.

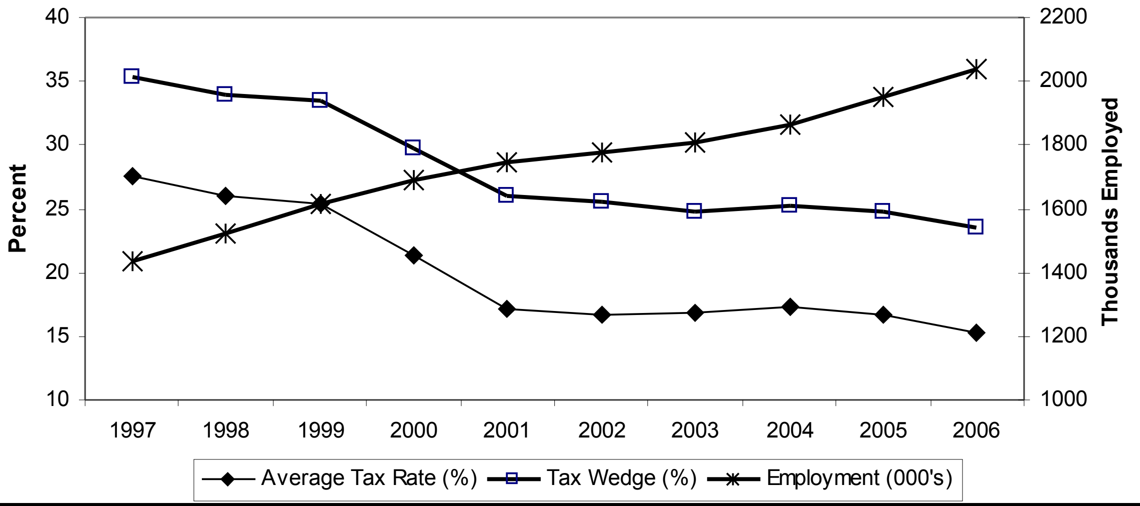
A comprehensive National Development Plan will be published in January 2007, setting a strategic context for some key areas of expenditure and for investment policy over the period to 2013.

5.2 Revenue Strategy

The Government continues to strive to build an equitable tax system which encourages economic growth, so as to ensure employment growth and continuing improvements in living standards for all. This is in line with the objectives of the Lisbon Strategy for growth and jobs.

The priority in recent Budgets has been to consolidate the employment-friendly environment established in Ireland over the last number of years. This has been achieved by maintaining the low tax burden on all, focusing resources towards those at the lower end of the income scale. For example, measures taken in Budget 2007 ensured that those earning the minimum wage remained out of the income tax net entirely, and that those earning the average industrial wage would not pay tax at the higher marginal rate. Economic circumstances also permitted a reduction in the highest marginal income tax rate, though somewhat offset by Health levy changes for higher earners. All workers in the tax net obtained a reduction in real terms in their tax burden.

Chart 2: Income Tax Burden 1997-2006
Single Person on Average Industrial Wage



Source: Department of Finance

Growth in the labour force reflects a combination of a number of elements including demographic factors, in particular high net inward migration, and an increase in the female labour force participation rate, from below 40% in 1995 to 53% in the first three quarters of 2006. Labour market tax policies pursued by Government have played an important role in translating this labour force growth into positive employment growth. Employment growth of 41% has been achieved between 1997 and the first three quarters of 2006. Chart 2 shows that the burden of taxation on those earning the average industrial wage has fallen quite significantly over this period.

Efficiency of Tax Collection

As a measure of the efficiency of the tax collection process in Ireland, it might be noted that, at 31 March 2006, the total tax debt outstanding was only 2.0% of gross receipts collected by the Office of the Revenue Commissioners in 2005. This is one of the lowest percentages of any tax administration world-wide. The figure of 2.0% compares to a total debt of 2.5% of gross receipts in 2004, 4% in 2000, 14% in 1995 and 26% in 1990.

Of that tax debt, one fifth is being managed, generally through an agreed instalment arrangement where the liable entity is given additional time to pay. Two fifths is under active collection while a further fifth is currently at enforcement. Only one fifth is under appeal and is not currently available for collection.

In the period since 1998, the Revenue Commissioners have collected just under €2.3 billion in one-off receipts from a number of special investigations. These include investigations into the holders of bogus non-resident bank accounts for tax evasion purposes and evasion in relation to offshore assets, as well as a further major investigation into the use of investment-related life assurance products to hide undisclosed income. Aspects of these investigations are still ongoing.

Review of Tax Incentives

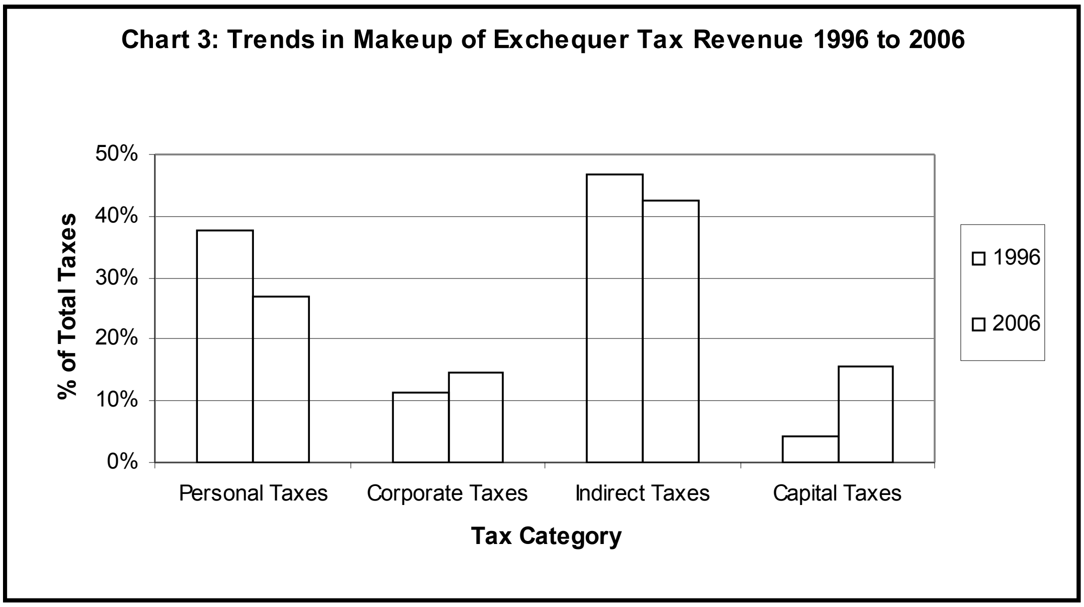
In Budget 2006, the Minister for Finance announced the termination, subject to certain transitional provisions, of the following incentive schemes; the urban renewal, town renewal and rural renewal schemes, and the special reliefs for hotels, holiday cottages, student accommodation, multi-storey car parks, third-level educational buildings, sports injuries clinics, developments associated with park and ride facilities and the general rental refurbishment scheme, while a smaller number, principally those with a social orientation, were retained on a more focused basis. The decision was based on the outcome of a major review of existing tax reliefs which over the course of 2005 evaluated the costs and benefits of each tax scheme. The review process had initially been announced by the Minister for Finance in Budget 2005. In addition, the Government decided to introduce a limit on the overall level of specified tax reliefs that high-earning individuals could claim in any one year.

