Ireland – Stability Programme Update

October 2008

<u>**Foreword**</u>

This document updates Ireland's Stability Programme. The previous update and the related Council Opinion were presented and discussed at the Dáil Select Committee on Finance and the Public Service on 28 May 2008.

This Update takes account of Budget 2009 and includes macroeconomic projections up to and including 2011. The Update is being presented to Dáil Éireann and submitted to the European Commission on Budget Day, 14 October 2008. As such, it also provides an update of the economic background to Budget 2009.

This 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.

The Stability Programme should be seen in conjunction with Ireland's National Reform Programme (NRP) 2008 – 2010, currently being prepared, which will outline a broad range of policies and initiatives to promote economic growth and employment performance in the context of the Lisbon Strategy for Growth and Jobs.

Contents

		Page
	Foreword	**D.2**
	List of Tables and Charts	**D.4**
1.	**Overall Policy Framework and Objectives**	**D.5**
1.1	Economic Outlook	D.6
1.2	Budgetary Stance	D.6
2.	**Economic Outlook 2008 – 2011**	**D.7**
2.1	Summary	D.7
2.2	The Economy in 2008	D.8
2.3	Macroeconomic Projections 2009 – 2011	D.10
2.4	Range of Forecasts	D.13
3.	**General Government Balance and Debt**	**D.14**
3.1	Summary	D.14
3.2	Policy Strategy	D.14
3.3	The Public Finances in 2008	D.14
3.4	Public Finance Projections 2009 – 2011	D.15
3.5	Cyclically-Adjusted Budget Balance and Fiscal Stance	D.18
3.6	Debt Level and Developments	D.19
4.	**Sensitivity Analysis and Comparison with Previous Updates**	**D.20**
4.1	Summary	D.20
4.2	Alternative Scenarios and Risks	D.20
4.3	Sensitivity of Budgetary Projections to Different Scenarios and Assumptions	D.20
4.4	Comparison with Previous Update	D.21
5.	**Quality of Public Finances**	**D.22**
5.1	Introduction	D.22
5.2	Policy Strategy	D.22
5.3	Revenue Strategy	D.22
5.4	Expenditure Policy	D.23
5.5	Review of Capital Expenditure	D.24
5.6	National Reform Programme 2008 – 2010	D.24
6.	**Sustainability of Public Finances**	**D.26**
6.1	Summary	D.26
6.2	Long-Term Budgetary Prospects including the Implications of Ageing	D.26
6.3	Sustainability Implications of Ageing	D.28
6.4	Policy Strategy	D.28
7.	**Institutional Features of Public Finances**	**D.30**
7.1	Introduction	D.30
7.2	Reform of the Budgetary and Estimates Process	D.30
7.3	Efficiency Review of Public Expenditure	D.30
7.4	Public Service Pay – Modernisation and Service Delivery	D.31
	ANNEX 1: Supplementary Data	**D.33**

List of Tables, and Charts

Tables[1]

		Page
Table 1	General Government Balance and Prospective Debt Ratio	D. 6
Table 2	Summary of Economic and Budgetary Indicators 2005 – 2008	D. 7
Table 3	Economic Indicators 2008: Budget and Current Forecast	D.10
Table 4	GDP Growth in Ireland's Main Trading Partners	D.11
Table 5	Macroeconomic Prospects	D.13
Table 6	Comparison of Macroeconomic Forecasts for Ireland in 2009	D.13
Table 7	General Government Budgetary Prospects	D.17
Table 8	Cyclical Developments	D.18
Table 9	General Government Debt Developments	D.19
Table 10	Impact on the Budget Balance of a 1% Change in the Rate of Growth	D.20
Table 11	Divergence from the Previous Update	D.21
Table 12	Annual Growth in Current Expenditure (%) 2005 – 2009	D.23
Table 13	Expenditure under the Multi-Annual Capital Investment Framework 2009 – 2013	D.24
Table 14	Long-Term Sustainability of Public Finances	D.27

Annex 1

Table 1a	Macroeconomic Prospects	D.33
Table 1b	Price Developments	D.34
Table 1c	Labour Market Developments	D.34
Table 1d	Sectoral Balances	D.34

