

# **Ireland – Stability Programme Update**

**December 2005**

## **Foreword**

*This document updates Ireland's Stability Programme. It includes macroeconomic projections up to 2008 and takes account of the measures adopted in Budget 2006.*

*This Update has been prepared in conjunction with Budget 2006 and is being presented to Dáil Éireann on Budget Day, 7 December 2005. As such, it also provides the economic background to Budget 2006.*

*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.*

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<sup>1</sup> 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 objective of the Government's economic and fiscal policies is to attain a sustainable rate of economic growth to facilitate full employment, improvements in living standards and a more socially inclusive 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. Delivering further improvements to families and to those on low incomes;
4. Enhancing public services and value for money;
5. Reducing the infrastructural deficit to secure future economic growth;
6. Maintaining sustainable public finances and keeping debt low to deal with population ageing in the future.

The Government considers that a stable macroeconomic environment and, in particular a commitment to sound public finances and the maintenance and improvement of 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 be in a position to meet anticipated fiscal pressures, including those arising from the ageing of the population.

### **1.1 Economic Outlook**

Notwithstanding a number of significant downside risks, the international environment for the Irish economy is projected to be broadly favourable over the next couple of years, based on the recent projections of the European Commission, the OECD and the IMF. Growth in the US and in Asia is expected to remain robust with a pick-up expected in the euro area and the wider EU economy over 2006 and 2007.

Against this favourable international backdrop, allied with strong momentum in domestic demand, the Irish economy should expand at a rate of between 4½% and 5% over the 2006 to 2008 period. The labour market is projected to continue to perform strongly with, on average, employment projected to increase by just under 2½% and the unemployment rate remaining below 4½% over the period. Inflation should remain moderate at an average rate of just under 2% in EU terms, broadly in line with the euro area average.

### **1.2 Budgetary Stance**

The projected budgetary position over the period 2006-08 is for a General Government budget deficit of 0.6% of GDP in 2006 followed by deficits of 0.8% in 2007 and 2008. The underlying (structural) budget balance, with a surplus of about ¼% in 2006 and averaging 0.2% for the period 2006-08, 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 2006-08 period. The debt-to-GDP ratio will be maintained at the second lowest in the euro area – around 28% for the forecast period – in line with the Government's long-term priorities outlined above. The market value of the assets of the National Pensions Reserve Fund is estimated to be 9.4% of GDP at the end of 2005.

**Table 1 – General Government Balance and Prospective Debt Ratio**

% of GDP	2005	2006	2007	2008
General Government Balance	0.3	-0.6	-0.8	-0.8
Cyclically-adjusted Balance	0.8	0.2	0.1	0.2
Debt Ratio (year end)	28.0	28.0	28.2	28.3

Source: Department of Finance

## **Chapter 2 – Economic Outlook**

### **2.1 Summary<sup>2</sup>**

The economy has continued to perform strongly in 2005 and growth is estimated at 4.8% in GNP terms and 4.6% in GDP terms. The outlook for the period 2006 to 2008 is a positive one, given projections of a broadly favourable international environment and strong momentum in the domestic economy. Against this backdrop, the economy is projected to grow by between 4½% and 5% over the forecast period. However, a number of external and domestic risks attach to this forecast. Table 5 on page E10 summarises the macroeconomic prospects for 2006-2008.

**Table 2 – Summary of Economic and Budgetary Indicators: 2000-2005**

% volume change unless otherwise indicated	2000	2001	2002	2003	2004	2005
GNP	9.5	3.9	2.7	5.1	4.0	4.8
GDP	9.2	6.2	6.1	4.4	4.5	4.6
Private consumption	8.6	5.6	3.5	3.4	3.8	5.3
Government consumption	8.2	10.6	7.4	3.5	2.4	3.2
Gross domestic fixed capital formation	7.3	-0.2	3.7	5.6	8.0	7.9
Exports of goods and services	20.2	9.3	4.0	0.8	7.0	2.0
Imports of goods and services	21.6	7.3	1.8	-1.4	7.6	3.0
Consumer Price Index (% change)	5.6	4.9	4.6	3.5	2.2	2.5
Harmonised Index of Consumer Prices	5.2	4.0	4.7	4.0	2.3	2.2
Unemployment (% of labour force)	4.3	3.9	4.4	4.6	4.4	4.3
Employment (% change)	4.8	3.1	1.8	1.9	3.0	4.7
Employment change ('000)	78	53	32	34	54	89
General Gov. Balance (% GDP) *	4.4	0.8	-0.4	0.2	1.4	0.3
General Gov. Debt (% GDP)	37.8	35.3	32.0	31.0	29.4	28.0

\* Deficit (-) / Surplus (+).

Source: 2000-2004 CSO except for public finance figures which are produced by the Department of Finance. 2005 figures are Department of Finance estimates.

### **2.2 The Economy in 2005**

While the economy is expected to grow relatively strongly in 2005, the composition of growth differs from that projected in the last update. The domestic economy has been the main driver of activity in 2005, while the contribution from net exports has been less than previously anticipated. As a result, GNP growth is projected to be marginally higher than GDP growth. National accounts data for the first half of 2005 show that the economy grew, on an annual basis, by 3.4% in GNP terms and 3.1% in GDP terms. The data show a strong pick-up in domestic demand, with the pace of personal consumption continuing to accelerate from a moderate rate of expansion in recent years. Investment continued to grow strongly, expanding by almost 10% in the first half of 2005. Exports were sluggish in the first half of the year, declining by 0.6% on an annual basis. Reflecting the import-intensive composition of domestic demand growth, import growth has outstripped that of exports in 2005, growing by 2.4% in the first half of the year.

#### **External Developments**

Although somewhat lower than in 2004, growth in the world economy has remained strong in 2005, with only a limited impact evident from higher energy prices. Growth has remained strong this year

<sup>2</sup> The analysis here is based on data available up to end-November 2005, and on the European Commission's assumptions regarding the external environment that are set out in the Annex.

in the US and China. More recently, the recovery in the Japanese economy seems to have become established while the euro area economy appears to be strengthening.

GDP growth in the US has held up well in 2005, notwithstanding the impact of hurricanes and pressure on households due to oil price and interest rate increases, and is projected to expand by 3.5% in 2005 compared to 4.2% in 2004 (European Commission figures). Growth in Asia remained very strong, particularly in China, with the Japanese economy performing better than expected. Following disappointing growth in the first half of 2005, euro area GDP picked-up in the third quarter and is forecast to average 1.3% for the year as a whole, compared to 2.1% last year. In the UK - an important trading partner for Ireland - domestic demand slowed down markedly and GDP growth declined sharply from 3.2% in 2004 to 1.6% in 2005.

### **Domestic Demand**

Domestic demand has been the main driver of growth this year. Reflecting strong growth in employment and earnings and continued low interest rates, personal consumption rose by 5.0% in the first half of 2005, compared with a more modest increase of 4.1% in the same period last year. For the year as a whole, personal consumption is expected to increase by 5.3%, the highest rate of growth since 2001.

Public expenditure is expected to come in broadly on target in 2005. Reflecting this, public consumption is projected to increase by 3.2% in volume terms this year.

Investment activity has been strong in 2005, particularly in the areas of housing and machinery and equipment. Total housing output for 2005 is estimated to be around 79,000 units, marginally ahead of output in 2004. There is some evidence of moderation in house price growth, with the main house price index rising by 6.8% in the first 10 months of 2005 compared to 8.1% over the same period last year. Purchases of machinery and equipment grew very strongly in the first half of the year and are expected to expand by over 15% for the year as a whole. In overall terms, total investment is forecast to grow by 7.9%.

### **Exports of Goods and Services**

One of the most notable features of the economy in 2005 has been the poor performance of exports of goods and services. In the first half of the year exports fell in volume terms by 0.6%, compared with an increase of 10.4% in the first half of 2004. The weakness in goods exports can partially be attributed to sector specific factors, in particular a poor performance in some parts of the manufacturing sector. The strength of the euro in the early part of the year may have affected performance, compounding competitiveness losses over recent years. In a break with the trend evident over recent years, services exports were also unusually weak in the first half of 2005.

However, the performance of merchandise exports appears to have accelerated in the second half of the year, increasing by 4.2% in value terms on an annual basis in the quarter ending September. Allied with the depreciation of the euro in the second half of the year, a pick up in export growth is anticipated. For the year as a whole, exports of goods and services are projected to increase by 2.0% in real terms.

### **Final Demand and Imports**

Final demand is projected to rise by 3.9% in 2005. Imports of goods and services are expected to rise by 3.0%, compared with an increase of 7.6% in 2004.

### **Balance of Payments**

The current account for the first half of 2005 was in deficit to the tune of €2.6 billion, a deterioration of almost €1.9 billion on the same period last year. This reflects the strength of import demand (due to strong growth in domestic demand, particularly in import intensive areas such as consumption and machinery and equipment investment) and the subdued performance of both goods and services exports. For the year as a whole, the current account balance is forecast to record a deficit of 2.4% of GDP.

## Employment and Earnings

Employment has grown very strongly in 2005 with an increase of 87,200 (4.7%) in the first three quarters of the year. Construction and services employment were particularly buoyant, reflecting the strength of domestic demand. Employment growth was almost matched by an increasing labour force due mainly to substantial migration, mainly from the new EU Member States, and rising participation rates, particularly amongst females. For the year as a whole, total employment is expected to rise by 89,000 (4.7%), while the unemployment rate is expected to average 4.3%.

Sectoral data point to relatively robust earnings growth in the first half of 2005. The strongest rate of growth was in the construction sector, where hourly earnings were 7.2% higher than in the first half of last year. In the public sector, weekly earnings rose by 5.9% year-on-year in the first half of 2005, while earnings in the banking, insurance and building societies sector were 5.2% higher over this period. Elsewhere in the economy the rates of increase were more modest. In the industrial sector, hourly earnings rose by 3.5% in the first half of the year, while in the distribution and business services sector, which includes those employed in retail, wholesale, accommodation, etc., annual weekly earnings growth averaged 3.3%. On the basis of these data, non-agricultural earnings per head are forecast to rise by 5.0% in 2005.

## Gross Domestic Product and Gross National Product

In overall terms, GDP is projected to grow by 4.6% in 2005, with GNP growth marginally stronger at 4.8%. However, a degree of uncertainty attaches to these forecasts given the diverging indications evident from employment data and other indicators of economic activity for the year to date.