Accordingly, the 2006 Finance Act provided for the phasing out of the above reliefs during the period 31 July 2006 to 31 July 2008 and the retention with extended investor holding periods of the reliefs for private hospitals, registered nursing homes and childcare facilities. The phasing out arrangements generally provide that full relief continues to be available for existing pipeline projects until 31 December 2006 with a reduction of relief to 75 per cent for expenditure incurred during 2007 and a further reduction to 50 per cent for expenditure incurred between 1 January 2008 and 31 July 2008. In addition, expenditure incurred from 1 January 2007 is contingent on 15 per cent of actual construction or refurbishment costs having been incurred by 31 December 2006. The 2006 Finance Act also provided, with effect from 1 January 2007, for the restriction on the use of tax reliefs for high income taxpayers earning over half a million Euro in a single tax year and a restriction on a sliding scale to those high income taxpayers earning between a quarter and half a million Euro a year.

These measures are in line with the Government taxation strategy to promote growth and jobs, across a wide and secure tax base. The new arrangements are also intended to enhance the equity and integrity of the overall tax system, by ensuring that high-earning taxpayers make a reasonable contribution to the State's finances.

5.3 Changing Sources of Exchequer Tax Revenue 1996 – 2006

The evolution of the shares of Exchequer tax revenues since 1996 is indicated in Chart 3 below.



The lower income tax burden, particularly for those on lower incomes, is the reason behind the decline in personal taxes as a share of total Exchequer tax revenues over the period. The share of corporate taxes has risen in line with improved corporate profitability while the share of indirect taxes has declined as a proportion of total Exchequer tax revenues. The amount of total taxes accounted for by capital taxes, most notably Stamp duty and Capital Gains tax has risen, particularly in more recent years, as a result of a buoyant property market and cuts in certain tax rates which encouraged more disposals.

5.4 Outlook for Expenditure 2007 – 2009

In 2007, while sustaining strong public investment, resources for day-to-day services will increase by an underlying 11.5% on a post-Budget basis over 2006. Within the total provision, key priority areas have been targeted:

- An additional €1.76 billion (14%) in gross current spending for health services;
- An additional €570 million (7.8%) in gross current spending for education and science; and
- An additional €1.8 billion (13%) in gross current spending for social welfare.

The Government is committed to reaching a target for Official Development Assistance of 0.7% of GNP by 2012 and an interim target of 0.5% of GNP in 2007. An additional €138 million (an increase of 21%) has been provided to meet the target of 0.5% of GNP in 2007.

Public capital investment in the medium-term, inclusive of the provision for investment under the new 10 year investment package for transport "Transport 21", will be provided for in the National Development Plan 2007 – 2013 which will be published in January 2007. Total planned investment for 2007 is €7.8 billion, of which €7.6 billion is Exchequer capital and €264 million is PPPs funded by annual payments from the Exchequer. On a cash basis when account is taken of the capital carryover of €159 million into 2007 Exchequer expenditure will be €7.8 billion representing a 13.2% increase on 2006.

Total General Government expenditure in 2007 will be 35.4% of GDP and 41.6% of GNP and will average 35.2% of GDP and 41.3% of GNP over the period to 2009. Table 7 in Chapter 3 shows the development of public expenditure in General Government terms.

5.5 Expenditure Management

The *Broad Economic Policy Guidelines* for 2005 – 2008 include the general recommendation that Member States should *"re-direct the composition of public expenditure towards growth-enhancing categories in line with the Lisbon strategy, […] ensure that mechanisms are in place to assess the relationship between public spending and the achievement of policy objectives and ensure the overall coherence of reform packages"* (Guideline no.3). Over the past number of years, Ireland has developed a range of initiatives aimed at managing and monitoring public expenditure in a more strategic manner, with a focus on *(i)* prioritising economic investment to support growth; *(ii)* efficiency and value-for-money; and *(iii)* effectiveness in the delivery of policy outcomes.

Management of Public Expenditure

The Government is committed to an expenditure policy which contributes to the achievement of sustainable economic and social development through a combination of growing expenditure broadly in line with the resources available and seeking to optimise value for money from public expenditure. Resources are being committed to key priority areas of health, education, social welfare and investment to address infrastructural deficits.

Spending on day to day services is planned and managed within an overall 3 year fiscal framework while, since 2005 with the introduction of 5 year rolling multi annual capital envelopes, capital investment has been planned and managed on a multi annual basis. The National Development Plan 2007 – 2013 will set out a 7 year framework and strategy for investment.

Arrangements for the ongoing monitoring and control of expenditure now include:

- The publication in January of expenditure profiles for the year ahead against which progress is monitored;
- Reporting to Government on a monthly basis on emerging trends and issues in relation to the public finances;
- Bi-monthly reporting to Government by the four Departments with the largest allocations for current spending.

The practice of bi-monthly reporting to Government was extended in 2006 to include reporting on progress on their capital programmes by Departments with capital spending in excess of €250 million.

These arrangements for management and control of public expenditure have proven very effective. For the fifth year in a row expenditure in 2006 is forecast to be within profile reflecting the Government's sound management of the public finances.

Table 12 – Measuring Expenditure Management

Year	Variance: Budget Estimate v. Outturn	Variance as a % of GNP
1997	1.7%	0.4%
1998	-0.8%	-0.2%
1999	1.6%	0.4%
2000	1.7%	0.4%
2001	1.5%	0.4%
2002	-0.4%	-0.1%
2003	-0.3%	-0.1%
2004*	-1.3%	-0.4%
2005*	-1.4%	-0.4%

* The outturn in the years 2004 and 2005, includes capital carryover of €237m and €289m respectively which was carried into 2005 and 2006 under the capital carryover arrangements in accordance with Section 91 of the Finance Act 2004. Source: Department of Finance.

Value for money framework
Building on the reforms of recent years, further progress was made in 2006 on putting in place a robust value for money framework designed to ensure that there is:

- More effective and efficient allocation and management of resources by Government and Ministers, Departments and Agencies;
- Better value for money for the taxpayer;
- Greater accountability to the Oireachtas (parliament) and the public.

A value for money framework is now in place which includes:

- The rolling multi-annual capital envelopes for public capital investment;
- Revised guidelines for the appraisal and management of capital expenditure;
- Public Private Partnerships to procure suitable projects;
- Reforms to public procurement, including moving to fixed price contracts as the norm;
- Additional value for money measures on procurement, ICT projects and consultancies announced in October 2005 and codified in a Department of Finance circular letter in January, 2006;
- New arrangements for Value for Money Policy Reviews in place of the Expenditure Review Initiative announced in June, 2006;
- A Central Expenditure Evaluation Unit in the Department of Finance to promote best practice in relation to appraisal and evaluation generally and compliance by Departments and Agencies with the enhanced Value for Money requirements;
- Reform of the Estimates and Budgetary process announced in Budget 2006.