Charts

Chart 1	General Government Debt as a % of GDP 2008	D.19

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

Chapter 1 - Overall Policy Framework and Objectives

Ireland's macroeconomic and fiscal policy continues to be set within the broad framework of the Stability and Growth Pact. The recent deterioration in the economic situation and budgetary position in Ireland, reflective of deteriorating international and domestic conditions, means that notwithstanding a supportive policy framework, meeting the Medium-term Budgetary Objective (MTO)[2] over the course of the programme period would be particularly challenging. The deviation from the MTO reflects the deterioration in the nominal balance which is attributable to a sudden and unprecedented contraction in growth in 2008 and 2009 from the previous year's growth of 6%. Several factors were at play here but can best be summed up by a marked deterioration in the international economic environment, including the international credit crisis, exchange rate fluctuations and a further loss of competitiveness, together with the sharp decline in construction sector activities and loss of construction related revenues, and a fall in consumer confidence. These were all significant causative factors in the deterioration. Ireland's low net public debt, forecast at around 25% in 2008 when account is taken of the assets of the National Pensions Reserve Fund[3] (NPRF), is of significant importance in these most exceptional circumstances.

This update is being prepared at a time of considerable uncertainty and crises in the international financial markets whose effect on the real economy is not yet quantifiable.

The budgetary strategy over the programme period reflects the Government's commitment to significant fiscal consolidation in order to return the public finances to a sustainable path reflecting the changed economic realities. It responds to the requirement under the Pact for an annual structural adjustment of at least 0.5% of GDP with a view to returning to a position of broad balance in the public finances as soon as possible. This adjustment (towards the MTO) is being pursued notwithstanding the necessity at the present time for additional expenditure to support jobs and growth in the Irish economy, and the impact of the automatic stabilisers in terms of additional welfare spending and the resultant sharp fall in tax revenue. Moreover, we will maintain continued high levels of public investment, of the order of 5% of GNP, to enhance economic capacity and infrastructure. Additionally, decisions announced in the Budget regarding initiatives in the areas of current and capital expenditure and tax revenue while involving a short-term fiscal cost, will yield important structural changes designed to achieve long-term cost savings and boost the growth potential of the economy.

The consolidation of the public finances is being pursued through substantial reductions in the rate of growth of public expenditure, with the annual growth in gross voted expenditure for the period 2009 – 2011 forecast to average 1.8% compared with 8.6% over the last 3 years. This will mean that there is a planned reduction of 2.1 percentage points (from 34% to 31.9% of GDP) in the expenditure ratio over the programme period. Tax measures are also being implemented to improve the fiscal position. These measures are underpinned by continued upgrading of frameworks for the monitoring and control of revenue and expenditure developments and improvement in the quality of the public finances.

Exchequer-funded public investment in priority infrastructural projects which serve to enhance the growth potential of the economy is being maintained at high levels of the order of 5% of GNP.

Care is required in making the necessary structural adjustments to bring order to the public finances. Due to the extent and the pace of the downturn it is clear that the consolidation effort should proceed

[2] The Medium-term Budgetary Objective (MTO) is for a structural budget position of close to balance (i.e. in the range of 0 to -0.5% of GDP).

[3] See table 1.

on a phased basis in the light of the evolving budgetary and economic position so as to avoid damage to the economy. The announcement in July 2008 of an initial set of measures designed to achieve savings of the order of €440 million in 2008 and €1 billion in 2009 was an important first step in this regard. Bringing forward the date of the Budget by two months was another significant step.

The Government is committed to rigorous implementation of the measures contained in Budget 2009 which are intended to support the realisation of the respective targets of -6.5% of GDP and -4.8% of GDP for the General Government Balance and structural balance in 2009. It is planned to improve the structural balance by about 3% of GDP over the programme period. Should it prove possible on the basis of the measures outlined to make more rapid progress (towards the MTO) this will be done. At the same time, the success of the budgetary strategy is also significantly dependent on positive developments both in the international environment and in the performance of Ireland's main trading partners.

1.1 Economic Outlook

The level of economic activity has contracted significantly this year, reflecting an adverse combination of internal and external factors. These same factors are likely to continue to depress activity next year, with the result that another year of negative growth is in prospect. On the assumption of (i) an improvement in the external environment in the later part of next year and in 2010 and (ii) a bottoming out of housing output next year, growth should begin to recover, eventually returning towards its estimated trend rate by 2011.

1.2 Budgetary Stance

The projected budgetary position over the period 2009 – 2011 is for a deficit in the General Government Balance of 6.5% of GDP in 2009 followed by deficits of 4.7% in 2010 and 2.9% in 2011. In terms of the cyclically-adjusted budget balance (CABB), a deficit of 4.8% of GDP is projected in 2009. The cyclically adjusted position points to deficits of 3.3% in 2010 and 1.9% in 2011.

