PART I EXPENDITURE STRATEGY

1. Introduction and Overview

For the first time since the onset of the global financial and economic crisis and our entry into the EU/IMF Programme, we are in a position to look beyond the era of fiscal consolidation. A focus on discipline has allowed us to meet all of the targets set in the EU/IMF Programme. Moreover, the disciplined approach has allowed for a significant refocusing of expenditure to meet increasing pressures and demands for public services. The scale of the unprecedented challenge we faced has been met by putting in place a series of reforms in how public services are managed and delivered, most recently through the Haddington Road Agreement, and establishing a robust framework to underpin decisions on expenditure allocations.

As we move beyond the Programme period, it is timely to question what represents a sustainable medium to long-term level of Government expenditure for Ireland. This must be considered in the context of the overall fiscal stance. Crucially, the medium to long-term planning of expenditure must also be firmly linked to sustainable economic growth. The Stability and Growth Pact and the *Fiscal Responsibility Act 2012 and 2013* make such a link a formal legal requirement of our Government. Fiscal policy in Ireland will be framed to ensure that fiscal rules established as part of the domestic and European budgetary reforms are respected, and any dialogue about the fiscal stance in general and the level and composition of expenditure in particular must be framed within the parameters of the new fiscal architecture.

Expenditure planning over the medium term must also ensure that available resources are used efficiently and effectively to address Government priorities. Ireland's new Medium-Term Expenditure Framework provides an integrated and adaptable multi-annual system for managing spending, and it will play a key role in ensuring resources are managed to good effect in a transparent and evidence based manner. The core components of the Expenditure Framework include the Public Spending Code, periodic Comprehensive Expenditure Reviews, on-going evaluations, fixed expenditure ceilings, performance budgeting and public accountability.

This Report sets the proposed allocation of financial resources over the period 2014 to 2016. Section I of the Report sets the scene by considering how public expenditure in Ireland has changed over time and examines how it may look in the future. Furthermore, it looks at the areas which present challenges for controlling public expenditure over the medium to long term and briefly discusses the reformed fiscal and expenditure framework within which they must be handled. Section II deals with Departmental allocations in 2014. It sets out the gross current and capital expenditure ceilings for each Department and details the measures to adhere to these ceilings in 2014. Allocations for 2015 and 2016 are set out and will be finalised as part of the forthcoming Comprehensive Review of Expenditure. Section III reviews the range of expenditure reforms undertaken over the past few

Expenditure. Section III reviews the range of expenditure reforms undertaken over the past few years, and explains their interlocking nature. It also compares our Public Expenditure Framework with best practice in OECD countries and considers possible future adjustments. The full details of the expenditure allocations for 2014 are set out in Section IV of this Report which presents the Budget estimates for Public Services in 2014.

2. The Size of the State

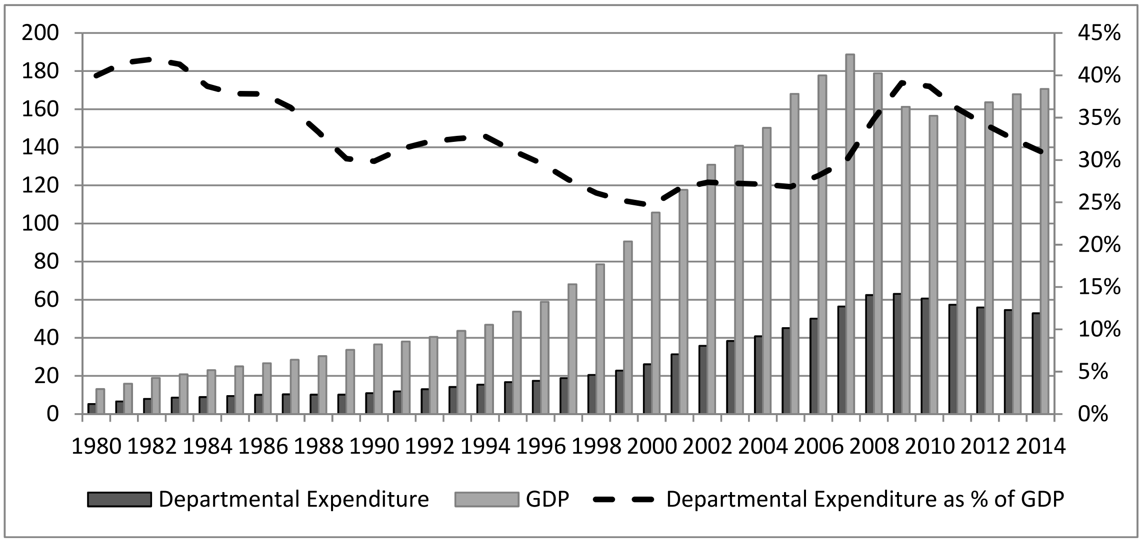
The size of the State refers to the resources it has available to it and the services it provides with those resources. In essence, Government voted expenditure is made up of current expenditure on day-to-day provision of services and capital investment. The overall expenditure allocated to Departments in 2014 is €52.9 billion, comprising of €49.6 billion current spend and €3.3 billion capital spend.