**Table 3 – Economic Indicators 2005: Budget Forecast and Estimated Outcome**

	<b>2005 Forecast (December 2004)</b>	<b>2005 Estimate (December 2005)</b>
GNP (% volume change)	4.7	4.8
GDP (% volume change)	5.1	4.6
Consumer prices (% change)	2.5	2.5
Unemployment rate (% labour force)	4.4	4.3
Employment growth ('000)	35	89
Employment growth (%)	1.9	4.7

Source: Department of Finance

## **2.3 Macroeconomic Projections: 2006-2008**

### Overview

With the pace of activity picking-up through 2005, the economy will enter 2006 with significant momentum. The external environment appears to be broadly positive, with international forecasting agencies projecting continued strong growth in the world economy over 2006 and 2007 and in particular a pick-up in the euro area. In the domestic economy, underlying conditions remain supportive and activity will receive a boost from factors such as the maturing of the SSIA<sup>3</sup> accounts. Against this essentially favourable background, GNP is expected to increase by about 4.7% on average, and GDP by 4.9%, over the 2006 to 2008 period.

These forecasts are based on EU Commission technical assumptions regarding key external variables and developments in our major trading partners (see Annex 1). As a small open economy, Ireland is vulnerable to changes in the world economic outlook. In this context, a number of significant downside risks attach to the international outlook including:

<sup>3</sup> The Special Savings Incentive Account (SSIA) Scheme was introduced by the Minister for Finance in the Finance Act 2001 with the objective of encouraging individuals to adopt a regular savings pattern. There is a 25% contribution from the Exchequer on the monthly amount saved on SSIA's over the five year qualifying period.

- The possibility of a sharp dollar correction, leading to an appreciation of the euro, given the large and growing global current account imbalances;
- The possibility of renewed upward pressure on oil prices; and
- The risk that the projected pick-up in growth in the euro area fails to materialise.

On the domestic front there are also a number of downside risks. Given the loss of competitiveness in recent years, the economy is vulnerable to any further deterioration. In addition, the fact that the construction sector now accounts for a historically high share of economic activity and employment, implies that the economy is vulnerable to any shock affecting this sector.

### External Outlook

According to the Autumn EU Commission forecasts, the outlook for the international economy remains positive, although risks to the outlook have heightened since their Spring forecasting round. Oil prices are forecast to remain high in 2006 and as global imbalances continue to grow, the risk of a disorderly unwinding of the situation is heightened. The Commission's forecasts for GDP growth in key economies are set out in Table 4 below. Based on these forecasts, the Commission estimate that Ireland's export markets will grow by 5.7% in both 2006 and 2007, compared with an estimated 5.1% this year.

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

% volume change	2004	2005	2006	2007
Germany	1.6	0.8	1.2	1.6
France	2.3	1.5	1.8	2.3
Italy	1.2	0.2	1.5	1.4
Euro area	2.1	1.3	1.9	2.1
UK	3.2	1.6	2.3	2.8
EU15	2.3	1.4	2.0	2.2
EU25	2.4	1.5	2.1	2.4
US	4.2	3.5	3.2	2.7
Japan	2.7	2.5	2.2	1.8

Source: European Commission 2005 Autumn Forecasts

### Domestic Demand

Personal consumption is expected to continue to be a major driver of growth over the forecast period, supported by strong earnings and employment growth and overall low interest rates (reflecting the technical assumptions adopted). The maturing of the SSIA accounts is expected to provide some impetus to consumption, particularly in 2007, when the bulk of the proceeds become available. However, while it is difficult to be certain about the prospective impact of SSIA maturity on consumption economic analysis, the experience of the impact of similar schemes in other countries and other evidence would tend to support a view that it is unlikely that a once-off factor of this nature will have a lasting impact on overall consumption patterns. In 2006 growth in personal consumption is forecast to be 5.8%, accelerating to 6.8% in 2007. A slightly lower growth rate of 4.6% is expected in 2008 as the effect of the SSIA scheme unwinds.

Public consumption is forecast to increase by an average of 3.5% in real terms over the period 2006 - 2008.

Investment growth is projected to moderate from 7.9% in 2005 to 4.7% in 2006, mainly as a result of a small decline in housing output. A relatively soft landing is in prospect for the housing sector, with new house completions projected to decline by 2.5% in 2006 and by 5.0% in both 2007 and 2008. This will be offset by investment in other building and construction, including a significant increase in spending on the public capital programme. Investment in machinery and equipment is expected to grow steadily over the projection period, reflecting favourable domestic and external conditions. In overall terms, investment growth over the 2006-2008 period is forecast to decelerate, growing at an average rate of 4.3%.

### Exports of Goods and Services

The projected pick-up in exports of goods and services in the second half of 2005 should be carried forward into next year. Together with the forecast acceleration in Ireland's export markets in 2006 and a relatively favourable exchange rate (based on the technical assumptions adopted), it seems reasonable to project an improvement in export growth to 4.0% in 2006. A further modest acceleration to 4.3% is forecast for 2007 and 2008. This would represent a fairly muted performance compared to that in recent years, reflecting the continued impact of earlier losses in competitiveness.

### Final Demand and Imports

Final demand is forecast to increase by 4.7% in 2006, rising to over 5% in 2007 and moderating to 4.3% in 2008, reflecting the unwinding of the SSIA effects on personal consumption. Imports of goods and services will grow broadly in line with these developments, growing by an average of 4.5% over 2006-2008.

### Employment and Earnings

The outlook for the labour market remains favourable, although the rate of increase in employment over the forecast horizon is expected to be lower than the very strong expansion projected for 2005. In 2006, employment is forecast to rise by 60,000 (or just over 3%), with growth decelerating to about 2% in 2007 and 2008. Employment growth will be concentrated in the services sector. Full employment conditions are likely to prevail with the unemployment rate averaging 4.4% over the period. Average per capita earnings growth is projected to moderate slightly over the projection period.

### Gross Domestic Product and Gross National Product

In overall terms, GDP growth is projected to accelerate slightly to 4.8% in 2006 and to 5.0% in 2007, before easing back to 4.8% in 2008. Growth in GNP will be slightly below this (0.2%) in each year. As previously outlined, there are a number of domestic and external risks attaching to this outlook.

**Table 5 – Macroeconomic Prospects**

% volume change unless otherwise indicated	2005	2006	2007	2008
GNP growth at constant market prices	4.8	4.6	4.8	4.6
GNP at current market prices (€m)	134,475	144,650	155,800	167,350
GDP growth at constant market prices	4.6	4.8	5.0	4.8
GDP at current market prices (€m)	159,900	172,550	186,275	200,600
<b>Components of real GDP</b>				
Private consumption expenditure	5.3	5.8	6.8	4.6
Government consumption expenditure	3.2	3.5	3.5	3.5
Gross domestic fixed capital formation	7.9	4.7	4.5	3.7
Exports of goods and services	2.0	4.0	4.3	4.3
Imports of goods and services	3.0	4.5	5.2	3.7
<b>Price Developments</b>				
Consumer Price Index	2.5	2.7	2.5	2.2
Harmonised Index of Consumer Prices	2.2	2.0	2.0	1.8
<b>Employment</b>				
Unemployment (% of labour force)	4.3	4.3	4.4	4.5
Employment	4.7	3.1	2.2	1.9
Labour productivity <sup>4</sup>	-0.2	1.7	2.7	2.8

Note: Tables 1a, 1b, 1c and 1d as set out in the guidelines are enclosed at Annex 2 (pages E35-36)

Source: Department of Finance

<sup>4</sup> Growth of GDP per person employed

## **2.4 Inflation**

### **Developments in 2005**

In the first ten months of the year, inflation as measured by annual changes in the Consumer Price Index (CPI) averaged 2.4%. Goods price inflation averaged just 0.7% over this period while services sector inflation averaged 3.9%.

The annual rate of inflation picked up in the autumn, mainly due to the impact of higher oil prices, which resulted in higher prices for petrol, diesel and home heating oil. However, with some easing of oil prices on international markets recently, retail fuel prices have subsequently eased somewhat. Taking this into account, CPI inflation is forecast to average 2.5% in 2005.

In terms of euro area comparisons, the appropriate measure of inflation is the Harmonised Index of Consumer Prices (HICP), which differs to some degree from the CPI in terms of coverage. In 2004, the differential between Irish and euro area HICP inflation narrowed significantly to just 0.2 percentage points, the lowest gap since the beginning of monetary union. This pattern has continued in 2005, with little difference between the inflation performance in Ireland and the euro area. HICP inflation in Ireland is forecast to average 2.2% in 2005 compared to the EU Commission forecast for the euro area of 2.3%.

### **Prospects for 2006 and Beyond**

In 2006, the rate of CPI inflation is expected to average 2.7%, partly reflecting the carryover impact of increases in oil prices and also the impact of higher mortgage interest repayments following the increase in wholesale rates in December. On the basis of current assumptions (see Annex 1), the effects of higher oil prices should fall out of the annual comparison in the second half of next year. SSIA-related expenditure may have an impact on consumer demand next year and in 2007, and this may have a modest effect on services sector inflation. HICP inflation is forecast to average 2.0% next year, compared to the European Commission's forecast for the euro area of 2.2%. CPI inflation is forecast to remain moderate over the entire forecast period, averaging 2.5% over 2006-2008. HICP inflation is forecast to be slightly lower, averaging 1.9% over this period.

## **2.5 Range of Forecasts**

The following table compares the Department of Finance 2006 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 2006**

Forecaster	Publication	Annual % change			
		GDP	GNP	CPI	Employment
Department of Finance	<i>Budget 2006</i>	4.8	4.6	2.7	3.1
Central Bank of Ireland	<i>Bulletin No.4 2005</i>	4¾	4½	2¾	2.3
ESRI	<i>QEC Autumn 2005</i>	5.0	4.9	2.5	2.5
European Commission	<i>Autumn 2005</i>	4.8	-	2.5*	2.2
IMF	<i>Article IV Staff Report Oct 2005</i>	4.9	4.9	2.5*	1.7
OECD	<i>Outlook No. 78 November 2005</i>	5.0	-	2.5*	2.6

\*HICP (Harmonised Index of Consumer Prices)

Source: Department of Finance and institutions cited

## **2.6 Forecast Performance**

It is of interest to review the track record of the Budget economic forecasts against those of other forecasting agencies. In recent months both the IMF and the ESRI<sup>5</sup> have concluded that all forecasters of the Irish economy have, particularly in the 1990's, consistently underestimated economic growth, mainly due to upside growth surprises. This was most clearly the case for external demand, which is particularly difficult to forecast in a globally-integrated economy like Ireland.

The table below shows the average divergence between the outturn as measured by the CSO and the annual forecasts for the 1997 to 2004 period produced by a number of agencies, including the Department of Finance. The results, as measured by the 'error' level across the different agencies, are very similar. The spread may well be explained, at least in part, by the timing of publication and the availability of up-to-date information. Information availability constrains all forecasts, particularly as short-term forecasting does not readily lend itself to the application of econometric or model-based analysis. The main conclusion from this analysis is that performance of the official forecasts published on Budget day compare well against those of other forecasting institutions.