The debt-to-GDP ratio is projected to be about 47.8% at the end of the programme period, which is below the present EU average debt level of just under 60% of GDP. However, consideration should be given to our net debt which takes account of the assets in the National Pensions Reserve Fund (NPRF). The market value of the assets of the NPRF was in the region of 10% of GDP at the end of June 2008. Table 1 below sets out the budgetary and debt position with an illustrative scenario of our net debt position.

Table 1 – General Government Balance and Prospective Debt Ratio

% of GDP	2008	2009	2010	2011
General Government Balance	-5.5	-6.5	-4.7	-2.9
Cyclically-Adjusted Balance	-5.0	-4.8	-3.3	-1.9
Debt Ratio (year end)[4]	36.0	43.4	47.5	47.8
Indicative net debt position				
NPRF[5] (est. rounded value %GDP)	11	12	13	14
Net debt ratio (est. value)	25	31	34	34

Source: Department of Finance

[4] The General Government debt ratio is measured on a gross basis, so liquidity held at year end will affect the gross debt. This debt ratio does not take into account the funds in the National Pensions Reserve Fund.

[5] For illustrative purposes, the value of the NPRF is assumed to grow by the additional annual 1% of Budget day GNP, required under current legislation, and assuming that the overall fund increases by the estimated current market 20 year bond rate of 5.9% per annum. The actual future value of the fund will depend on market conditions and could rise or fall.

Chapter 2 – Economic Outlook 2008 – 2011

2.1 Summary

When the December 2007 Update of the Stability Programme was submitted to the EU Commission, a number of downside risks to the 2008 outlook were identified. In the period since then all of these risks have materialised, with the result that this year has proven to be a very difficult one for the Irish economy.

A marked deterioration in the external environment has occurred and this, together with a major contraction in the house building sector, has resulted in a particularly challenging set of circumstances. In summary terms, the level of economic activity is expected to contract by 1¼% this year. Of particular note is the sharp contraction in domestic demand which, in addition to restraining overall demand growth, has implications for the public finances because of its greater impact on tax revenue.

Looking towards next year and beyond, it is clear that the uncertainty attached to the outlook is even greater than normal, given the highly unusual environment currently prevailing. At this stage, no significant improvement in external conditions is expected in the short-term while on the domestic front, the indications are that a further substantial reduction in the level of home-building is in prospect. In these circumstances, a further contraction in the level of activity is expected next year, with GDP forecast to decline by about ¾% (GNP is forecast to decline by around 1%).

On the basis of a recovery in the external environment, and assuming that residential construction activity bottoms out next year (and hence does not impart a downward drag on overall growth thereafter), the pace of economic growth is expected to pick up in 2010 and return towards its estimated trend rate the following year.

Table 2 – Summary of Economic and Budgetary Indicators: 2005 – 2008

% volume change (unless otherwise indicated)	2005	2006	2007	2008
GNP	5.8	6.3	4.1	-1.6
GDP	6.4	5.7	6.0	-1.3
Private consumption	7.1	7.1	6.3	0.7
Government consumption	2.9	4.8	6.0	3.9
Gross domestic fixed capital formation	14.1	4.0	1.2	-19.2
Exports of goods and services	5.2	5.7	6.8	2.5
Imports of goods and services	8.2	6.3	4.1	-0.8
BoP Current account (% GDP)	-3.5	-3.6	-5.4	-5.4
Harmonised Index of Consumer Prices	2.2	2.7	2.8	3.4
Consumer Price Index (% change)	2.5	4.0	4.9	4.4
Unemployment (% of labour force)	4.4	4.4	4.5	5.8
Employment (% change)	4.9	4.5	3.6	0.0
Employment change ('000)	91	88	73	0
General Gov. Balance (% GDP) *	1.7	3.0	0.2	-5.5
General Gov. Debt (% GDP)	27.3	24.7	24.8	36.0

* Deficit (-) / Surplus (+).
Source: 2005-2007 CSO, except for public finance figures which are produced by the Department of Finance. 2008 figures are Department of Finance forecasts.