See Chapter 7 for more details of these reforms.

The above table, and the expected 2006 outturn included in the Budget 2007 Statistics and Tables, show that these arrangements have delivered an improvement in expenditure control. Overall, the expectation for 2006 is that total spending will be closely in line with the original Budget estimate.

Chapter 7 includes additional material regarding expenditure management.

5.6 General Government Expenditure on Public Services

Against a background of current economic and revenue growth, Ireland has been able to make considerable progress in addressing the infrastructural deficit, and in improving a broad range of key public services. In relation to the key priority areas of health, education and social welfare, the level of resources invested has been significantly increased, with corresponding improvements in the quality of public services and outcomes. At the same time there have been significant increases in the level of resources devoted to official development assistance. Some specific examples include the following:

- Improvements in access to healthcare including the doubling in the number of day cases being treated in public hospitals since 1997, where such cases now account for roughly half of the overall total; a reduction in waiting times for operations where the times for most common procedures have been cut to 2 to 5 months reflecting the impact of the National Treatment Purchase Fund's management of over 50,000 cases to date; the expansion of primary care services, including the rollout of primary care teams and the introduction of a General Practitioner Visit Card for certain low earners;

- The enhanced range of services and supports for persons with disabilities as part of the National Disability Strategy; increased investment in the services for older people focused on their remaining in the community for as long as possible.

- Improvements in educational achievement. Successive OECD International Tests (taken by 15 year olds) carried out under the Programme for International Student Assessment (PISA) have shown that Ireland ranks significantly above the OECD average in reading literacy and performs around the OECD average in mathematical literacy and in scientific literacy.

- Improvements in access to education for those with special needs, as there are now 7,000 resource and learning support teachers in the school system to enable children with special educational needs and learning difficulties receive a proper level of educational services in mainstream classes. Alongside them, there are over 8,000 special needs assistants (whole-time equivalents) meeting the care needs of these children to ensure that such children receive any necessary educational supports.

- Advances made in addressing poverty and improving social welfare rates in real terms. Over the period 1997 – 2007, the State Pension (contributory) will have increased by over 49% in real terms, and for the lowest social welfare rate the real increase will have been 58%. In addition, child benefit rates have also been increased in very substantial terms. The rate for the first and second child has increased by 193% in real terms since 1997.

- EU Member States have committed to collectively increasing their Official Development Assistance (ODA) to 0.56% of GNI by 2010. Ireland's ODA contribution has increased from 0.31% of GNP in 1997 to 0.50% of GNP in 2007, compared to a forecast EU average contribution rate of 0.43% in 2006.

The post-Budget 2007 Estimates provisions for health and education will fund further improvements in services including the following main areas:

- €245 million additional funding in respect of services for older people. This is in respect of the full year impact of Budget 2006 package (€40 million) and the 2007 Budget package.
- €100 million additional funding for services for persons with disabilities;
- €75 million additional funding for the commissioning and opening of new units and other developments in the acute care sector;
- A National Childcare Strategy was introduced by the Minister in Budget 2006. This is a five year strategy, costing a cumulative €2.65 billion over 5 years, to address the supply and the cost of childcare. A provision of €381 million is included in the 2007 Estimates for the Early Childcare Supplement. There will be a further 4 week increase to both paid and unpaid maternity leave in 2007 bringing the duration of paid maternity leave to 26 weeks and the duration of unpaid maternity leave up to 16 weeks.

- Additional funding of €50 million is being provided in 2007 across a range of educational programmes for new initiatives / expansion of services in accordance with commitments given in the new social partnership agreement, *Towards 2016*, in areas such as language support, Youthreach, adult literacy and quality enhancements in the Post-Leaving Certificate sector.

- 800 extra teachers will be provided at primary level in 2007, bringing to almost 1,900 the number of additional teachers provided since 2005, to reduce class size and help tackle problems of disability and disadvantage.

- Additional funding of €20 million is being provided in 2007 for the Social Inclusion Plan – "Delivering Equality of Opportunity in Schools", which combats disadvantage in primary and secondary schools serving communities with the highest concentration of disadvantage.

- Additional funding of €40.7 million is being provided in 2007 for educational investment under the Strategy for Science Technology & Innovation – as part of a multi-annual investment programme covering the years 2007 – 2009 initially.

- Additional funding of €45 million is being provided for the Strategic Innovation Fund, to bring the size of the fund to €60 million in 2007.

5.7 Infrastructural Investment

National Development Plan 2000-2006

Spending under the Economic and Social Infrastructure Operational Programme of the National Development Plan 2000 – 2006 has delivered major improvements to the economic and social infrastructure throughout the country in the areas of roads, public transport, environmental infrastructure, sustainable energy, housing and health. Cumulative Exchequer investment under the ESIOP by end 2006 is forecast to be in the order of €23 billion, well ahead of target. The breakdown of this spending by the main programme areas is as follows:

- Roads €6.9 billion
- Public Transport €3.3 billion
- Housing €7.5 billion
- Water & Sewerage €2.1 billion
- Health €3.3 billion.

National Development Plan (NDP), 2007 – 2013

A new National Development Plan for the period 2007 – 2013 will be published in January 2007. It will provide the framework for investment over the next seven years. The Plan will seek to address the investment necessary to maintain national competitiveness and promote regional development within a sustainable economic and budgetary framework.

The Plan will focus on investment priorities in public economic and social infrastructure including roads, public transport, environmental services, energy, communications, housing, education, health and childcare. It will also address investment priorities in human capital (including education) and social inclusion. The promotion of science technology and innovation will also feature in the Plan as will enterprise development including the development of agriculture, tourism and marine. It will also address a number of horizontal issues including All-Island Co-operation, Regional Development in line with the National Spatial Strategy, Environmental Sustainability and the Rural Economy.