**Table 7 – Economic Forecast Performance 1997-2004**

<b>Forecaster</b>	<b>Publication</b>	<b>Divergence from Outturn<sup>6</sup></b>
Central Bank	<i>Winter Bulletin</i>	2.66%
ESRI	<i>Winter QEC</i>	2.92%
EU Commission	<i>Autumn Forecast</i>	2.57%
IMF	<i>WEO – Sept./Oct.</i>	2.80%
OECD	<i>Outlook – Nov. /Dec.</i>	2.62%
Dept. of Finance	<i>Budget</i>	2.59%

Source: Department of Finance

<sup>5</sup> *The Quarterly Economic Commentary Forecasting Record 1994 to 2004*, QEC Autumn 2005. *Ireland: Selected Issues*, IMF Country Report No. 05/370, October 2005

<sup>6</sup> Divergence from the CSO outturn is measured using Root Mean Squared Forecast Error.

## **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 basically sound.

The debt/GDP ratio is projected to be below 28.5% to end-2008, less than half the present EU average debt level of around 63% of GDP, and the second lowest in the euro area.

The outlook is for a General Government budget deficit of 0.6% of GDP in 2006 followed by deficits of 0.8% in both 2007 and 2008. These projected balances include the cost of infrastructural investment that is approximately twice the EU average over the period.

The underlying (structural) 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 key objectives of the Government with regard to budgetary and economic policy are:

1. Improving equity and opportunity;
2. Fostering employment and economic growth;
3. Delivering further improvements to families and to those on low incomes;
4. Enhancing public services and value for money;
5. Reducing the infrastructural deficit to secure future economic growth;
6. Maintaining sustainable public finances and keeping debt low to deal with population ageing in the future.

The formulation of medium-term budgetary policy in accordance with the requirements of the Stability and Growth Pact and the commitment made by the Heads of State and Government in March 2005 facilitates confidence, investment and growth, and thereby supports the Government objectives for employment, prosperity and balanced economic development. In particular, the growth of public expenditure must be kept broadly in line with underlying revenue growth, ensuring budgetary sustainability going forward. The Government is determined that Ireland's public finances should be in a good position to address emerging budgetary pressures over the longer term, including the budgetary consequences of an ageing population.

### **3.3 Actual Balances and Implications of Forthcoming Budget**

A surplus of 0.3% of GDP on the General Government Balance is currently projected in 2005, compared with a surplus of 1.4% in 2004 and a planned deficit of -0.8% for 2005 at the time of last year's Budget.

The bulk of the improvement in the forecast outturn GGB with respect to last year's Budget estimate can be explained by the following factors:

1. An excess in tax receipts of €1,800 million or 1.1% of GDP;
2. A net shortfall in expenditure of €300 million or 0.2% of GDP;
3. An improvement in the net deficit of the Local Government sector of €140 million or 0.1% of GDP;

4. An improvement in the net surplus of the Social Security sector of €100 million or 0.1% of GDP.

These improvements are partially offset by the inclusion of the full projected cost of the repayment of certain nursing home charges (€1 billion or 0.6% of GDP)<sup>7</sup>.

The 2005 General Government Balance was again significantly affected by once-off factors. In particular, Special Investigations by the Revenue Commissioners are expected to yield a non-recurring €500 million approximately (0.3% of GDP) this year, while the nursing home charges repayment is also a once-off. Excluding these, and other minor once-off factors, the underlying budget balance in 2005 is a surplus of the order of 0.6% of GDP.

A General Government deficit of 0.6% of GDP is planned for 2006, followed by deficits of 0.8% in 2007 and 2008. Ireland is expected to continue to have the second lowest debt-to-GDP ratio in the euro area with a ratio of 28.0% in 2006.

An ongoing programme of infrastructural investment is having a significant impact on the General Government Balance. In order to address acute infrastructural needs and provide a basis for growth in the medium-term, Ireland's investment in infrastructure is currently running well ahead of the EU average. If public investment in Ireland were at the EU average level, the General Government Balance position would improve by about 1.5% of GDP.

In response to the infrastructural needs of the economy, public investment including PPP capital funded by annual payments from the Exchequer, will average about 5.0% of GNP over the period 2006-2010, up from 4.7% in the last update. This takes account of the impact of the recently announced "Transport 21" initiative. More detailed information in relation to Government expenditure and revenue issues is set out in Chapter 5.

A series of existing tax reliefs are being discontinued, subject to transitional measures, on foot of a rigorous process of evaluation that has been ongoing during 2005. The ending of the tax schemes will result in Exchequer savings of several hundred million euro per annum, although the full benefits will not be realised until after 2012 when the bulk of existing capital allowances have been claimed in tax returns. The review exercise will contribute to a wide, secure and equitable base for Ireland's pro-growth, pro-jobs taxation policies into the medium- and longer-term.

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.

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<sup>7</sup> Eurostat confirmed on 5th August 2005 that all repayments due in respect of the Nursing Home charges, regardless of when they are actually disbursed, should be recorded as expenditure in 2005.

**Table 8 – General Government Budgetary Prospects**

	<b>2004</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>
	€m	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
<b>Net Lending by sub-sector</b>						
<b>General government</b>	2,117	1.4	0.3	-0.6	-0.8	-0.8
<b>Central government</b>	1,455	1.0	0.2	-0.6	-0.9	-0.8
<b>State government</b>	n/a	n/a	n/a	n/a	n/a	n/a
<b>Local government</b>	285	0.2	-0.1	-0.1	-0.1	-0.1
<b>Social security funds</b>	377	0.3	0.2	0.2	0.2	0.1
<b>General government</b>						
<b>Total Revenue</b>	52,206	35.1	33.5	32.8	32.8	32.6
<b>Total Expenditure</b>	50,088	33.7	33.2	33.4	33.7	33.3
<b>Net lending/borrowing</b>	2,118	1.4	0.3	-0.6	-0.8	-0.8
<b>Interest expenditure</b>	1755	1.2	1.2	1.2	1.2	1.2
<b>pm. FISIM<sup>8</sup></b>	-17	0.0	0.0	0.0	0.0	0.0
<b>Primary balance</b>	3,873	2.6	1.5	0.6	0.4	0.5
<b>Selected components of revenue</b>						
<b>Total taxes</b>	37,739	25.4	25.8	25.3	25.4	25.4
<b>Taxes on production and imports</b>	19,294	13.0	13.4	13.1	13.3	13.2
<b>Current taxes on income, wealth etc.</b>	18,242	12.3	12.2	12.0	12.0	12.0
<b>Capital taxes</b>	203	0.1	0.2	0.2	0.1	0.1
<b>Social contributions</b>	9,059	6.1	6.2	6.2	6.1	6.1
<b>Property Income</b>	1,485	1.0	1.0	0.9	0.9	0.9
<b>Other</b>	3,923	2.6	2.3	2.3	2.2	2.1
<b>Total Revenue</b>	52,206	35.1	35.3	34.7	34.7	34.4
<b>pm Tax Burden</b>	47,122	31.7	32.3	31.7	31.8	31.7
<b>Selected components of expenditure</b>						
<b>Collective consumption</b>	8,015	5.4	6.0	6.1	6.2	6.2
<b>Total social transfers</b>	15,842	10.7	10.5	10.3	10.0	9.8
Social transfers in kind	2,460	1.7	1.8	1.8	1.9	1.9
Social transfers other than in kind	13,382	9.0	8.7	8.4	8.2	8.0
<b>Interest Expenditure</b>	1,755	1.2	1.2	1.2	1.2	1.2
<b>Subsidies</b>	820	0.6	0.6	0.6	0.7	0.7
<b>Gross fixed capital formation</b>	5,370	3.6	3.7	3.8	4.0	4.2
<b>Other</b>	18,286	12.3	11.3	11.4	11.4	11.3
<b>Total Expenditure</b>	50,088	33.7	33.2	33.4	33.7	33.3

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

### **3.4 Structural Balance and Fiscal Stance**

Over the course of the business cycle, the economy will typically alternate between periods of above- and below-trend growth. The cyclical position of the economy, in turn, will have an impact on the

<sup>8</sup> Financial Intermediation Services Indirectly Measured (FISIM) measures the value added by financial institutions.

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, there are considerable uncertainties surrounding estimates of the CABB for Ireland. These have been outlined in previous updates (see, for instance, Stability Programme Update December 2003). In part, these concerns reflect the uncertainty surrounding estimates of potential output (and hence the output gap) in a small and very open economy which has undergone considerable structural change over the last decade. In addition, there are a wide range of estimates for the sensitivity of the budget balance to changes in GDP growth. In these circumstances, the actual figures for the General Government Balance and the General Government Debt are likely to convey more relevant information and insight into the nature of fiscal policy in Ireland going forward.

Notwithstanding these caveats, estimates of the cyclically-adjusted budget balance are presented in table 9 and show a CABB of ¼% in 2006, 0.1% in 2007 and 0.2% in 2008. The estimates are based on the macro-economic and budgetary forecasts set out elsewhere in this Stability Programme Update. Estimates of potential output are based on the EU Commission's production function methodology. A budget sensitivity factor of 0.40 is used in line with EU Commission estimates.

**Table 9 – Cyclical Developments**

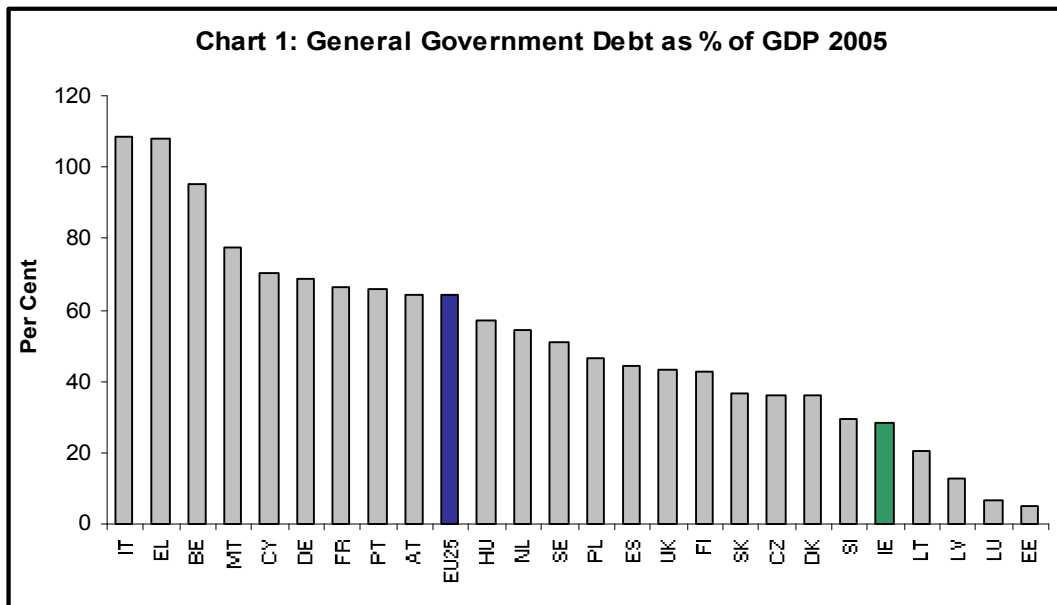
% of GDP	2004	2005	2006	2007	2008
<b>Real GDP Growth (%)</b>	4.5	4.6	4.8	5.0	4.8
<b>Net lending of general government</b>	1.4	0.3	-0.6	-0.8	-0.8
<b>Interest expenditure (incl. FISIM)</b>	1.2	1.2	1.2	1.2	1.2
Potential GDP growth	5.8	6.1	5.5	5.3	4.8
Output gap (% potential output)	0.1	-1.3	-2.0	-2.3	-2.3
Cyclical budgetary component	0.1	-0.5	-0.8	-0.9	-0.9
Cyclically adjusted balance	1.4	0.8	0.2	0.1	0.2
Change in CABB	1.8	-0.6	-0.6	-0.2	0.1
Cyclically adjusted primary balance	2.6	2.0	1.4	1.3	1.4
Change in CAPB	1.8	-0.6	-0.6	-0.2	0.1

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

### **3.5 Debt Level and Developments**

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

Over the Programme period, the gross debt level is expected to remain around 28% of GDP.