2.2 The Economy in 2008

This year has been an exceptionally difficult one for the Irish economy, with a combination of external and domestic factors weighing on developments. The level of GDP is now projected to decline by 1¼% this year; the corresponding figure for GNP is for a decline of 1½%. This would be the first negative growth rate in 25 years. Lower levels of activity have been accompanied by a deterioration in labour market conditions, and an average unemployment rate of 5¾% for the year as a whole is expected, up from 4.5% a year earlier. The harmonised rate of inflation looks set to average 3½%, in line with that of the euro area as a whole.

External Developments

Global economic conditions deteriorated this year. According to the IMF, GDP growth in the world's advanced economies – which constitute most of our export markets – is set to slow from 2.6% last year to 1.5% this year (forecasts for individual countries are contained in table 4). The ongoing international financial market difficulties, higher commodity prices and housing cycle effects in some countries are the main factors impacting on developments in our major trading partners. These developments have also been associated with major exchange rate shifts; for instance, in September the euro-sterling bilateral rate had appreciated by 16 per cent compared with a year earlier.

Reflecting these developments, the export performance was fairly muted in the opening half of the year, recording annual growth of just 1.5%. Merchandise exports rose by 1.7% while exports of services – where double-digit growth has been recorded in recent years – rose by just 1.2%. In the second half of the year, continued modest demand growth in our main export markets and competitiveness pressures associated with exchange rate appreciation are likely to continue to weigh on the export performance, so that for the year as a whole an increase of 2½% is forecast.

Domestic Demand

Developments in the new house building sector are having a major impact on overall economic trends. National accounts data show that new house building in the first half of the year was nearly one-third lower than in the same period a year earlier. While spending on home improvements remained relatively buoyant in this period, non-residential building and construction activity in the first half was virtually flat when compared with the corresponding period a year earlier. Taking into account a decline of 20% in purchases of machinery and equipment, total investment spending declined at an annual rate of nearly 19% in the first half of the year.

Leading indicators of new housing output point to a further significant slowdown in the second half of the year (and into next year), so that for the year as a whole, completions are now expected to be about 47,000 units, compared to just over 78,000 units last year. To put this into perspective, a contraction in residential investment of this magnitude would represent a drag of about 4 percentage points on overall economic activity. The current indications are that commercial investment spending will ease in the second half, so that on the assumption of no significant purchases of machinery and equipment, a decrease of 19¼% in investment spending is forecast for the full year.

The growth of consumer spending has slowed this year, with national accounts data showing an annual increase of just 1.1% in the first half of the year. Household incomes have been adversely affected by weak employment growth and more modest wage increases, while relatively high consumer price inflation has eroded the purchasing power of incomes. Consumer confidence has also declined and this may be affecting spending decisions. All of these factors will continue to restrain the growth of personal consumption in the second half, with weak retail sales figures and the relevant tax revenues over the summer months providing confirmation of this. In overall terms, therefore, consumer spending is forecast to increase by just ¾% this year.

The volume of government consumption – purchases of goods and services by central and local government – rose by 3.9% year-on-year in the first half of this year, and an increase of this magnitude for the year as a whole is expected. This represents an easing from last year.

Final Demand and Imports
Imports of goods and services in the first half of the year were 0.2% lower than in the same period a year earlier. Merchandise imports declined by 6.8% over this period, consistent with weak retail sales and the decline in machinery and equipment purchases. Imports of services rose at an annual rate of 6.0% over this period. Balance of payments data indicate that royalty payments were especially strong in the first half, partly reflecting relatively strong output growth in some of the high-technology sectors of manufacturing. For the year as a whole, the volume of imports is forecast to decline by ¾%.

Balance of Payments
After being in broad balance since the beginning of this decade, a significant deficit on the current account of the balance of payments emerged in 2005 and this has widened in the period since then. In relation to this year, the merchandise trade surplus may improve somewhat, mainly due to the impact of lower merchandise import volumes. On the other hand, the indications are that the services deficit will widen this year, which would reverse a narrowing trend which has been evident since 2002. Assuming that the incomes balance is broadly unchanged from last year, an overall current account deficit of about -5½% of GDP is forecast for this year.

Gross Domestic Product and Gross National Product
Quarterly national accounts data show that the level of GDP in the first half of the year was 1.0% lower than in the same period of last year; the equivalent figure for GNP was a decline of 0.6%. Economic activity is expected to remain weak in the second half of the year so that for the year as a whole, GDP and GNP are now expected to decline by 1¼% and 1½% respectively.