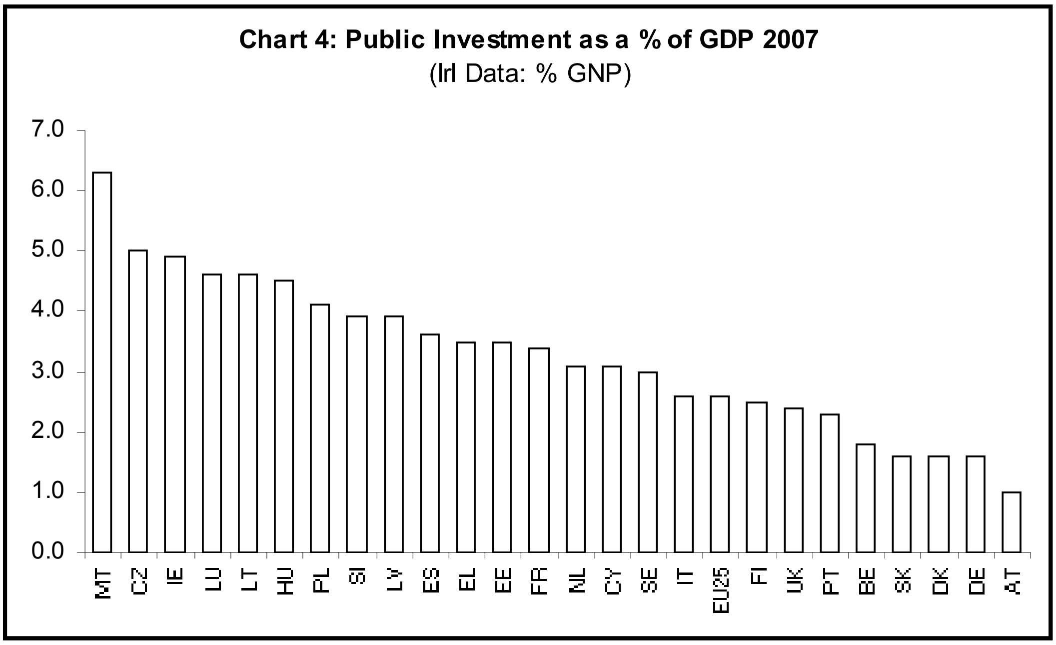
Multi-Annual Envelopes

The rolling 5 year multi annual capital envelopes, with their carryover facility, provide medium-term certainty for Government Departments and agencies in planning and managing their capital programmes and projects.

The introduction of this carryover facility has ensured that significant sums in unspent capital are available for spending the following year. It is projected that €159 million will be carried over from 2006 into 2007[10]. Taking account of the impact of the capital carryover facility total Exchequer spending on investment in 2006 is forecast to be 16.4% higher than in 2005; the equivalent figure for 2007 is estimated as 13.2%.

The 2007 capital allocation provides for a total public capital investment of €7.8 billion. Some €7.6 billion of this is Exchequer capital and €264 million is PPP capital to be funded by annual payments from the Exchequer. Public investment will be some 5% of GNP which is around twice the EU average. In addition, it is estimated that €540 million will be invested in user charge PPP projects, mainly in the roads area.

[10] The definitive amount for capital carryover will be set out in the Appropriation Act, 2006.



Source: European Commission Autumn Forecasts 2006; Irish data: Department of Finance (forecasts)

There are currently some thirty major privately-financed projects at various stages of procurement or planning ranging from roads to environmental services, with ten projects already operational or in construction, including education projects and tolled roads.

Overall, the investment provisions contained in the Estimates and in Budget 2007 represent a prudent use of available resources to support sustained economic progress into the future.

Productive Investment
Over recent years, investment in Research & Development, Education, Employment Supports and Training has increased significantly, aimed at improving competitiveness and boosting the supply side of the economy. Productive investment (current and capital) in 2007 in these areas will amount to about €10.1 billion (6.3% of GNP) as against €3.6 billion in 1997. The investment can be broken down as follows:

- Education: €8.4 billion
- Research & Development: €814 million
- Employment Supports and Training: €932 million.

These will also be priority areas for investment under the National Development Plan 2007 – 2013.

Investment in Balanced Economic Development
The provision for gross Exchequer capital expenditure on the programme of decentralisation of Government departments and agencies is €170 million. This programme will involve the progressive relocation of some 10,000 personnel out of Dublin City to regional centres and is designed to support the objectives of balanced regional development and economic growth contained in the National Spatial Strategy. See Section 7.8 for details of progress.

Chapter 6 - Sustainability of Public Finances

6.1 Summary

The sustainability of the public finances is defined as the ability to meet projected public expenditure from available public funds over the long-run. For many EU Member States, including Ireland, a key concern in this respect is the ageing of the population. An increasingly older society gives rise to significant budgetary challenges as the task of financing rising age-related expenditure falls to a relatively smaller working age population.

Recent projections by the EU Economic Policy Committee indicate that age-related public spending in Ireland will increase from 15.2% of GDP in 2005 to some 23.3% in 2050[11]. While expenditure on pensions will account for the majority of this increase, spending on health and long-term care is also set to rise. In contrast, minor savings are projected in the areas of education and unemployment benefit expenditure.

Ireland's ability to meet these challenges will depend on the implementation of appropriate and timely policy responses. To this end, a range of Government initiatives - including the establishment of the National Pensions Reserve Fund and ongoing public service pension reforms - have been put in place. In addition, Government strategy remains committed to prudent budgetary planning, maintaining a low debt burden and, improving labour force participation rates. Notwithstanding these policy responses, the European Commission considers Ireland to be at 'medium risk' when it comes to the long-term sustainability of the public finances[12]. As such, further measures will be required going forward. In particular, it will be important to factor the budgetary implications of an ageing society into longer term policy developments, including those related to pensions. There is also a need to take advantage of the current fiscal and demographic 'window of opportunity' to maximise investment in Ireland's physical infrastructure, so as to improve productive capacity and better equip the economy to meet the challenges ahead.

6.2 Long-Term Budgetary Prospects including the Implications of Ageing

The latest Eurostat demographic projections indicate that the size and composition of Ireland's population will undergo considerable change in the coming years[13]. Notably, a marked increase in the number of older people is projected to occur so that by 2050, the proportion of the population aged 65 and over relative to the population aged 15-64 (the old age dependency ratio) will be in the order of 45%, nearly treble the 2004 figure of 16.4%. This implies that Ireland will move from having six people of working age for every older citizen to a ratio of just over two to one.

From a public finance perspective, a 'greying' population will pose significant challenges. Foremost amongst these is a substantial rise in age-related public expenditure. On a no policy change basis, current projections indicate that this category of Government spending will increase from 15.2% of GDP in 2005 to 23.3% in 2050 (see Table 13).

While technical long-run projections of the type presented here are of course subject to appreciable margins of error (they assume that existing patterns of activity will persist, which as experience has shown, is not always a reliable assumption), they nevertheless have a value in demonstrating the likely scale of the fiscal challenge facing Ireland in the coming decades.

[11] Economic Policy Committee & European Commission (2006) *The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004 – 2050).*

[12] European Commission (2006) *The Long-Term Sustainability of Public Finances in the European Union.*

[13] Economic Policy Committee & European Commission (2005) *The 2005 EPC Budgetary Projections Exercise: Agreed Underlying Assumptions and Projection Methodologies*.