Source: European Commission Autumn Forecasts 2005; 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 in the order of 19% of GDP at end-2005.

**Table 10 – General Government Debt Developments**

% of GDP	2004	2005	2006	2007	2008
<b>Gross debt</b>	29.4	28.0	28.0	28.2	28.3
<b>Change in gross debt ratio</b>	-1.6	-1.4	0	+0.2	+0.1
<b>Contributions to change in gross debt ratio</b>					
<b>Primary balance</b>	-2.6	-1.5	-0.6	-0.4	-0.5
<b>Interest expenditure (incl. FISIM)</b>	1.2	1.2	1.2	1.2	1.2
<b>Stock-flow adjustment</b>	0.3	0.7	2.1	2.3	2.1
Nominal GDP	-2.0	-2.1	-2.0	-2.1	-2.0
Net Receipts of Social Security Funds	1.2	1.2	1.2	1.2	1.1
Other factors influencing the debt ratio	0.6	-0.2	0.2	0.3	0.3
<i>Of which:</i>					
Privatisation receipts	-	-	-	-	-
Increase in local authorities debt	0.1	0.1	0.1	0.1	0.1
<b>p.m. implicit interest rate on debt</b>	4.0	4.2	4.3	4.6	4.4

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 2006-08 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 would change the General Government Balance (GGB) by about ½% of GDP in the short run. However, changes to the composition of growth can impact significantly on that general rule, as was the case in 2005.

### **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. Firstly, the estimates should be seen as indicative and are subject to considerable uncertainty. Secondly, it is assumed that there is no fiscal policy response to the changed budgetary position 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 vary according to the type of economic shock used in the model simulation.

### **4.3 Sensitivity of Budgetary Projections to Different Scenarios and Assumptions**

Estimates from the Economic and Social Research Institute (ESRI) derived from the HERMES model suggest that a 1% lower growth rate resulting from higher interest rates would lead to a deterioration in the GGB of about 0.4% in the short run (the results are broadly symmetrical in that higher growth resulting from lower interest rates would improve the GGB by a similar magnitude). The short run impacts are shown in table 11 below. The impact on the GGB in the first year is relatively small. However, as the higher interest rates feed through into industrial costs the magnitude rises to 0.5% (relative to baseline) in the second year after the shock before falling back to 0.4% in the third year.

**Table 11 – Impact on the Budget Balance of 1% Change in Rate of Growth**

	<b>2006</b>	<b>2007</b>	<b>2008</b>
Baseline GDP Growth (%)	4.8	5.0	4.8
GGB (% GDP) (including contingency)	-0.6	-0.8	-0.8
Cumulative impact of 1% change in growth on GGB (% GDP)	Up to 0.3%	Up to 0.5%	Up to 0.4%
GGB Range (% GDP)	-0.9 to -0.3	-1.3 to -0.3	-1.2 to -0.4

Source: Department of Finance

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 from the ESRI suggest that a 1% increase in growth resulting from stronger world output would improve the GGB by about 0.2% of GDP in the short run. The impact in the first year is small (0.1% of GDP) 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% of GDP (relative to baseline) in the second year and to 0.3% of GDP in the third year as the private sector adjusts. It should be noted that these results are somewhat smaller than previously quoted, reflecting 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 12 compares this Stability Programme Update with the updated Programme of December 2004. GDP growth in 2005 is now estimated at 4.6%, compared to a forecast of 5.1% in last year's Stability Programme Update. GDP forecasts for 2006 and 2007 have also been revised. GNP growth in 2005 is now estimated to be 4.8%, compared to a forecast of 4.7% in last year's Update.

The General Government Balance in 2005 is now projected at 0.3% of GDP, compared with -0.8% anticipated in the last Update. This revision in the 2005 forecast outturn arises primarily from the inclusion of the estimated cost of the repayment of certain nursing home charges (0.6% of GDP or €1 billion)<sup>9</sup>, offset by a projected excess in tax receipts of €1,800 million (or 1.1% of GDP).

**Table 12 – Divergence from Previous Update**

	2004	2005	2006	2007	2008
Real GDP growth (%)					
previous update	5.3	5.1	5.2	5.4	-
latest update	4.5	4.6	4.8	5.0	4.8
Difference	-0.8	-0.5	-0.4	-0.4	-
General government balance (% of GDP)					
previous update	0.9	-0.8	-0.6	-0.6	-
latest update	1.4	0.3	-0.6	-0.8	-0.8
Difference	0.5	1.1	0.0	-0.2	-
General Government Gross debt (% of GDP)					
previous update	30.5	30.1	30.1	30.0	-
latest update	29.4	28.0	28.0	28.2	28.3
Difference	-1.1	-2.1	-2.1	-1.8	-

Source: Department of Finance

<sup>9</sup> Eurostat confirmed on 5th August 2005 that all repayments due in respect of the Nursing Home charges, regardless of when they are actually disbursed, should be recorded as expenditure in 2005.

## Chapter 5 – Quality of Public Finances

### 5.1 Policy Strategy

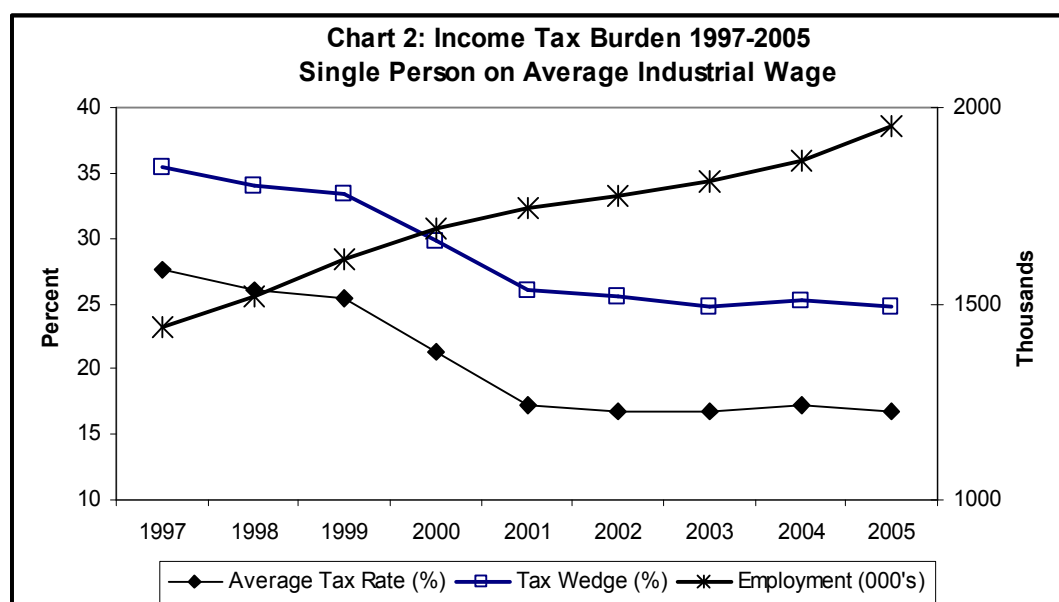
The objectives set out by Government include sustaining a strong economy, promoting competitiveness and building a caring society. In pursuit of these objectives funding has been provided to:

- 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;
  - payment rates for those in receipt of social welfare payments and pensions;
  - improvements in the health sector;
  - childcare, and
  - a significant increase in Overseas Development Aid spending.

### 5.2 Revenue Strategy

Tax policy is geared to promoting a job-friendly environment to facilitate robust employment growth, the development of a favourable environment for business development, and a better quality of life for all. This strategy is in line with the objectives of the Lisbon strategy.

The policy in recent Budgets has been to consolidate the employment-friendly environment established in Ireland over the years. This has been done by maintaining the low tax burden on all and focusing the resources available at the lower end of the income scale. For example, measures taken in Budget 2005 achieved the target of taking those on the minimum wage out of the income tax net and ensuring that all workers obtain a reduction in real terms in their tax burden.



Source: Department of Finance

Growth in the labour force reflects a combination of the underlying growth in the population aged 15 years and over, and increasing female labour force participation, with the latter increasing from below 40% in 1995 to 50% in 2004. Proactive labour market tax policies have played an important role in matching this labour force growth with positive employment growth. Employment growth of 31%

has been achieved between 1997 and mid-2005. Chart 2 shows that the income tax burden on those on the average industrial wage has fallen quite significantly over this period.