National accounts data also show a negative GDP deflator for the first half of the year. This mainly reflects adverse movements in the merchandise terms of trade, which in turn is partly due to the impact of exchange rate appreciation on export prices as well as higher prices for imported energy and food products. These overall price trends, together with the lower volume of activity, mean that the nominal value of GDP this year will be lower than last year, something which has not happened before.

Labour Market
Conditions in the labour market have deteriorated markedly as this year has progressed, with only a very modest annual increase in the level of employment in the second quarter. The lower level of employment in the construction sector was the main factor weighing on overall employment growth. However, labour force growth also slowed over the first half, as the level of inward migration slowed and participation rates stabilised. This slower rate of increase in labour supply helped to limit the rise in survey-based unemployment in the first half of the year.

Available evidence suggests that conditions in the labour market have deteriorated further in recent months. For instance, the number on the Live Register increased significantly over the summer months, with the unemployment rate on this basis reaching 6.3% in September.[6] In these circumstances, it is likely that that annual employment growth will turn negative in the second half of the year, driven by a further decline in construction sector employment. Taken in conjunction with outturn data for the first half, no change in the overall level of employment is expected for the year as a whole. Unemployment is forecast to continue to rise over the second half, resulting in an average rate of 5¾% for the full year.

Inflation
As measured by the Irish domestic measure – the Consumer Price Index (CPI) – inflation averaged 4.6% for the first nine months of the year, driven primarily by the global rise in oil and food prices and increases in mortgage interest rates. An easing in the average rate of inflation is expected in the coming months due to a combination of weaker domestic demand, exchange rate factors, moderating

[6] This is subject to revision when the third quarter survey-based measure is published later this year.

commodity prices, favourable base effects and the recent ECB interest rate cut. On this basis, CPI inflation is expected to average 4½% for 2008 as a whole.

For euro area comparisons, the appropriate measure of inflation is the Harmonised Index of Consumer Prices (HICP). The main difference between the CPI and the HICP is the exclusion of mortgage interest from the latter. HICP inflation averaged 3.5% in the nine months to September 2008, 0.1 percentage points lower than the euro area equivalent. For the year as a whole, HICP inflation is expected to average 3½%.

Table 3 – Economic Indicators 2008: Budget and Current Forecast

	2008 Forecast (December 2007)	2008 Forecast (October 2008)
GNP (% volume change)	2.8	-1.6
GDP (% volume change)	3.0	-1.3
Consumer prices - HICP (% change)	2.4	3.4
Unemployment rate (% labour force)	5.6	5.8
Employment growth ('000)	24	0
Employment growth (%)	1.1	0.0

Source: Department of Finance.

2.3 Macroeconomic Projections 2009 – 2011

Overview

The current global economic environment is characterised by considerable uncertainty. For instance, it is unclear how the upheaval in global financial markets will impact further on economic activity in the world's advanced economies. In these circumstances, macro-economic forecasts for a small globally-integrated economy such as Ireland, which is also experiencing a housing market adjustment, are even more uncertain than normal.

Notwithstanding this, it is clear that another difficult year is in prospect for 2009. On the basis of recent IMF forecasts, GDP growth is expected to be very weak in many of our trading partners next year. In addition, the current level of the exchange rate, especially vis-à-vis sterling, will potentially raise competitiveness issues for some firms and sectors. All told, therefore, the external environment will not be supportive of any significant improvement in our export performance in 2009. On the domestic front, a further decline in the level of new housing output is expected next year. Total employment is projected to contract for the first time since 1991 and unemployment will continue to rise, averaging in excess of 7%. On the other hand, the recent 50 basis points reduction in policy interest rates should have at least some positive impact in terms of counteracting the many negative factors at work next year.

On the assumption that the recovery in our main trading partners gains momentum in 2010, prospects here should begin to improve, especially if housing output bottoms out next year, which is the current assessment. In overall terms, therefore, GDP is forecast to contract by ¾% next year, gradually improving thereafter and returning towards its estimated trend rate by 2011.

Notwithstanding the relatively poor outlook, the risks remain firmly on the downside. The key identifiable risks include:

- The possibility that global financial market problems persist and spread further into the real economy for some time;
- A steeper or more prolonged downturn in our main trading partners;
- The possibility of further exchange rate appreciation, especially against sterling or the dollar;
- The possibility of a sharper than assumed decline in residential investment or of a more prolonged downturn in this sector;

- Further increases in commodity prices.

The main upside potential relates to the possibility that the external sector records stronger than assumed growth.