2.1 Trends over time

In nominal terms, overall expenditure increased from €5.0 billion in 1983 to €52.9 billion in 2014; in real terms the State's expenditure has tripled in size over that 30 year period. However, as a proportion of the overall size of the economy, Government expenditure has varied around a long term average of 30% of GDP (35% GNP). The variation is a consequence of differing levels of change in both the size of the economy and expenditure.

Figure 1 below sets out Government expenditure as a proportion of the size of the economy (measured in terms of either GDP or GNP) for the past 30 years.

Figure 1: Government expenditure as a proportion of economy size



Source: Dept. of Finance

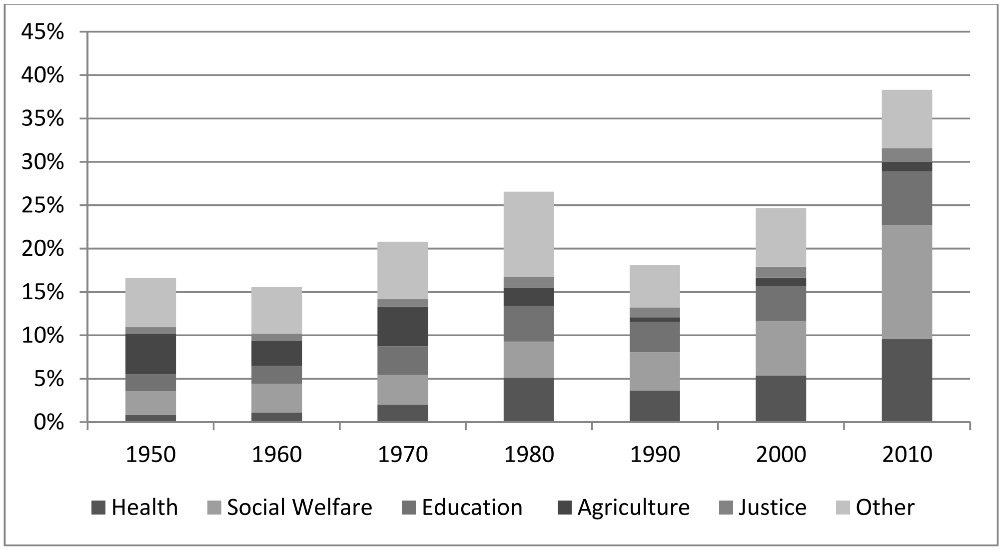
Figure 1 shows that there are five main phases; however the overall pattern is for expenditure to lag the broad economic trend:

- 1980-1990: This decade saw nominal growth in GDP, but expenditure relative to the size of the economy fell dramatically, driven by the consolidation in the second half of the decade.
- 1990-1994: This trend reversed at the beginning of the 1990s, when economic growth was less than half the growth seen in expenditure (GDP grew by 28% but expenditure grew by 66%)
- 1995-2000: Expenditure growth accelerated, but it didn't keep pace with economic growth (GDP over this period grew by 97% while expenditure grew by 56%)
- 2001-2007: After 2001 the trend reversed again – between 2001 and 2007 GDP grew by 60%, peaking at €188.7 billion and expenditure rose by 80%.
- 2008-2013: Finally, the graphs show the collapse in economic growth between 2008 and 2010 (GDP fell from its peak of €188.7 billion in 2007 to €156.4 billion in 2010) and the related impact on cyclical expenditure through the automatic stabilisers. The effect on gross expenditure of the significant fiscal consolidation undertaken from that point can be seen from 2009.