### Efficiency of Tax Collection

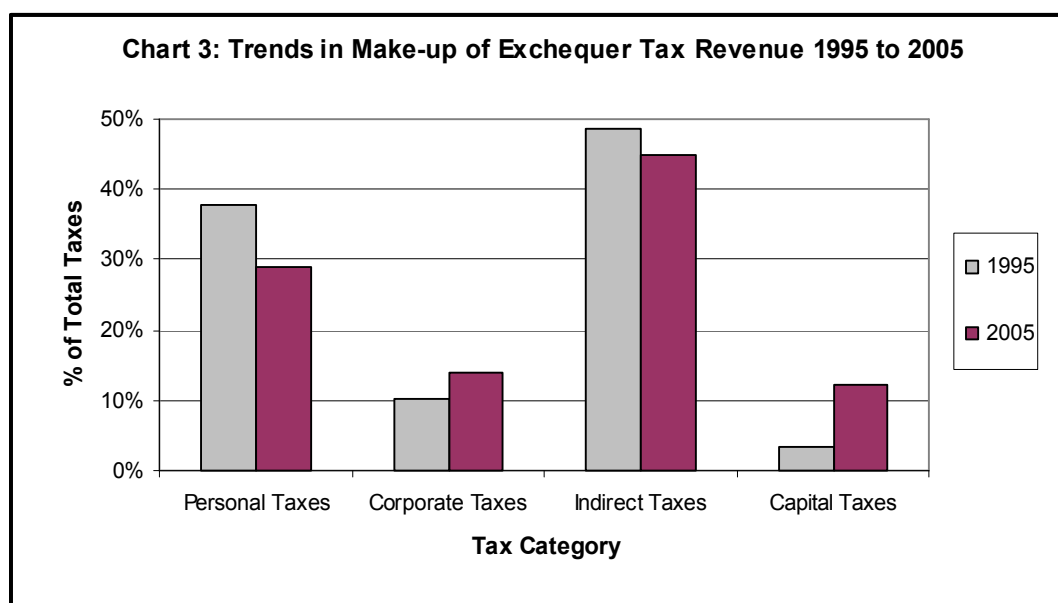
As a measure of the efficiency of the tax collection process in Ireland, it might be noted that, at 31 March 2005, the total tax debt outstanding was €1.2 billion representing 2.5% of gross Revenue net receipts collected in 2004. This is one of the lowest percentages of any tax administration internationally. The figure of 2.5% compares to a total debt of 4% of gross receipts in 1999, 15% in 1994 and 30% in 1989. In the period since 1998, the Revenue Commissioners have collected in excess of €2 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. Aspects of these investigations, in particular the latter, are still ongoing. In April 2005, the Revenue Commissioners announced a further major investigation into the use of investment-related life assurance products to hide undisclosed income. So far in 2005, this investigation has yielded over €380 million

### Review of Tax Incentives

Over the course of 2005, a major review of existing tax incentives schemes has been underway, on foot of the Minister for Finance's announcement to this effect in Budget 2005. Under the review process, the costs and benefits of each tax scheme have been rigorously evaluated. Arising from this, a wide number of tax incentive schemes are being discontinued (subject to transitional arrangements), while a smaller number, principally those with a social orientation, are being retained on a more focused basis. In addition, the Government has decided to introduce a limit on the overall level of specified tax reliefs that a high-earning individual can claim in any one year. These measures are in line with the Government's strategy of applying taxes at a low rate, so as to promote growth and jobs, across a wide and secure tax base. The new arrangements will also 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 1995 to 2005

The evolution of the shares of Exchequer tax revenues over the last decade is indicated in Chart 3.



Source: Department of Finance

The lower income tax burden, especially for those on lower incomes, led to a decline in its share of total Exchequer tax revenues over the period. The shares of corporate taxes rose in line with the move

towards a unified corporate tax rate while the share of indirect taxes has declined as a proportion of total Exchequer tax revenues. The share of total taxes taken up by capital taxes has risen over the last decade, in particular in recent years, as a result of a buoyant property market and cuts in certain tax rates.

#### **5.4 Outlook for Expenditure 2006-2008**

In 2006, while sustaining strong public investment, resources for day-to-day services will increase by an underlying 9.9% on a post-Budget basis over 2005. Within the total provision, key priority areas have been targeted:

- an additional €1.1 billion (10%) on an underlying basis when account is taken of one-off expenditure primarily related to the establishment of the Health Service Executive in gross current spending for health services;
- an additional €549 million (8%) in gross current spending for education and science;
- an additional €1.3 billion (11%) in gross current spending for social welfare; and
- a multi-annual National Childcare Strategy at a cost of over €300 million in 2006.

The Government is committed to reaching a target for Overseas Development Aid of 0.7% of GNP by 2012 and an interim target of 0.5% of GNP in 2007. An additional €129 million (an increase of 24%) has been provided to meet the target of increasing spending on overseas development aid to 0.47% of GNP in 2006.

Public capital investment, inclusive of the provision for investment under the new 10 year investment package for transport “*Transport 21*”, will be maintained at some 5% of GNP or above in the medium-term. Total planned investment under the 2006-2010 capital envelope is €43.5 billion, of which €38 billion is Exchequer capital and €5.5 billion is PPPs funded by annual payments from the Exchequer. This is an increase of €7 billion or 19.3% over the 2005-2009 envelope.

Total General Government expenditure in 2006 will be 33.4% of GDP and 39.8% of GNP and will average 33.5% of GDP and 40.0% of GNP over the period to 2008. Table 8 in chapter 3 shows the development of public expenditure in General Government terms.

#### **5.5 Expenditure Monitoring and Control**

The Broad Economic Policy Guidelines 2003-2005 recommended that Ireland “*enhance the efficiency of public expenditure and improve revenue and expenditure planning in a stability-oriented medium-term framework building on the range of measures recently introduced to improve the planning, management and control of expenditure*” and “*prioritise the roll-out of the infrastructural elements of the National Development Plan, while preserving budgetary stability*”.

##### **Efficiency of Public Expenditure**

Building on reforms of recent years there was increased focus on securing better value for money from public expenditure in 2005. A number of new measures were introduced in this regard including the publication in February 2005 of revised Department of Finance Guidelines for the Appraisal and Management of Public Expenditure Proposals in the Public Sector, an initiative on value for money on ICT Projects and Consultancies and additional measures on value for money announced by the Minister for Finance in October 2005. Major reform of the Budgetary and Estimates Process is being announced in Budget 2006 to increase accountability to Parliament for public expenditure. See Section 7.2 for more details on these reforms.

##### **Public Expenditure Planning**

Capital expenditure is planned within a 5 year framework following the introduction of rolling 5 year multi-annual capital envelopes in Budget 2004. Due to the particular importance attached to transport investment in promoting competitiveness, sustainable economic growth and balanced regional

development, a 10 year framework has been put in place for transport investment called “*Transport 21*”, see Section 7). Spending on day-to-day services is currently planned within an overall 3-year fiscal framework. The Irish Government is committed to an expenditure policy (along with other fiscal policies) that (i) grows spending broadly in line with resources, (ii) meets the circumstances of the Irish economy, and (iii) addresses the key social priorities. The practice of bi-monthly reporting to Government is being extended in 2006 to include reporting by large capital spending departments of progress on their capital programmes.

### **Monitoring and Control of Public Expenditure**

The procedures put in place at end-2002 to improve the arrangements for the control and management of public expenditure, and which have proven very effective, were continued in 2005 – the publication in January of expenditure profiles for the year ahead; reporting to Government on a monthly basis on the emerging trends in the public finances; and bi-monthly reporting to Government by the four Departments with the largest current spending allocations – Education & Science; Health & Children; Justice, Equality & Law Reform and Social & Family Affairs.

**Table 13 – 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%

\* The outturn includes as spending in 2004, €237m in capital spending which was carried into 2005 under the capital carryover arrangements in accordance with Section 91 of the Finance Act 2004.

Source: Department of Finance

The above table, and the expected 2005 outturn included in the *Budget 2006 Statistics and Tables*, shows that these arrangements have delivered an improvement in expenditure control. Overall, the expectation for 2005 is that total spending will be broadly 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 overseas development aid. Some specific examples include the following:

- Improvements in access to healthcare including a 35% increase since 1997 in the number of patients treated in hospitals as in-patient or day care patients, a reduction in waiting lists, increased funding for services for people with physical and intellectual disabilities resulting in extra residential, respite and day care places, improved services for the elderly and in the areas of childcare and mental health services.

- 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 approximately 5,000 resource and learning support teachers in the primary system to enable children with special educational needs receive a proper level of educational services. From a base of 299 in 1997, there are also over 6,000 special needs assistants (whole-time equivalents) employed in first and second level schools to ensure that children with special educational needs in mainstream classes receive the educational supports necessary.
- Advances made in addressing poverty and improving social welfare rates in real terms. Over the period 1997 to 2006, the old age contributory pension will have increased by over 45% in real terms, and for the lowest social welfare rate the real increase will have been almost 49%. In addition, child benefit rates have also been increased in very substantial terms.
- EU Member States have committed to collectively increasing their Official Development Assistance (ODA) to 0.56% of GNI by 2010. Ireland's ODA contributions have increased from 0.31% of GNP in 1997 to 0.47% of GNP in 2006, compared to a forecast EU average contribution rate of 0.43% in 2006.

The post Budget 2006 Estimates provisions for health and education will fund further improvements in services which include the following:

- Budget 2006 has provided for a multi-annual National Childcare Strategy at a cost of over €300 million in 2006. This Strategy includes the following strands:
  - **Supply measures:** A new 5-year National Childcare Investment Programme with the aim of funding an additional 50,000 childcare places by 2010. This is over and above the 15,000 places already expected to come on stream over the next 2 years under existing programmes. A total of €575 million, including a capital envelope of €357 million is being allocated to this Investment Programme over the 5 year period from 2006 to 2010. Other supply measures include an intensification of childcare training efforts and an income disregard for tax purposes for up to €10,000 in income from “informal” childminding.
  - **Affordability:** Recognising the particular costs associated with caring for pre-school children, a new Early Childcare Supplement is being introduced with effect from the second quarter of 2006. This will be a quarterly payment at a rate of €250 in respect of every child aged under 6 years. This initiative will cost €265 million in 2006 and €353 million in a full year.
  - **First year of life:** The duration of paid maternity benefit is being extended by 4 weeks from March 2006 at cost of €35 million in 2006 and €42.5 million in a full year. A commitment is also given to a further 4 week extension in 2007 at which stage the total duration of paid maternity leave will stand at 26 weeks. To complement this, an extra 4 weeks unpaid maternity leave will be introduced in 2006 and a further 4 weeks unpaid in 2007.
- €150 million in funding in a full year for caring for the elderly to include a new home care package for frail older people living in the community or who are acute hospital patients and are at risk of admission to long-term care.
- Additional funding of €100 million for Disability and Mental Health Services will allow for increases in the numbers of residential, respite and day places and home supports for people

with intellectual, physical or sensory disabilities; and will also improve the range of multi-disciplinary support services.

- Current funding of €60 million is provided to follow recent capital investment, to enable the opening of new beds and treatment facilities throughout the country.
- Additional Primary Care funding will provide improved delivery of community primary care services, allowing for an additional 350,000 persons to be covered by comprehensive out of hours general practitioner cover.
- Additional funding of €13 million is to be provided to the National Treatment Purchase Fund to further reduce the waiting times for patients by increasing treatment capacity for both in-patients and out-patients by some 3,500.
- 500 extra teachers to be provided at primary level over the next 2 years to reduce class size and tackle disadvantage;
- A multi-annual investment programme for the Third Level Education sector is being provided, with funding of €1.2 billion being allocated for this purpose over the 5 year period 2006-2010, including a Strategic Innovation Fund of €300m.
- A new Social Inclusion Plan – “Delivering Equality of Opportunity in Schools” – will result in significant additional funding being allocated to some 600 Primary schools and 150 Post-Primary schools, which are classified as disadvantaged.
- A new initiative has been introduced in the area of special needs whereby all schools will be allocated resources based on a weighted model without the need for psychological assessment for the high incidence categories of need.