Table 13 – Long-Term Sustainability of Public Finances*

% of GDP unless otherwise stated	2005	2010	2020	2030	2050
Age-Related Spending Projections (EU Economic Policy Committee)					
Total Age-related expenditures (1) = (2)+(7)+(8)+(9)+(10)	15.2	15.4	17.1	18.8	23.3
Total Pension expenditure (2) = (3)+(6)	4.6	5.2	6.5	7.9	11.1
Social security pensions (3) = (4)+(5)	3.4	3.8	4.5	5.5	8.4
Old-age and early pensions (4)	2.3	2.5	3.3	4.2	7.1
Other pensions (5)	1.1	1.2	1.3	1.3	1.3
Occupational pensions (Public Service) (6)	1.2	1.4	2.0	2.4	2.7
Health care (7)	5.3	5.5	5.9	6.4	7.3
Long-term care (8)	0.6	0.6	0.6	0.7	1.2
Education expenditure (9)	4.0	3.5	3.4	3.2	3.1
Other age-related expenditures (Unemployment benefit) (10)	0.7	0.6	0.6	0.6	0.6
Pension reserve fund assets	8.0	11.1	18.1	26.0	21.9
Underlying Assumptions (EU Economic Policy Committee)					
Labour productivity growth (y-on-y %)	3.3	3.8	2.2	1.7	1.7
Real GDP growth (y-on-y %)	5.7	5.2	3.0	2.1	1.6
Participation rate males aged 20-64 (%)	86.2	87.3	88.4	88.1	88.3
Participation rate females aged 20-64 (%)	64.5	68.5	73.3	75.3	75.6
Total participation rates aged 20-64 (%)	75.4	77.9	80.9	81.7	82.0
Unemployment rate aged 20-64 (%)	3.6	3.1	3.1	3.1	3.1
Population aged 65+ over total population (%)	11.2	11.8	14.8	18.4	26.2
Real interest rate (%)	3.0	3.0	3.0	3.0	3.0

* Please refer to Annex 3 for the definition of pensions used in these projections. The methodology adopted when projecting forward the assets of the National Pensions Reserve Fund is also described in this Annex. Details of the underlying assumptions and the methodologies covering the remaining projection categories are set out, respectively, in the 2005 and 2006 publications of the EU Economic Policy Committee and the European Commission.

The projections presented in Table 13 indicate that age-related public spending will rise significantly between 2005 and 2050. The main features of the results are as follows:

- Spending on pensions is expected to increase to 11.1% of GDP in 2050, more than twice the corresponding 2005 figure of 4.6%.
- The majority of the projected increase in pension spending is accounted for by the Social Security component of the pension system. Most notably, spending on the ‘Old-Age and Early pensions’ category, which covers pensioners who are aged 65/66 and over, is set to rise from 2.3% of GDP in 2005 to 7.1% in 2050.
- Public Service pensions are projected to increase by 1.5% of GDP over the period 2005 – 2050.
- Expenditure on health and long-term care trends upwards over the projection timeframe and is expected to account for 8.4% of GDP in 2050.
- The results suggest that there is some potential for minor savings in relation to education and unemployment benefit spending (0.9% of GDP in 2050).
- Projections for the value of the National Pensions Reserve Fund as a percentage of GDP rise steadily to 26% by 2030, before falling back to 21.9% in 2050.

Long-term expenditure projections of this nature were previously undertaken by the Department of Finance and published as part of Ireland's 2005 Stability Programme Update. Allowing for differences in methodology and coverage, the change over the period 2005 – 2050 in the total age-related spending estimates presented by the Department of Finance (9.2% of GDP) is broadly in line with that set out above (8.1% of GDP).

Clearly, the demographic shift to an older population will have significant budgetary implications. As the above projections illustrate, this trend could lead to an increase of more than 50% in age-related expenditure as a percentage of GDP. In 2005, such spending amounted to approximately €23 billion. However, by 2050, the corresponding figure will be almost €9 billion higher in 2005 terms[14]. In this context, Ireland's ability to safeguard the public finances over the longer term will depend on the implementation of appropriate and timely policy responses. To date, a wide variety of Government initiatives aimed at easing age-related spending have been introduced. These are discussed in Section 6.4.

6.3 Sustainability Implications of Ageing

On the basis of the above projections, the European Commission considers Ireland to be at 'medium risk' when it comes to the long-term sustainability of the public finances. Put in simple terms, the analysis carried out the Commission indicates that Ireland would need to run substantial surpluses in the medium-term to cope with the long-term costs of ageing. This implies that the potential funding gap, as measured by the Commission's sustainability indicator, would have to be met by a reduction in spending elsewhere or by increases in taxation[15]. Such policies would in turn affect the actual growth rate of the economy.

For this reason, the current consideration of pension policy, from a fiscally sustainable perspective, will need to cover not only the scope and adequacy of benefits, but also pension funding arrangements and the retirement age in general.

6.4 Policy Strategy

The importance of ensuring that the economy will be in a position to meet anticipated long-run fiscal pressures has become embedded in the Irish policy making process. Reflecting this, a wide range of initiatives which are designed to take into account long-term spending pressures and the welfare needs of older members of society into the future, have been introduced. An overview of implemented and ongoing interventions and reforms is provided below.

The National Pensions Reserve Fund: The NPRF was established in 1999 with the aim of pre-funding in part, the future Exchequer cost of social welfare and public service pensions. A statutory obligation has been placed on the Government to pay a sum equivalent to 1% of GNP from the Exchequer into the Fund each year until at least 2055. Drawdowns are prohibited prior to 2025. On the basis of a set of assumptions governing the manner of drawdown (for which there are no set legislative rules as of yet) and the rate of interest, Table 13 provides projections for the average value of the fund out to 2050.

A major reform of public service pension provision: Underway since 2004, reforms implemented so far have, in relation to most new public servants, allowed for the raising of the minimum pension age from 60 to 65 and for removal of a compulsory retirement age for most new public servants (these measures are expected to have a positive impact on future labour supply). A cost-neutral early retirement scheme with actuarially reduced benefits (facilitating improved labour mobility) has also been introduced. In due course, further measures will be brought before Government for consideration and decision. Upon its completion, it is anticipated that the overall reform package will ensure a sustainable public service pensions position.

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[14] Expressing age-related spending in 2050 in 2005 terms implies a present value cost of approximately €32 billion (using a 3% discount rate).

[15] Please refer to Annex 3 for a definition of the sustainability indicator used by the European Commission.

The introduction of Personal Retirement Savings Accounts: Aimed at encouraging supplementary pension coverage, these saving accounts are currently being offered to consumers by the pensions industry. The Government's intention is to raise coverage to 70% of the workforce aged 30 and over. The QNHS 'Module on Pensions' published by the CSO for the first quarter of 2005, indicates that coverage for the target group amounted to 59%, the same as in quarter one of 2004.

Tax incentives for private pension provision: A series of significant tax incentives have been introduced for the purpose of promoting pension provision amongst the self-employed, employers in non-pensionable employment and proprietary directors. These incentives are aimed at encouraging individuals to plan for pension provision early on in their careers.

SSIA pension incentive scheme: The Finance Bill 2006 announced a new incentive scheme to encourage individuals on low incomes to invest money from their Special Savings Incentive Accounts (SSIAs) into pensions. Further incentives for individuals who have under-funded their pension in the past, but wish to improve their position as they near retirement, were also announced.