External Developments

External conditions are expected to remain difficult next year. According to the IMF, GDP growth in the world's advanced economies is set to slow further, from 1.5% in 2008 to 0.5% next year. In terms of our main export markets, demand looks set to slow sharply in the UK, US and in the euro area (see table 4).

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

	2007	2008	2009
Euro area	2.6	1.3	0.2
Germany	2.5	1.8	-
France	2.2	0.8	0.2
Italy	1.5	-0.1	-0.2
UK	3.0	1.0	-0.1
US	2.0	1.6	0.1

Source: World Economic Outlook, IMF October 2008.

The prospects of fairly modest external demand together with competitiveness pressures associated with real exchange rate appreciation mean that the outlook for the exporting sector is not particularly favourable. In overall terms, export growth of just 2½% is forecast for next year, in line with this year's fairly muted performance. Even achieving this modest growth rate is contingent upon continued export growth in some of the high technology sectors of manufacturing. A modest improvement in the rate of export growth is forecast for later years, in line with the assumed recovery in our export markets.

Domestic Demand

The prospects are for a further slowdown in the rate of growth of consumer spending next year. The growth rate of household disposable income is forecast to remain muted, on foot of the projected decline in employment and more modest nominal wage growth, while no significant improvement in sentiment is anticipated. On the other hand, the forecast decline in consumer price inflation will provide some support for real income growth. When all of these factors are taken into account, consumer spending is projected to rise by just ½% next year. As employment levels stabilise and eventually begin to increase, a modest pick-up in spending is expected over the following years.

Developments in the new house building sector will have a major impact on overall trends once again next year. The current position is one of weak demand for new housing with indications of oversupply (albeit difficult to quantify). In such an environment, a further reduction in supply is in prospect, and this is consistent with leading indicators of future output such as new housing starts. The current forecast is for completions of around 25,000 units next year, which would be roughly half this year's level. Non-residential investment spending is also forecast to decline next year, mainly due to lower levels of activity in the commercial property sector. In these circumstances, overall investment spending is forecast to decline by 17¼%. An improvement is assumed thereafter, as activity in the new house building sector gradually reverts upwards towards more sustainable levels.

Public consumption is projected to rise by ¾% in real terms next year, with growth rates of ½% in each of the following two years. These moderate rates of growth confirm the Government's tighter controls on public expenditure.

Final Demand and Imports

Imports of goods and services are forecast to decline by 1% next year, in line with the assumption of weak domestic demand. Imports are expected to increase thereafter in line with the pick-up in final demand. Lower import volumes should contribute towards some narrowing of the current account

deficit, which is expected to be about 3½% of GDP for next year. Further modest improvements in later years are anticipated.

Gross Domestic Product and Gross National Product

In overall terms, therefore, many of the factors weighing on demand this year will continue to do so in 2009, with the result that GDP is forecast to decline by about ¾% next year (GNP is forecast to decline by 1%). The pattern of growth is likely to be similar to that of this year: domestic demand is expected to contract once again, and while net exports should contribute positively to growth, this is mostly a reflection of weak imports rather than a strong export performance.

The GDP deflator is expected to be positive, so that a small increase in nominal GDP is expected. Notwithstanding this, the nominal value of GDP next year is expected to be below 2007 levels.

Once the external headwinds begin to ease and activity in the housing market stabilises, thus removing the large negative drag on growth, the rate of growth should accelerate, returning towards potential by 2011.

Labour Market

Conditions in the labour market are forecast to deteriorate further next year on foot of the very weak activity experienced this year and next. Employment in the construction sector is expected to continue to decline in line with the assumption of lower levels of new housing output. While this may be the most high profile sectoral employment trend, there are signs that net employment creation in some other sectors is also coming under pressure. For the year as a whole, employment is forecast to decline by 20,000 or just under 1%. However, labour force growth should continue to slow, reflecting the assumptions of lower inward migration and a stabilisation of participation rates. Unemployment is forecast to average 7¼% for the year as a whole, its highest rate since 1998. A modest increase in employment is expected in later years, with a consequent small decline in unemployment, as growth picks up.

Inflation

Inflation is expected to moderate over the course of 2009, due in part to favourable base effects (such as the impact of this year's higher oil prices falling out of the annual comparison) along with developments in the wider economy. The recent ECB interest rate cut will also underpin an easing in the rate of CPI inflation. For 2009, CPI inflation is forecast to be 2½% while HICP inflation is forecast to be 2¼%. A further easing in inflationary pressures is expected over the medium-term - CPI inflation is forecast to be 2.0% in 2010 and 1¾% in 2011, with HICP inflation of 1¾% expected in 2010 and 1½% in 2011.