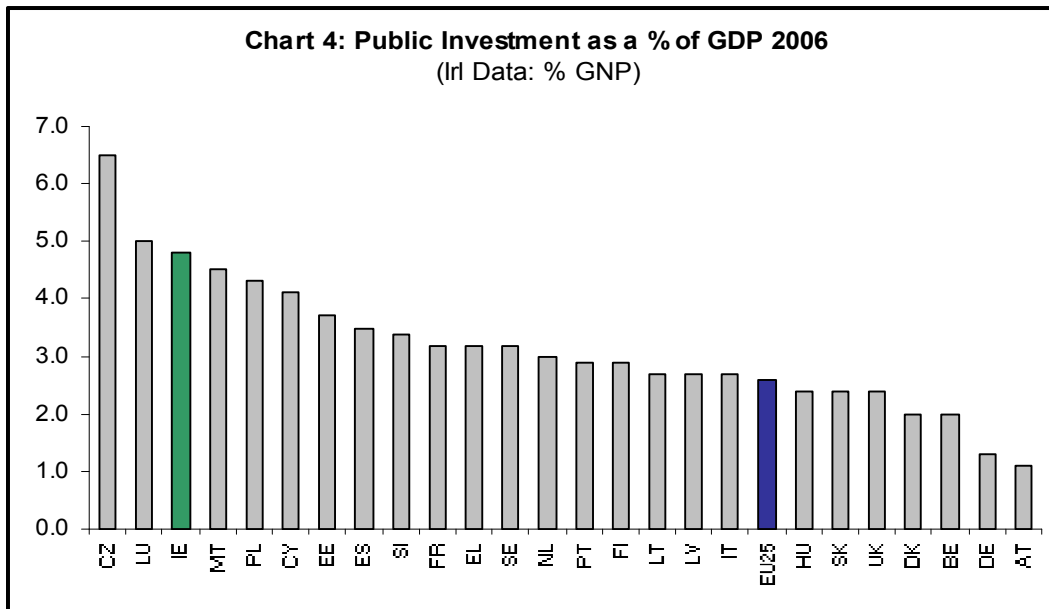
## **5.7 Infrastructural Investment**

Through the Operational Programmes in the National Development Plan, particularly the Economic and Social Infrastructure Programme (ESIOP), and more recently with the introduction of multi-annual capital investment envelopes the Government has demonstrated its commitment to infrastructure delivery by maintaining public capital investment at levels well above the EU average. (as illustrated in Chart 4). The 2006 gross Exchequer capital provision is €6.7 billion or nearly €7.1 billion on a cash basis when account is taken of the capital carryover from 2005.

This compares with €2 billion in 1997, an increase of over 250% over the period. The total capital investment in 2006 inclusive of PPPs funded by annual payments from the Exchequer under the multi-annual capital envelope will be €6.9 billion.

More than half of the 2006 provision is for spending under the ESIOP. ESIOP investment is delivering 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 (in the order of €24 billion) will be well ahead of target. In 2006 alone, the Government will invest €4 billion under the ESIOP. The programme covers areas such as:

- Roads & Public Transport      €1.9 billion
- Housing                              €1.3 billion
- Water & Sewerage                €0.3 billion
- Health                                €0.5 billion



Source: European Commission Autumn Forecasts 2005; Irish data: Department of Finance (forecasts)

### Multi-Annual Envelopes

The rolling 5 year multi annual capital envelopes, with their carryover facility, are providing medium-term certainty for Government Departments and their implementing agencies.

The introduction of this carryover facility has ensured that significant sums in unspent capital are not lost to Departments and Agencies at year end but instead are available for spending the following year. It is projected that €346 million will be carried over from 2005 into 2006<sup>10</sup>. Taking account of the impact of the capital carryover facility total Exchequer spending on investment in 2005 is forecast to be 15% higher than in 2004; the equivalent figure for 2006 is estimated as 19%.

The 2006-2010 capital envelope provides for a total public capital investment of €43.5 billion over the period. Some €38 billion of this is Exchequer capital and €5.5 billion is PPP capital to be funded by annual payments from the Exchequer. This represents an increase of €7 billion or 19.3 over the 2005-2009 capital envelope. The target for PPPs funded by user charges, which are additional to the envelope, is €2 billion over the same period. It is expected that the target for user charged PPP will largely be met by the roads programme.

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

Overall, the investment provisions contained in the Estimates and in Budget 2006 represent a prudent use of available resources to support sustained economic progress into the future.

Additional material on the multi-annual capital envelopes is provided in Chapter 7.

### Other 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 2006 in these areas will amount to about €9.2 billion (6.4% of GNP) as against €3.6 billion in 1997. The investment can be broken down as follows:

- Education: €7.7 billion
- Research & Development: €631 million

<sup>10</sup> The definitive amount for capital carryover will be set out in the Appropriation Act, 2005

- Employment Supports and Training: €843 million

### **Investment in Balanced Economic Development**

The revised capital envelope for the period 2006-2010 announced in the Budget makes provision for €900 million gross capital expenditure on the programme of decentralisation of Government departments and agencies. 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.

### **National Development Plan (NDP), 2007-2013**

The Government announced in August 2005 that a successor Plan will be prepared to the current NDP, which covers the period 2000-2006. The next NDP will seek to address the investment now necessary to maintain national economic competitiveness within a sustainable budgetary and economic framework. It will in particular focus on the priorities for investment in public economic and social infrastructure and also in human resources in the education and training areas. As part of the preparations for the next NDP, the Economic and Social Research Institute (ESRI) has been contracted to conduct an ex-ante evaluation of investment priorities. Also, as part of the preparations, a wide ranging consultation process in particular involving the social partners, regional interests and other concerned interest groups is due to commence shortly.

## 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.

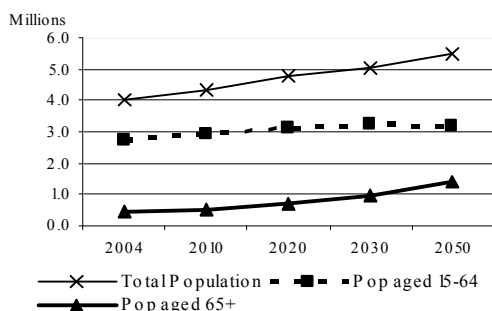
Department of Finance projections presented in Section 6.2 below indicate that public spending on pensions, health and long-term care will increase from 11.2% of GDP in 2005 to some 21.3% in 2050. In contrast, minor savings are projected in the areas of education and child benefit expenditure.

Notwithstanding these projections, Ireland is well placed in terms of its ability to meet the budgetary challenges posed by population ageing. In particular, the range of appropriate and timely policy responses that have been implemented to date - such as the establishment of the National Pensions Reserve Fund and ongoing public sector pension reforms and initiatives - will facilitate the easing of age-related spending pressures in the future. Furthermore, Government strategy is geared towards maintaining the existing low levels of debt and unemployment, improving labour force participation rates and supporting the economy's long-term growth potential by means of strategic public investment. The combined effect of these measures should secure the sustainability of the public finances for the decades ahead.

### 6.2. Long-term Budgetary Prospects including the Implications of Ageing

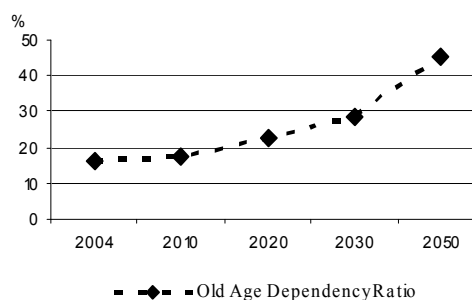
The most recent Eurostat population projections indicate that Ireland's population will increase from 4 million in 2004 to almost 5.5 million in 2050. These projections, which are derived from various assumptions concerning fertility rates, life expectancy and net migration flows, reveal that both population numbers and composition will undergo considerable change in the coming years.<sup>11</sup> For example, a marked increase in the number of people aged 65 and over is expected to occur. Moreover, it is projected that by 2050, the percentage 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%, more than double the 2004 figure of 16.4%.

**Chart 5: Population Projections**



Source: Eurostat

**Chart 6: Old Age Dependency Ratio**



Source: Eurostat

This projected change in the composition of Ireland's demographic structure has a number of implications for the evolution of the public finances. Foremost amongst these is the prospective

<sup>11</sup> Please refer to the Economic Policy Committee report *The 2005 EPC Budgetary Projections Exercise: Agreed Underlying Assumptions and Projection Methodologies* for further details.

substantial increase in age-related public expenditure as a result of a larger share of the population moving into the relevant age brackets.

In an attempt to quantify the potential budgetary impact of population ageing, Table 14 provides projections of age-related spending out to 2050 (The pensions element of the projections forms part of the EU Economic Policy Committee's 2005 budgetary projections exercise). An overview of the underlying methodology is provided in Annex 3. While technical long run projections of this type are subject to a high degree of uncertainty, they nevertheless have a value in demonstrating the likely scale of the budgetary and sustainability challenge facing Ireland in the years ahead.

**Table 14 – Long-Term Sustainability of Public Finances**

% of GDP unless otherwise stated	2005	2010	2020	2030	2050
<b>Age-Related Spending Projections (Department of Finance)</b>					
Total Age-related expenditures (1) = (2)+(7)+(8)+(9)+(10)	15.9	16.0	17.8	19.6	25.1
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)	5.9	5.8	6.2	6.7	8.5
Long-term care (8)	0.7	0.7	0.9	1.1	1.7
Education expenditure (9)	3.5	3.2	3.1	2.9	2.8
Other age-related expenditures (Child Benefit) (10)	1.2	1.1	1.1	1.0	1.0
Pension reserve fund assets	8.0**	11.1	18.1	26.0	21.9
<b>Underlying Assumptions (EU Economic Policy Committee)</b>					
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.

\*\* For technical reasons, this figure is not comparable with the figure quoted in section 1.2.

Source: Department of Finance and EU Economic Policy Committee

The projections presented in Table 14 indicate that public spending on the principal age-related aggregates – namely pensions, health and long-term care – 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 percentage points of GDP over the period 2005 to 2050.
- Expenditure on health and long-term care trends upwards over the projection timeframe and is expected to account for 10.2% of GDP in 2050.
- The results suggest that there is some potential for minor savings in relation to education and child benefit spending (0.9 percentage points 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 projections of this nature have also recently been undertaken by Barrett and Bergin (2005)<sup>12</sup>. Allowing for differences in methodology and the underlying demographic and other assumptions, the change over the period 2005-2050 in the total age-related spending estimates presented in the Barrett et al. study (10.7 percentage points of GNP) is broadly in line with that set out above (11.3 percentage points in GNP terms).

Reflecting the partial focus of the Economic Policy Committee's exercise to date, the projections presented here do not incorporate a revenue component. Such projections out to 2050 are of course subject to appreciable margins of error. They assume that current economic patterns of activity will persist into the longer term. Experience has shown that this is not always a reliable assumption.

Overall, the demographic shift to an older population constitutes a challenge to the long-term sustainability of the Irish public finances. Nonetheless, factors such as Ireland's low level of debt (the estimated figure for General Government Debt at the end of 2005 is 28.0%), low tax ratio, established record of sound budgetary management and relatively high potential growth rate, suggest that Ireland is in a reasonably favourable position to deal with the potential risks posed by population ageing. The European Commission in its document 'The Sustainability of Public Finances based on the 2004 Updates of the Stability and Convergence Programme' (April 2005), identifies Ireland as one of the Member States facing only 'limited risks' vis-à-vis long-term sustainability.