Green Paper on Pensions Policy: Under the social partnership agreement 'Towards 2016', the Government has committed itself to the publication of a Green Paper on Pensions Policy. This Paper will outline the major policy choices and challenges facing Ireland's pension system, having considered the views of the social partners and other stakeholders. In response to the consultations that will follow the publication of the Green Paper, and within twelve months of the ratification of 'Towards 2016', a framework for comprehensively addressing the pensions agenda over the longer term will be put forward by Government.

National Pensions Review: In January 2006, the 'National Pensions Review' which included, inter alia, a review of current coverage and adequacy, an examination of alternatives to the existing system and recommendations for consideration by Government, was published. On foot of the Review, the Minister for Social and Family Affairs requested the Pensions Board to carry out a technical examination of the practical issues associated with a mandatory pension system. The resultant report 'Special Savings for Retirement' was published in August 2006.

Actuarial review of the Social Insurance Fund: The latest review has commenced and is expected to be completed by mid 2007.

Health Service Reform Programme: The Health Service Reform Programme announced in June 2003 aims to create 'a health service that provides high quality care, better value for money and improves health care management'. Implementation of the various reform measures is proceeding. The establishment of the Health Information and Quality Authority (HIQA) is the final major piece of the reform infrastructure.

Financing long-term care: An Interdepartmental Group on Long-Term Care was established in January 2005 and has reported to Government. The Government and social partners have agreed on a number of principles as to the future direction of policy, which are reflected in the new social partnership agreement *'Towards 2016'*.

Provision of childcare: A National Childcare Strategy was announced in Budget 2006, comprising the Early Childcare Supplement, National Childcare Investment Programme and extending maternity leave (paid and unpaid). These measures reinforce the Government's commitment to limiting cost pressures and increasing the number of facilities available to parents so as to support female labour force participation.

Chapter 7 – Institutional Features of Public Finances

7.1 Introduction

This Chapter sets out developments in relation to reform of the Estimates and Budgetary Process and in relation to recent improvements in the arrangements for managing public expenditure. These reforms and improvements will enhance the quality of public expenditure management and public accountability.

7.2 Reform of the Budgetary and Estimates Process

Budget 2006 proposed a reform of the Budgetary and Estimates Process designed to improve accountability to Parliament regarding value for money while retaining the right and duty of the Government to direct and manage the budgetary process.

The first step in the reform process was the publication of the *Pre-Budget Outlook* (PBO) in October 2006. The new publication replaced the Economic Review and Outlook that had been published in previous years. It set out the contextual framework within which Budget 2007 was prepared by updating the Budget 2006 economic and fiscal projections, not only for the current year but also for the following two years. Therefore, the publication of the PBO improves the transparency of the process for framing the annual Budget. It marks a step in modernising the budget process by providing improved and more relevant information to the public and their representatives.

From 2007, the Minister for Finance will engage each Spring with the Finance and Public Services Committee on the economic and fiscal background to the current and following two budgets as set out in the Stability Programme Update.

Also from 2007, Ministers will produce annual output statements to accompany their Estimates giving information on performance. From 2008 these output statements will include information on outturns against targets.

After the Revised Estimates Volume for 2007 is presented to the Dáil in February 2007, individual Ministers will present the first Annual Output Statement of their Departments to the relevant Oireachtas Committee for their consideration of the Department's Estimates. The output statement will set out the high level goals of the Departments and Offices as contained in their strategy statements. It will set out for each goal the programmes and key strategies being followed to achieve the goals. It will give the key output targets for each programme. After these individual examinations, the Finance and Public Services Committee will co-ordinate the preparation of a report to the Dáil on the deliberations of the Committees.

Preparations in Departments for the production of their Annual Outputs Statement are advancing. It is expected that the initial annual outputs statement will be improved over time through iteration and interaction with the Committees.

7.3 Multi-Annual Capital Investment Framework

The 5 year rolling multi-annual capital envelopes for public investment introduced in 2004 were further embedded in 2006 and their operation improved. A 5 year capital envelope is not being published in Budget 2007 because the National Development Plan 2007 – 2013 which will be published in January 2007 will set out an investment framework and strategy for the next 7 years.

Public Private Partnerships

There is a provision of €264 million for PPP/NDFA capital funded by unitary payments from the Exchequer in 2007. The NDP 2007 – 2013 will set out a 7 year investment framework which will include targets for PPP projects.

Legislation has been published to give effect to the July 2005 Government decision to consolidate the relevant skills and capacity required to support PPP procurement in the Central Government area into a specialised "Centre of Expertise", located in the National Development Finance Agency (NDFA). The Centre of Expertise will undertake the procurement of projects on behalf of Departments /Agencies (with the exception of roads and rail areas and the environment area where existing arrangements will continue to apply).

The decision of Government to establish a Centre of Expertise in NDFA for the procurement of PPPs aims to give impetus to the PPP process and increase deal flow.

Management of Capital Programmes
Under the general conditions of sanction for the multi-annual capital envelopes, Departments and agencies are required to comply in all cases with the Department of Finance guidelines for the appraisal and management of capital projects, public procurement and value for money requirements. Departments and agencies must put in place systems to report regularly to their management on the evaluation of projects prior to approval, and on progress on the management of capital projects and capital programmes. They must also arrange to carry out spot-checks for compliance with the capital appraisal guidelines and report on these and on progress generally under their capital envelopes to the Department of Finance.

Content of Capital Appraisal Guidelines
All projects under capital programmes or included in business plans must be subject to project appraisal under the Department of Finance Capital Appraisal Guidelines as amended by the Department of Finance VFM circular of 25 January 2006.

The main requirements are:

- Projects involving minor refurbishment works, fit outs etc. with a value of less than €0.5 million will undergo a simple assessment.

- Projects between €0.5 million and €5 million will be the subject of a single appraisal, comprising elements of preliminary appraisal (to determine if a project justifies more detailed consideration) and detailed appraisal (a detailed assessment to determine if a project should go to planning and implementation stages).

- A preliminary appraisal and a full detailed appraisal will be carried out for all projects costing over €5 million. These larger projects will undergo a more sophisticated analysis with projects over €30 million being required to undergo a full cost benefit analysis at detailed appraisal stage.

- All capital programmes with an annual value in excess of €50 million and of 5 years duration or more are required to be evaluated at the beginning and mid-point of each 5 year cycle, unless otherwise agreed with the Department of Finance. Formal structures for the monitoring and management of investment programmes to include the appointment of a programme co-ordinator and a monitoring committee must also be put in place.

- The new guidelines also provide for a clearer definition of the respective roles and responsibilities of all involved in the management and appraisal of capital programmes and projects: Government, Ministers, the Department of Finance, Government Departments and public bodies.

- An individual must be appointed Project Manager to manage each major project.

- Departments and Offices must report on progress on major projects against budget and timescales in their annual reports.

- Peer review arrangements must be put in place for all major ICT projects.