2.2 Composition of spend

There is a tendency to assume that the public services of today are also the public services of yesterday. However, over the last six decades or so there have been some notable changes in the composition of Government expenditure (see Figure 2).

Figure 2: Departmental Expenditure as a proportion of economy size 1950-2010[1]



Source: Dept. of Public Expenditure & Reform

For instance, while expenditure on agriculture accounted for more than a quarter of total Government expenditure in 1950, today it accounts for about 2%. Conversely, combined expenditure on health, social welfare and education, which today account for about 80% of total Government spending, accounted for 33% in 1950. Expenditure in the Justice area has remained relatively constant over the years, accounting for 4.6% in 1950 and 4.1% in 2010.

3 Expenditure Consolidation: Scale and impact

Over the course of the economic crisis successive Irish Governments have sought to consolidate overall public expenditure. Since 2008 there has been a reduction in aggregate public expenditure of some €7.8 billion.

It should be noted that this overall reduction has been achieved against a backdrop of having to respond to increased needs for public services and supports. Over the period there were increases in the number of people on the live register (from 160,451 in September 2007 to 408,670 in September 2013), the number of medical cards (from 1.27 million in 2007 to 1.87 million in 2013) and the number of students at primary and secondary school (from 814,033 in 2007 to 889,269 in 2013). The economic crisis has meant that people are more likely to find themselves at risk of poverty. Almost a third (30%) of public expenditure is targeted at helping people and protecting families, and this safety net has been maintained throughout the consolidation period. Evidence published by the CSO shows

[1] As a percentage of nominal GDP.

that social transfers and pensions play a central role in reducing the risk of poverty. They alone bring the “at risk of poverty” rate down, from just over 50% to just over 15%. This 35 percentage point reduction in the rate going to social transfers and pensions is notably larger than the EU average of 27 percentage points.

Table 1: Change in Expenditure by category, 2007-2014

Government Expenditure, 2007-2014

	2007	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
Pay	16.6	17.2	17.5	16.0	15.6	15.3	15.1	14.5
Pensions	1.5	2.1	2.6	2.7	2.8	3.1	3.0	2.9
SW - Live Register	1.4	2.1	3.7	4.1	3.9	3.6	3.7	3.3
SW - Other	13.8	15.4	16.5	16.5	16.8	16.6	16.2	16.0
Other Programmes	15.3	16.6	15.5	14.9	13.8	13.3	13.2	12.9
(of which) Health non-pay	*6.4*	*6.9*	*7.1*	*6.9*	*6.9*	*6.7*	*6.6*	*6.6*
Education non-pay	*1.9*	*2.0*	*1.9*	*2.1*	*1.8*	*2.0*	*2.0*	*2.0*
Other	*7.0*	*7.7*	*6.5*	*5.9*	*5.1*	*4.6*	*4.6*	*4.3*
Gross Current Expenditure	**48.6**	**53.4**	**55.8**	**54.2**	**52.9**	**51.9**	**51.2**	**49.6**
Gross Capital Expenditure	**7.8**	**9.0**	**7.3**	**6.4**	**4.5**	**4.0**	**3.4**	**3.3**
Gross Total Expenditure	***56.4***	***62.4***	***63.1***	***60.6***	***57.4***	***55.9***	***54.6***	***52.9***

Source: Dept. Public Expenditure and Reform

As is evident from Table 1, the largest nominal reduction in expenditure has been on capital investment, which has decreased from a peak of €9 billion in 2008 to €3.3 billion in 2014. While expenditure on capital infrastructure has decreased considerably since the onset of the crisis it cannot be forgotten that over the course of the past two decades there had been significant infrastructural investment and upgrading throughout the country. Among the most visible and beneficial legacies of Ireland’s economic expansion is the national motorway network. The network now links Dublin to each of the main regional centres and the border with Northern Ireland. This investment, in the order of €6.6 billion, has significantly reduced journey times, accidents and vehicle maintenance costs. Substantial benefits have also accrued from the investment of €6.4 billion into water and wastewater infrastructure over the past decade, leading to better quality drinking and wastewater and improved environmental and habitat protection, as well as water conservation measures. Critical infrastructure to ensure on-going support for industrial, commercial and other development has also been put in place. A further €4.8 billion has been invested in primary, secondary and tertiary education infrastructure through the building of new schools to meet demographic pressures, updating to modern ICT equipment and broadband connections as well as upgrading and extending existing schools and universities.