### **6.3. Policy Strategy**

In recent years, the importance of sustainability has become ingrained within Ireland's policy making process. Moreover, in tandem with ensuring the sustainability of the system as a whole, Government strategy is also geared towards maintaining the welfare and living standards of older members of society into the future. To this end, current policies are designed to take into account long-term spending pressures and welfare consequences. An overview of implemented and ongoing policy interventions and reforms is provided below. Given the projected rise in pension liabilities and health / long-term care costs over time, a particular policy emphasis has been placed on these elements of public expenditure.

*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 14 provides projections for the average value of the fund out to 2050.

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<sup>12</sup> Barrett, A. and Bergin, A. (2005) 'Assessing Age-Related Pressures on the Public Finances, 2005 to 2050'. *Budget Perspectives 2006*. Dublin: The Economic and Social Research Institute.

*A major reform of public service pension provision:* Underway since 2004, reforms implemented to date have allowed for the raising of the minimum pension age and the 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 an acceptable retirement income for all public servants on a more sustainable basis.

*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' released by the CSO in 2004 indicated that coverage for the target group amounted to 59%, up from the 57% figure reported in the previous module. The experience with SSIA's offers an opportunity to build up a savings habit and to provide more readily for future pension provision.

*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.

*National Pensions Review:* The Pensions Board report 'Alternative Systems of Pension Provision' is expected to be available shortly. The report, which forms part of the National Pensions Review, will consider a number of potential alternatives to the existing pension system.

*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 included in the Programme is ongoing.

*Financing long-term care:* A study on the future financing of long-term care in Ireland was published by the Government, along with a review of the existing nursing home subvention scheme, in mid-2003. A cross-Departmental 'High Level Working Group on Long-Term Care' will report to the Minister for Health and Children and the Minister for Social and Family Affairs on these issues in the near future.

*Provision of childcare:* The Government is committed to the delivery of additional childcare places, thereby increasing the number of facilities available to parents, limiting cost pressures and so underpinning 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

### **7.2 Reform of the Budgetary and Estimates Process**

Budget 2006 proposes a major reform of the Budgetary and Estimates Process designed to improve accountability to Parliament while retaining the right and duty of the Government to direct and manage the budgetary process. Discussions on the introduction of the reforms will take place with the opposition Finance spokespersons and the Chief Whips.

The changes to budgetary process proposed for 2006 include the following:

- Beginning in 2006, the Minister for Finance would engage early in each year with the Finance and Public Services Committee on economic and budgetary projections for each of the three years in the Stability Programme Update (SPU);
- In autumn, from autumn 2006, revised Stability Programme economic projections will be published. This will replace the Economic Review and Outlook.
- From 2007, Ministers would prepare an annual output focused statement for their Departments and Offices to be submitted to the relevant Dáil Committee in tandem with the annual estimates for each Department/Office. The Annual statements would set objectives for the current year and report, with effect from 2008, on the outturn for the previous year;
- When the Annual Statements have been examined by the Select Committees, the Finance and Public Services Committee would coordinate the preparation of a report for the Dáil.

### **7.3 Multi-Annual Capital Investment Framework**

The focus in 2005 was on embedding the 5 year rolling multi-annual capital envelopes for public investment introduced in 2004 and improving their operation. In February 2005 the Department of Finance introduced revised guidelines for the appraisal and management of capital expenditure to encourage a better approach to appraisal and management of capital programmes and projects and to reflect best practice. Together with the revised capital appraisal guidelines the multi-annual capital envelopes are producing a more even flow of projects and leading to more projects being completed on time and within budget.

While there has been an improvement in project flow and quality the Government is concerned at the slow pace of delivery of some capital programmes overall and has decided that in 2006 large capital spending Departments will be required to report progress to Government on a bi-monthly basis on their capital spending.

In November, 2005, the Government announced “*Transport 21*” a ten year capital investment framework for transport that involves investment of €34.4 billion in the 10 year period 2006- 2015. Of this, about €26.4 billion will be direct Exchequer funding and about €8 billion will be through Public Private Partnerships, of which €2 billion will be toll-based investment.

#### **7.4 Public Private Partnerships**

The five year capital investment framework for the period 2006-2010 as referred to in Chapter 5, includes a provision of €5.5 billion for PPP/NDFA capital funded by unitary payments from the Exchequer.

In July 2005, the Minister for Finance announced an initiative to consolidate the relevant skills and capacity required to support PPP procurement in the Central Government area into a single specialised "Centre of Expertise" which will be located in the National Development Finance Agency (NDFA). The Centre of Expertise will be responsible for the procurement of all new PPP projects in the Central Government area (with the exception of roads and rail areas and the environment area where existing arrangements will continue to apply) and for handing them over to the relevant Minister after construction is complete. Departments/ sponsoring agencies will remain responsible for selecting appropriate projects for procurement and for agreeing the output specifications and budgets for them.

The role of the NDFA will be expanded to include the procurement delivery function on behalf of Departments. The initiative will focus in the initial stages on progressing new projects suitable for PPP procurement in three key Departments – Education and Science, Health and Children and Justice, Equality and Law Reform.

The decision of Government to establish a Centre of Expertise in NDFA for the procurement of PPPs and to concentrate on PPP projects in these sectors will give impetus to the PPP process and increase deal flow. The Minister for Education and Science announced a major expansion in the Government's PPP projects in September 2005. Under the plans €300 million will be allocated for the provision of 23 new post-primary schools and 4 primary schools. In addition €255 million will be allocated for the delivery of third level projects under the PPP model.

#### **7.5 Procurement Management Reform and Planned Changes to Public Sector Contracts**

Significant savings and benefits arise from more effective procurement of supplies, services and capital works. The procurement management reform initiative contains a set of actions which seek to improve the way the public sector undertakes procurement with a view to achieving better value for money for the significant spend involved. This initiative is seeking to equip the public sector to better leverage this significant buying power to deliver value for money across all markets over the medium to longer term.

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 the amendment and introduction of new standard forms of construction contracts which will transfer appropriate risks to contractors who are best placed to manage them. The purpose of this initiative is to help reduce the scale and scope of cost overruns on construction projects, to help public sector bodies to control construction projects more effectively and to help facilitate early project delivery.

The new approach will also involve contractors submitting competitive tenders where the price, including a cost for the identified risks they intend to manage and control, is tendered for on a lump sum fixed price basis. Under the new arrangements, the contract price should remain firm and fixed for the duration of the project to the greatest extent possible. In relation to construction related services (e.g. Architects and Engineers), the Government wanted to see a move away from a situation where fees rise as project costs rise and decided to introduce greater competition into the procurement process without compromising on quality. Consultations on the implementation details are underway with the construction industry with a view to introducing the new suite of fixed-price contracts early in 2006.

## **7.6 Expenditure Review Initiative**

At end November 2005, 12 reviews were completed in 2005, 14 had been quality assessed and were close to completion, 7 were at quality assessment stage, and 21 were ongoing. In addition to the expenditure reviews, a substantial amount of evaluation work is also undertaken by Departments and Offices outside of the Expenditure Review Initiative (ERI) such as under the National Development Plan and by means of sectoral evaluations.

In addition to completing outstanding reviews under the existing round of reviews in 2005, Departments focused on implementing the recommendations of the October 2004 Expenditure Review Central Steering Committee Progress Report on ERI to the Minister for Finance. These improvements will strengthen the effectiveness of the ERI by tightening the focus of the expenditure review process, securing better quality reviews, ensuring more timely completion of reviews in compliance with Government decisions, and requiring a systematic response by Government Departments and their agencies to expenditure review recommendations. Measures designed to make Departments more accountable externally in relation to the ERI include a requirement that copies of all future review reports should be forwarded to the appropriate Parliamentary Committees. Plans for the next round of ERI for 2006-2008 are at an advanced stage.

## **7.7 Management Information Framework**

The Management Information Framework (MIF) is an integral part of the Irish Government's public service modernisation programme (the Strategic Management Initiative). It is a framework aimed at providing Government Departments and Offices with modern financial management systems integrated with output measurement to enhance performance and accountability. The MIF will facilitate improved financial and performance reporting and ensure better decision-making about the allocation of resources and better management of resources allocated. It will also facilitate greater transparency in, and accountability for, the use of those resources. MIF financial management systems have been installed in almost all Government Departments and Offices since early 2005. Work on the non-financial performance aspects of the MIF is continuing across Departments and Offices with a view to completion of the MIF project by its target date of end 2006.

## **7.8 Value for Money from Public Expenditure**

A number of reforms have been introduced in recent years designed to assist the better management of public expenditure and of programmes and projects. These include 3 year administrative budget agreements, the expenditure review initiative, 5 year capital investment framework, extended to 10 years in the case of the recently launched *Transport 21* framework and rules and guidance in relation to public procurement, public private partnerships and appraisal and management of capital programmes.

Building on these reforms the Government recently announced an Initiative on Management of ICT Projects and Consultancies and the Minister for Finance announced on 20 October, 2005 the introduction of additional measures to secure better value for money.

The management of ICT Projects and Consultancy Initiative provides, amongst other things, for:

- the immediate introduction of a peer review process for major ICT projects,
- a review by the Department of Finance of existing guidelines for the engagement of consultants.

The additional measures announced on 20 October included:

- Fixed-price lump-sum contracts becoming the norm for public contracts

- For large projects over €30 million, there will be formalised contracts review by the Departments concerned with reports to their Minister and with provision for audit by the Department of Finance.
- No extension of large service contracts without tendering if the extension is more than 50% of the original contract or exceeds €250,000, whichever is the lower.
- Measures in relation to training of specialist IT and capital project management staff, open recruitment of a number of full-time specialists to the public sector on IT procurement and capital project evaluation and management, and secondment of IT procurement specialists between the public and private sectors.

The Department of Finance is engaging with Departments generally in relation to updating existing guidelines and other necessary steps to ensure that all the measures are implemented in full.

## **7.9 Expenditure Management and Reform in the Health Sector**

The Government announced, in June 2003, a major programme of reform of the health services to ensure that the quantity and quality of services that people receive match the significant investment in those services.

The on-the-ground implementation of reform is now well underway and will, of its nature, continue for several years. The Health Service Executive (HSE) was given statutory effect from 1 January 2005, providing a single national management structure to replace the old, regional health board system. Under the Health Act, *“the object of the Executive is to use the resources available to it in the most beneficial, effective and efficient manner to improve, promote and protect the health and welfare of the public.”*

A permanent Chief Executive Officer has been appointed to the HSE and the senior management team is now in place. For the first time a national service plan was drawn up for 2005 and approved by the Minister for Health and Children, as required under the Health Act 2004. The national service plan will be central to driving accountability and continual improvement within the system.