Many major capital projects are now coming in within Budget and on or ahead of schedule

7.4 Procurement Management Reform including Construction Procurement

Procurement Management Reform

Effective and efficient procurement policies, procedures and practices in public sector bodies can have a significant impact on obtaining value for money in the purchase of goods and services by the State. The 2005 National Public Procurement Policy Framework requires that a process of procurement management reform should be one of the key strategic priorities of public service bodies. Procurement management reform aims to improve procurement policies and procedures through a process of analysis and planning. Public sector bodies are required to analyse their procurement structures and practices and adopt improved procurement practices and procedures though the development of a Corporate Procurement Plan. These plans should provide targeted and strategic direction to procurement planning in public bodies. The Department of Finance is providing practical assistance to public bodies in the development and completion of these plans.

Construction Procurement Reform

To help minimise cost overruns and to facilitate early project delivery, the Government agreed to introduce significant changes involving fixed-price lump-sum public sector contracts to complement the rolling multi-annual investment envelopes and to provide better value for money for the State. The changes involve introduction of new Standard Forms of Construction Contracts which will transfer appropriate risks to contractors who are best placed to manage them. A suite of four new Forms of Construction Contracts for public works comprising traditional (employer design) contracts for civil engineering and building works and "design and build" contracts for civil engineering and building works has been developed. The contract conditions are designed to provide for optimal risk transfer to help achieve greater cost certainty, better value for money and timely and more efficient delivery of public works projects. Under the new arrangements, the contract price should remain firm and fixed for three years.

In conjunction with the development of the new construction contracts Standard Conditions of Engagement for Construction Consultants have also been developed. These Conditions and associated guidance are structured and balanced in a way that incentivises more efficient and effective consultant performance to better protect the public interest. The Conditions also change the fee payment mechanism by introducing competitive bidding on a fixed price lump sum basis as the norm while not compromising on quality.

The implementation of the new contracts and arrangements will commence in 2007.

7.5 Value for Money from Public Expenditure

Building on the reforms outlined above, the Government introduced the Value for Money and Policy Review initiative in June 2006. The Value for Money and Policy Reviews include formal Reviews for the period 2006 – 2008 already agreed to be carried out under the old Expenditure Review Initiative as well as all other Policy Reviews conducted and commissioned by Departments which impact on value for money. Under these new arrangements, the Government have approved some 90 formal Value for Money Reviews to be carried out by Departments and Offices for the period 2006 – 2008. Each Department's and Office's programme of formal reviews will focus on significant areas of expenditure and major policy issues and will, as a general rule, have a minimum indicative coverage of 10-15% of their respective Budgets. All formal Value for Money Reviews must be published and submitted to the relevant Select Oireachtas Committee for consideration. Other policy reviews which impact on Value for Money will also generally be published and submitted to the relevant Select Committee.

In addition, a Central Expenditure Evaluation Unit has been established in the Department of Finance, to promote best practice in the evaluation, project appraisal and compliance by Departments and Agencies with value for money requirements. It will focus in particular on ensuring that Department of Finance frameworks in relation to the appraisal and management of programmes and projects are being implemented, and overseeing ongoing Programme evaluation under the Value for Money and Policy Review initiative. It will also co-ordinate programme evaluation under the forthcoming National Development Plan 2007 – 2013.

7.6 Public Service Pay – Modernisation and Service Delivery

The new Social Partnership Agreement, ***Towards 2016***, is the seventh such agreement since the Social Partnership process began in 1987. Significantly, in terms of economic and social developments, the Agreement takes a ten-year perspective. The pay and related elements will be reviewed more regularly - the initial pay agreement covers 27 months.

General Public Service Pay Trends

On public service pay, the more recent national agreements have restored stability to the pubic service industrial relations scene. The year-on-year level of increase in the Exchequer pay bill is coming down, from 18% in 2001 to 8.4% in 2006 and a projected increase of some 7.3% in 2007.

Public Service Pay Deal and link to Modernisation

The new public service pay agreement provides for a pay increase of 10% over a twenty seven month period with an initial five months' pay pause. This increase is to apply as follows:

- 3% from 1 December 2006;
- 2% from 1 June 2007;
- 2½% from 1 March 2008; and
- 2½% from 1 September 2008.

What was critically important for the Government was that these pay increases are linked to a robust agenda of measures to improve the effectiveness and efficiency of public services. The agreement provides for this.

The payment of the pay increases is dependent, in the case of each sector, organisation and grade, on verification of co-operation with flexibility and ongoing change, including co-operation with satisfactory implementation of the agenda for modernisation set out in the Agreement, maintenance of stable industrial relations and absence of industrial action in respect of any matters covered by the Agreement. Payment is dependent on verification of satisfactory achievement of these provisions.

Modernisation

For more than ten years a programme of modernisation of each sector of the public service has been under way. This has been underpinned by legislation and by putting in place several important innovations such as performance management development systems, management information systems and quality customer service initiatives. This process has resulted in real improvements in public services and there is now a well-established acceptance by public servants of the need for co-operation with further modernisation and flexibility. These improvements, and the extent of co-operation being delivered, have been verified by the sectoral groups which were set up to assess if the pay increases under the previous agreement, *Sustaining Progress*, were warranted.

Under the new agreement, a performance verification process, broadly similar to that which operated under Sustaining Progress, has been put in place to ensure that modernisation targets are met and appropriate action is taken where they are not, including, where appropriate, the non-payment of increases under this Agreement. The modernisation measures now agreed are designed to ensure that work is organised such that high quality services are delivered to the public. A particularly important development is the proposed increase across the public service of open recruitment at senior levels as a means of gearing public service organisations up for the challenges ahead, including coping with an increasingly aging workforce. There will also be greater use of competitive processes for promotion purposes and a range of measures to streamline terms and conditions and to support better mobility and workforce planning. Other key points are:

- Agreement on greater scope for contracting out of services.
- There will be co-operation with the introduction of shared services between public service and related organisations.
- Discussions will be held to give effect to the commitment to the provision of certain services outside normal hours.
- Staff redeployment, as a means of addressing emerging work needs, is accepted and there is agreement to team and cross-organisational working.

There are other measures specific to different sectors of the public service.

There is also to be progress on measuring performance across the public service through the use of performance indicators, the realisation of the potential for shared services and the phasing out of outdated work practice arrangements.

7.7 Public Sector Numbers

The Government remains committed to controlling public sector numbers as part of its approach to managing public expenditure and securing better value for money, but the policy is not being implemented indiscriminately. The Government has consistently taken the line that priority must be given to frontline and essential services.

The numbers in the civil service, the local authority, defence and non-commercial semi-state sectors have been held below agreed ceilings but increases have been allowed in frontline staff in the key areas of Health and Education to improve the delivery of important services to the public and to meet the Government commitment to increase Garda numbers to 14,000.