The nominal change in headline expenditure between 2009 and 2013 however does not reveal how the additional upward pressures on day to day expenditure due to increased service demand from demographics and other factors, has been managed.

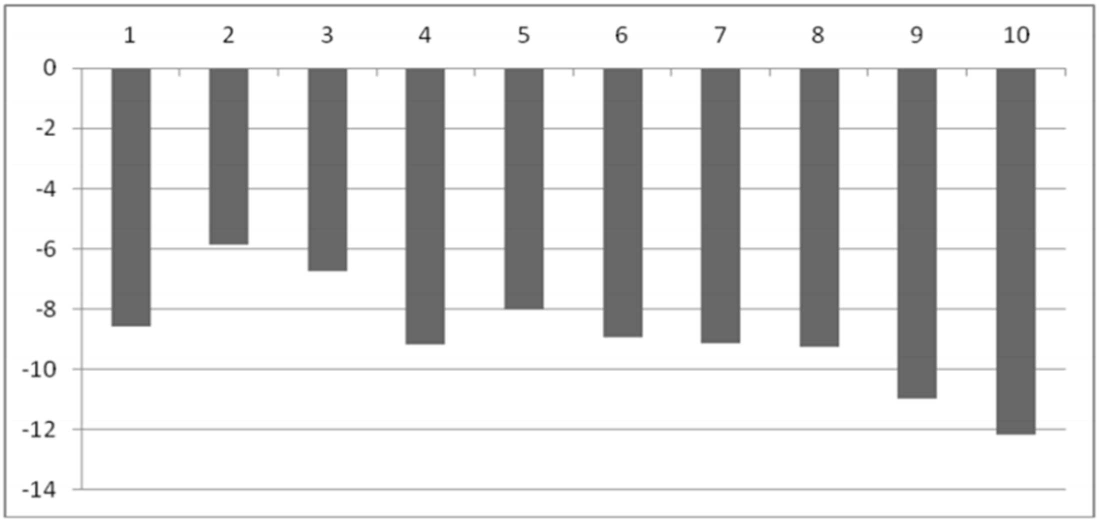
In essence this has been done by requiring the public service to be more cost efficient. While demand for public services has increased, the human and financial resources made available to it have been reduced in number and cost. There have been significant reductions in the public service pay bill and in the resources that have been made available to Departments and Agencies to deliver services. The gross pay bill has been reduced from a peak of €17.5 billion in 2009 to just over €14.5 billion in 2013 both through a series of reductions in pay rates and the numbers working in the public service. The net cost to the Exchequer was lowered by nearly a further billion per year from the introduction of the Pension Related Deduction in 2009. In overall terms, the number working in the public service has decreased from just over 320,000 in 2008 to just over 290,000 in mid-2013..

Numerous actions have been taken to balance the fiscal reality of consolidation with maintaining social cohesion. In terms of equality, Ireland has maintained a gini coefficient[2], (based on Household Budget Survey data) of 0.31. This compares favourably with international benchmarks and shows that consolidation measures have been based on ability to pay, with those in the top two income deciles facing the greatest reductions.

As illustrated in Figure 3, over the full 2008 to 2013 period, the largest percentage losses of equivalised disposable income were in the top two deciles (11 and 12 per cent for deciles 9 and 10 respectively).

[2] The Gini-coefficient is a measure of income dispersion which ranges from 0 to 100, with 0 representing maximum equality and 100 being complete inequality (i.e. one individual holding all income).

Figure 3: Impact of income tax, welfare and public service pay policy changes, 2008-2013 (% change by decile of equalivalised disposable income)



Source: ESRI 2013

The highest earning 20% in the State have seen the largest decreases in their disposable income. The lowest losses were in the 2nd and 3rd deciles (6 and 7 per cent). A key factor in the lower losses for deciles 2 and 3 is that this is where pensions are concentrated and payment rates for pensioners were held constant. The bottom decile, however, lost over 8 per cent of equivalised disposable income, arising from a combination of indirect tax increases and reductions in welfare payment rates for those of working age, and significant cuts in Child Benefit.