Major issues on which developments are ongoing include:

- Health Information and Quality Authority (HIQA): An interim board was announced in January 2005. Legislation to set up this body on a statutory basis is expected to be published shortly.
- Restructuring of the Department of Health and Children: which under the new arrangements will now focus largely on policy development, resource allocation and holding the delivery system (primarily the HSE) to account for performance.
- Consultant Contract: A revised consultant contract is seen as essential to progress reform in the hospital sector. While the representative bodies had been refusing to enter negotiations because of a separate dispute about indemnities for clinical matters, these issues have been resolved and talks have recently commenced.

## **7.10 Public Service Pay – Modernisation and Service Delivery**

On public service pay, the more recent national agreements have restored stability to the public service industrial relations scene and the year-on-year level of increase in the Exchequer pay bill is coming down, from 18% in 2001 to 9% in 2005. In 2004 as part of the mid-term review of *Sustaining Progress* a new public service pay agreement was reached. This mirrored the increases agreed for the private sector. The increases agreed were:

- 1.5% from 1 June 2005 (except for those earning up to and including €351 per week where a 2% increase will apply)
- 1.5% from 1 December 2005, and
- 2.5% from 1 June 2006.

In the first phase of the pay agreement under *Sustaining Progress*, the payment of increases was linked to achievement of objectives set out in each sector and included maintenance of industrial peace and co-operation with modernisation initiatives. The achievement of these objectives was monitored by independent Performance Verification Groups. This format applies equally to the second phase payments.

The parties also agreed that there would be a further public service pay benchmarking exercise that would begin in the second half of 2005 and would report in the second half of 2007.

The benchmarking process has yielded a number of benefits. The last exercise moved the system fundamentally away from the rigid system of cross-sectoral relativities where groups in different sectors sought increases based on movement of other grades and instead has moved pay determination to a system that links pay levels in the public service to pay levels for comparable jobs in the private sector.

In addition, in implementing the increases from the last exercise the payments were linked to real and verifiable change and industrial peace (as outlined above). There has been industrial relations stability in the public service since the beginning of the current agreement in 2003 – in contrast to previous years. Modernisation changes have also been introduced.

The intention would be, in any future agreement, to continue to link payments to agreed changes in public services and maintenance of industrial peace.

#### **7.11 Implementation of the Reduction in Public Sector Numbers**

In Budget 2003, the Minister for Finance announced that public service numbers would be capped and would decrease by 5,000 over a 3 year period. The Government subsequently agreed the timing and details of the reductions.

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, Education and Gardaí to improve the delivery of important services to the public.

#### **7.12 Decentralisation**

Progress continues to be made towards implementing the Government's decision on public service decentralisation under the auspices of the Decentralisation Implementation Group. The organisations and locations in the first phase of moves have been identified. This will involve almost 4,000 staff in 15 organisations moving to 21 locations. Updated implementation plans have been prepared and in the majority of cases property solutions have been identified. A number of advance moves are underway, while the first full scale moves will take place in 2006. Other decentralising organisations are moving to a more active stage in their planning, and a schedule of moves between now and 2009 has been prepared. In the case of State agencies, a more individualised approach is being pursued. Agreement has been reached on a number of the human resources and industrial relations issues and discussions are continuing in other areas. New applications to decentralise continue to be received.

## **ANNEX 1: Basic Assumptions**

**Table 15 – Basic Assumptions**

	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>
<b>USD/€ exchange rate</b>	1.25	1.21	1.22	1.22
<b>Nominal effective exchange rate (% change)</b>	0.0	-0.8	0.4	0.4
<b>World GDP growth (excl. EU) (%)</b>	5.2	5.0	4.7	4.7
<b>EU GDP growth (%)</b>	1.5	2.1	2.4	2.4
<b>Growth of relevant foreign markets (%)</b>	5.1	5.7	5.7	5.7
<b>World import volumes (excl. EU) (%)</b>	8.6	8.7	8.4	8.4
<b>Oil Prices (Brent, USD/Barrel)</b>	55.0	61.4	60.3	60.3

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**

	<b>2004</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>
	Level	rate of change	rate of change	rate of change	rate of change	rate of change
<b>Real GNP</b>	121,032	4.0	4.8	4.6	4.8	4.6
<b>Nominal GNP</b>	124,250	6.8	8.2	7.6	7.7	7.4
<b>Real GDP</b>	145,319	4.5	4.6	4.8	5.0	4.8
<b>Nominal GDP</b>	148,556	6.8	7.6	7.9	8.0	7.7
<b>Components of real GDP</b>						
<b>Private consumption expenditure</b>	67,733	3.8	5.3	5.8	6.8	4.6
<b>Government consumption expenditure</b>	19,464	2.4	3.2	3.5	3.5	3.5
<b>Gross domestic fixed capital formation</b>	34,492	8.0	7.9	4.7	4.5	3.7
<b>Changes in stocks (% GDP)</b>	766	0.5	0.2	0.2	0.2	0.2
<b>Exports of goods and services</b>	124,558	7.0	2.0	4.0	4.3	4.3
<b>Imports of goods and services</b>	101,200	7.6	3.0	4.5	5.2	3.7
<b>Contributions to real GDP growth*</b>						
<b>Final domestic demand</b>	-	3.9	4.8	4.4	4.9	3.7
<b>Changes in stocks</b>	-	-0.1	0.2	0.2	0.2	0.2
<b>External balance of goods and services</b>	-	0.7	-0.4	0.2	-0.0	1.0

\* Figures subject to rounding

Source: CSO (2004), Department of Finance (2005-08)

**Table 1b – Price Developments**

	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>
	rate of change	rate of change	rate of change	rate of change	rate of change
<b>GDP deflator</b>	2.2	2.9	2.9	2.8	2.8
<b>HICP</b>	2.3	2.2	2.0	2.0	1.8
<b>CPI</b>	2.2	2.5	2.7	2.5	2.2
<b>Export price deflator (goods and services)</b>	-0.8	1.0	2.2	2.0	2.0
<b>Import price deflator (goods and services)</b>	-0.5	1.5	2.5	2.0	2.0

Source: CSO (2004), Department of Finance (2005-08)

**Table 1c – Labour Market Developments**

	<b>2004</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>
	Level	%	%	%	%	%
<b>Employment, persons</b>	1,864,925	3.0	4.7	3.1	2.2	1.9
<b>Unemployment rate (%)</b>	86,825	4.4	4.3	4.3	4.4	4.5
<b>Labour Productivity, per employee (GDP)</b>	-	1.5	-0.2	1.7	2.7	2.8

Source: CSO (2004), Department of Finance (2005-08)

**Table 1d – Sectoral Balances**

	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>
	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
<b>Net lending/borrowing vis-à-vis rest of world</b>	-0.8	-2.4	-3.3	-	-
	-0.5				
<b>Statistical discrepancy</b>	(level = €-705m)	-	-	-	-

Source: CSO (2004), Department of Finance (2005-08)

## **ANNEX 3. Age-Related Spending Projections: Definitions and Methodology**

### **Definitions**

*Pension expenditure:* The EPC's 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.

### **Projections Methodology**

*Social Security pensions:* Social Welfare pension expenditure projections adopt a bottom up approach. Firstly, the rates applicable to the various pension payments are projected out to 2050, taking into account appropriate extra allowances. The Old-Age Contributory pension rate is indexed to nominal earnings and all other rate rises are at this same flat rate<sup>13</sup>. An estimate of overall spending is provided by multiplying the projected payment rates by the number of pensioners claiming each type of payment.

In projecting forward the number of Social Security pensioners, the starting point is the 2005 provisional estimates of the proportion of the population aged 65/66 and over in receipt of pension payments of the types covered in the 'Old-Age and Early pensions' category, and those aged 65 and under covered by the 'Other pensions' heading<sup>14</sup>. On the basis of assumptions as to how these proportions will change between the base year and 2050, the number of recipients of the various pension payments in a given year is calculated via a gradual move between the start and end points. The core assumptions imposed are that approximately 97% of males and 76% of females will be entitled to an Old Age Contributory pension in 2050. The move between the two points takes into account demographic developments and also changes in the employment rate. The latter allows for the fact that some eligible individuals may choose to continue working and therefore not claim a pension.

*Public Service pensions:* These projections represent an update of the detailed analysis carried out by the Commission on Public Service Pensions (2000), and are based on the large number of assumptions made at that time in relation to withdrawals, age, illness and retirement patterns<sup>15</sup>. Actual

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<sup>13</sup> However, increases for means tested pensions are adjusted downwards in line with the current means adjustment mechanism in place for the Old Age Non-Contributory and Widow / Widower's Non-Contributory schemes. As such, the difference between contributory and non-contributory payment rates in 2005 is maintained throughout the projection period.

<sup>14</sup> The numbers in receipt of Disability Allowances, Disability Benefit and the Pre-Retirement Allowance are based on 2004 data as 2005 provisional estimates for the number of recipients of these payments are not yet available. In addition, note that the figures for pensioners in receipt of Old Age Contributory, Retirement and Old Age Non-Contributory pension payments also include adult dependants some of whom may be below 65/66 years in age.

<sup>15</sup> Commission on Public Service Pensions (2000) *Final Report*. Available at [www.finance.gov.ie](http://www.finance.gov.ie).

spending on Public Service pensions in 2004 is taken as the starting point and the number of public servants is assumed to remain constant over the projection period. In addition, reforms implemented in 2004 including the raising of the minimum pension age and the removal of a compulsory retirement age for most new public servants are accounted for in the projected spending figures.

*Health care:* In estimating public health care spending out to 2050, the above projections draw on an OECD rule of thumb that persons aged 65 and over consume, on average, four times as much health care as those aged less than 65<sup>16</sup>. Building on this assumption, an 'under 65 years equivalent' spending estimate is calculated by taking the 2004 Exchequer current health expenditure figure (minus spending on pensions and long-term care of the elderly) and dividing it by the sum of the population aged 65 and under and four times the population aged 65 and over. The resultant estimate is then indexed to nominal earnings and to the population aged 65 and under and four times the population aged 65 and over.

*Long-term care:* The amount spent on care for older people in 2004 is taken as the base figure when projecting future spending on this component of public expenditure. Over time, spending on long-term care is assumed to rise in line with nominal earnings and with the change in the population aged 65 and over.

*Education:* In projecting education expenditure out to 2050, the 2004 current spending figure (less an estimate for pensions) is decomposed into spending on primary, secondary and third level education. Spending on each of these sectors is subsequently indexed to nominal earnings and to the rate of change in the numbers in education in the relevant age cohort.

*Child Benefit:* Child benefit expenditure is projected out to 2050 by indexing the 2004 spending figure to the change in the population aged 0-19 and to nominal earnings.

*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.

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<sup>16</sup> OECD (1987) *Financing and Delivering Healthcare: A Comparative Analysis of OECD Countries*. Paris: OECD.