7.8 Decentralisation

Progress continues to be made towards implementing the Government's decision on public service decentralisation under the auspices of the Decentralisation Implementation Group (DIG). To date (October 2006) decentralising organisations have established a presence in 12 new locations and over 2,300 staff have been assigned to decentralising posts, many of whom are currently being trained in their new post prior to relocation. It is expected that decentralising Departments and Offices will have a presence in a total of 29 new locations around the country by the end of 2007. The property programme is well advanced. Property acquisition negotiations have been completed or significantly advanced in 35 locations. Discussions have concluded on a number of human resource and industrial relations matters and are being progressed on other issues. All Departments and Offices have produced implementation plans setting out the detailed arrangements they are putting in place to plan for relocation while also ensuring business continuity and effective delivery of services to customers. In the case of State agencies, a more individualised approach is recommended by the DIG. New applications to decentralise continue to be received. A facility is being operated to allow general service civil service staff remaining in Dublin to express preferences in relation to the organisations to which they would like to transfer.

ANNEX 1: Basic Assumptions

Table 14 – Basic Assumptions

	2006	2007	2008	2009
USD/€ exchange rate	1.25	1.27	1.27	1.27
Nominal effective exchange rate (% change)	0.5	0.4	0.1	0.1
World GDP growth (excl. EU) (%)	5.7	5.2	5.2	5.2
EU25 GDP growth (%)	2.8	2.4	2.4	2.4
Growth of relevant foreign markets (%)	9.9	6.4	6.1	6.1
World import volumes (excl. EU) (%)	9.1	8.3	7.9	7.9
Oil Prices (Brent, USD/Barrel)	65.6	66.3	68.0	68.0

Source: European Commission

ANNEX 2: Supplementary Data

(In accordance with the guidelines on the format and content of Stability and Convergence Programmes. Indicators in bold are compulsory data).

Table 1a – Macroeconomic Prospects

	2005 Level	2005 rate of change	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change
Real GNP	130,932	5.3	5.7	5.3	4.6	4.0
Nominal GNP	135,914	9.3	9.5	8.5	7.8	6.9
Real GDP	155,723	5.5	5.4	5.3	4.6	4.1
Nominal GDP	161,163	9.2	9.0	8.1	7.6	6.8
Components of real GDP						
Private consumption expenditure	73,282	6.6	6.5	7.3	4.8	4.1
Government consumption expenditure	21,751	4.6	3.6	3.7	3.5	3.4
Gross domestic fixed capital formation	40,869	12.8	6.8	5.4	3.8	2.5
Changes in stocks (% GDP)	166	0.1	0.2	0.2	0.2	0.2
Exports of goods and services	128,861	3.9	4.8	4.9	4.6	4.5
Imports of goods and services	108,710	6.5	5.9	6.2	4.3	3.9
Contributions to real GDP growth*						
Final domestic demand	-	6.8	5.4	5.4	3.9	3.1
Changes in stocks	-	-0.1	0.2	0.2	0.2	0.1
External balance of goods and services	-	-1.3	-0.2	-0.3	0.6	0.9

* Figures subject to rounding
Source: CSO (2005), Department of Finance (2006 – 2009)

Table 1b – Price Developments

	2005 rate of change	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change
GDP deflator	3.5	3.4	2.7	2.8	2.6
HICP	2.2	2.7	2.6	2.0	1.7
CPI	2.5	4.0	4.1	2.4	2.0
Export price deflator (goods and services)	1.6	2.7	2.0	2.2	2.3
Import price deflator (goods and services)	1.7	2.8	2.1	1.8	1.8

Source: CSO (2005), Department of Finance (2006 – 2009)

Table 1c – Labour Market Developments

	2005 Level	2005 %	2006 %	2007 %	2008 %	2009 %
Employment, persons	1,952,000	4.7	4.4	3.5	2.1	1.6
Unemployment rate (%)	89,000	4.3	4.4	4.4	4.5	4.6
Labour Productivity, per employee (GDP)	-	0.8	0.8	1.7	2.5	2.5

Source: CSO (2005), Department of Finance (2006 – 2009)

Table 1d – Sectoral Balances

	2005 % of GDP	2006 % of GDP	2007 % of GDP	2008 % of GDP	2009 % of GDP
Net lending/borrowing vis-à-vis rest of world	-2.6	-3.4	-4.3	-4.0	-3.5
Statistical discrepancy	0.0	-	-	-	-

Source: CSO (2005), Department of Finance (2006 – 2009)

ANNEX 3: Age-Related Projections: Definitions and Methodology

Definitions

Pension expenditure: The Economic Policy Committee's (EPC) definition of pensions is as follows: 'Pensions should cover pensions and equivalent cash benefits granted for a long period (over one year) for old age, early retirement, disability, survivors and other specific purposes which should be considered as equivalents or substitutes for above-mentioned types of pensions, i.e. pensions due to reduced capacity to work or due to labour market conditions'.

Social Security 'Old Age and Early pensions': This category covers Old Age Contributory, Retirement, Old Age Non-Contributory, Widow / Widower's Contributory, Widow / Widower's Non-Contributory, Invalidity, Carers, Blind Persons and Lone Parent pension payments to those aged 65/66 and over. Direct recipients of these payments are included in the model along with the number of adult dependants covered under the Old Age Contributory, Retirement and Old Age Non-Contributory schemes. In line with the EPC definition of pensions, non-cash benefits such as telephone rental and fuel allowances that can be claimed by persons aged 66 years and over are not modelled.

Social Security 'Other pensions': Widow / Widower's Contributory, Widow / Widower's Non-Contributory, Carers, Blind Persons, Disability, Pre-Retirement and Invalidity pension payments to individuals aged 65 and under are covered by this heading. As above, direct recipients are included.

S2 Sustainability Gap Indicator: S2 represents the size of the permanent budgetary adjustment required to fulfil the inter-temporal budget constraint over the infinite horizon. In other words, it measures by how much revenue needs to rise, or non-age related spending fall, so that the present value of revenue is equal to the present value of spending over an infinite horizon, taking into account the current level of debt.

Projections Methodology

Expenditure Projections: The methodologies used in projecting forward the various categories of age-related expenditure can be found in the 2006 report by the Economic Policy Committee and the EU Commission, 'The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004-2050)', and in the accompanying description of Ireland's pension model[16].

National Pensions Reserve Fund: In projecting forward the average net assets of the NPRF, the starting point is its value at 31 December 2004. The fund is rolled forward by assuming a real interest rate of 3% and by allowing for the continuation of Exchequer contributions amounting to 1% of GNP until 2055. While withdrawals are permitted to begin in 2025, there are no set legislative rules as of yet governing the manner of drawdown. In line with the approach of the Pensions Board, it is assumed that post 2025 drawdowns increase from an initial level (which is set at 0.1% of GNP) in line with the increase in the population aged 65 and over from the 2025 base figure. In addition, the drawdown level as a percentage of GNP is assumed to peak in 2055 before being scaled back so as to lead to the exhaustion of the Fund by 2070.

[16] http://ec.europa.eu/economy_finance/epc/epc_sustainability_ageing_en.htm.