Challenges

In the next decade Ireland will face a number of significant challenges which will affect how the State will prioritise its expenditure. The scale of the unemployment problem, climate change, and demographic pressures will put large demands on public resources.

Long Term Unemployment

Following the economic collapse, very many people lost their jobs, especially in construction, and large scale unemployment re-emerged as a key challenge for the Irish economy. The standardised unemployment rate peaked at just over 15%. Although it has stabilised over the last three years it remains at an unacceptably high level – 13.3% as of September 2013.

This level of unemployment has serious individual, social and economic consequences. Those who are unemployed for significant periods risk losing the workplace skills they have built up over time. Young people leaving training and education who are then unable to access employment represent a waste both of the investment made in them and of their individual potential. For those reasons labour market policy places particular emphasis on the activation of the long term unemployed, and on the integration of young people into employment.

Unemployment represents a loss of potential, undermines consumption and imposes significant costs on the social protection budget. In particular, the effects of prolonged unemployment increase the risk of poverty and contribute to a negative cycle of inter-generational poverty. Activation, training and education policies can reduce unemployment by ensuring that skills are maintained, developed and aligned with the needs of the economy, so that the unemployed are successful in accessing job opportunities that will become available as the economy recovers.

Climate Change

Climate change may have several consequences for Ireland. First a warming climate is likely to alter Ireland's weather patterns, increasing the likelihood and frequency of extreme weather events such as flooding and droughts. Such weather events would put greater pressure on the national strategic infrastructure, requiring increased investment in the repair, replenishment and climate proofing of roads, railways and the electricity and water networks. In the agricultural sector, while a warmer average annual temperature is likely to benefit the growing season, more frequent extreme weather events could reduce output and increase the costs of farming.

Secondly, the costs of meeting Ireland's Greenhouse Gas Emissions targets for 2020 and 2050 will entail additional costs for both the public and private sectors, as Ireland shifts to a low/neutral emissions economy. Agriculture in particular faces a significant challenge because it contributes almost 30% of national GHG emissions.

Demographic Change

In the coming years the demographic profile is forecast to change with significant repercussions for the Exchequer. The European Commission forecasts that the population of Ireland will continue to grow, increasing to 6.5 million by 2050[3]. Today over 20% of Irish people are under the age of 14, and European Commission forecasts expect that this will remain the case at least until 2025. As this cohort age and enter the workforce they will increase the tax base and growth potential of the economy. However in the next few years population growth will put financial and service pressures on public services, particularly the education system.

In the longer term it is forecast that the demographic profile will increasingly get older. European Commission forecasts to 2060 project a decrease in the working age population of 7% from the 2010 base period, and an increase in the elderly population of 10% over the same period. This presents a

[3] European Commission, (2012), 'The 2012 Ageing Report Economic and budgetary projections for the 27 EU Member States (2010-2060)', European Economy 2/2012.

significant challenge to the Exchequer in respect of its revenue base. As the proportion of the elderly increases and the working-age population shrinks, the revenue base of the State reduces just as demand for public services and pension income increases. A recent study for the Department of Social Protection highlighted major concerns about the long-term sustainability of current welfare policies.

The challenge of demographic change is not unique to Ireland; in fact it is more pronounced in many other European countries. While the recent increase in fertility rates along with inward migration may somewhat delay and mitigate the impact on the Exchequer of long term demographic trends, the aging profile of Ireland's population will nevertheless represent a major financial challenge as we approach the second half of this century.

Ireland's Public Expenditure Framework

The Government is on course to return Ireland's public finances to a sustainable path and is committed to ensuring that they remain on such a path. Over the last number of years, Ireland has introduced a number of changes to its budgetary architecture that establish the framework within which future challenges will be addressed. Some of these changes are a consequence of new EU rules, while others build on the Government's determination to ensure sustainable public expenditure by developing existing procedures and linking them with new mechanisms. Together these elements constitute a framework that concentrates attention on whether or not the limited public resources available to the Government are being used in an efficient manner to deliver effective public services. This overall framework is detailed in Part III.