Table 5 – Macroeconomic Prospects

% change (unless otherwise indicated)	**2008**	**2009**	**2010**	**2011**
GNP growth at constant market prices	-1.6	-1.0	2.4	3.5
GNP at current market prices (€m)	158,050	158,400	164,550	173,550
GDP growth at constant market prices	-1.3	-0.8	2.7	3.7
GDP at current market prices (€m)	187,300	188,125	196,175	207,550
Components of real GDP				
Private consumption expenditure	0.7	0.5	1.7	2.4
Government consumption expenditure	3.9	0.7	0.6	0.4
Gross domestic fixed capital formation	-19.2	-17.2	3.5	5.5
Exports of goods and services	2.5	2.5	3.4	3.7
Imports of goods and services	-0.8	-1.0	2.2	2.3
External Trade				
Current account (% GDP)	-5.4	-3.4	-3.3	-2.6
Price Developments				
HICP	3.4	2.2	1.8	1.6
CPI	4.4	2.5	2.0	1.8
Labour Market				
Unemployment (% of labour force)	5.8	7.3	7.0	6.5
Employment	0.0	-0.9	0.5	1.2
Labour productivity (GDP/person employed)	-1.3	0.2	2.1	2.4

Note: Tables 1a, 1b, 1c and 1d as set out in the guidelines are enclosed at Annex 1 (pages 33-34).
Source: Department of Finance.

2.4 Range of Forecasts

The following table compares the Department of Finance 2009 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 2009

		Annual % change				
Institution	**Publication**	**GDP**	**GNP**	**Inflation*** **(HICP)**	**(CPI)**	**Employment**
Department of Finance	*Budget 2009*	-0.8	-1.0	2.2	2.5	-0.9
Central Bank of Ireland	*Bulletin No.4, Oct 2008*	-0.9	-1.3	1.6	1.9	-0.9
ESRI	*QEC Autumn 2008*	-0.7	-0.7	2.4	2.0	-2.2
IMF	*World Economic Outlook, Oct 2008*	-0.6	n.a.	2.4	n.a.	n.a.
Consensus	*Reuters poll, end September ** *	0.0	0.0	2.6	2.7	n.a.

Source: Department of Finance and institutions cited

* The Department of Finance's forecasts of CPI inflation are based on a technical assumption of unchanged interest rates.
** Poll of 11 economists mostly in the financial sector (it should be noted that there is a minor element of double-counting in this table as the ESRI is also included in the Reuters poll).

Chapter 3 – General Government Balance and Debt

3.1 Summary

The Government's budgetary strategy aims to restore stability to the public finances over the medium-term, while preserving a high level of public capital investment of the order of 5% GNP over the period.

The outlook is for a General Government deficit of 5.5% of GDP in 2008, followed by deficits of 6.5% in 2009, 4.7% in 2010 and 2.9% in 2011. The cyclically adjusted deficit will be an estimated 4.8% of GDP in 2009 and will improve by an average of 1.5% of GDP each year thereafter.

The debt-to-GDP ratio is forecast to be about 36% in 2008, well below the present EU average debt level of just under 60% of GDP. Account must also be taken of our net debt position, which is forecast at around 25% of GDP at end 2008. The gross debt ratio is projected to be about 47.8% of GDP at end-2011.

3.2 Policy Strategy

Ireland has traditionally been a strong performer under the Stability and Growth Pact. It has had General Government surpluses for ten of the last eleven years. In addition, General Government debt decreased from 54% of GDP in 1998 to 25% of GDP in 2007, before account is taken of the assets in the National Pensions Reserve Fund.

As outlined in chapter 2, the deterioration in international economic conditions has had a significant impact on the Irish economy. In addition, domestic pressures, in particular the contracting construction sector and its spillover into the wider economy are compounding these international difficulties in 2008 and 2009. The economy will show a substantial loss in output over both these years with an expected cumulative loss in output compared to potential of about 7% of GDP. This has resulted in a rapid deterioration in tax revenue, substantial expenditure pressures, e.g. social welfare expenditure and a General Government deficit of 5.5% of GDP in 2008 is now expected

In the face of a very challenging outlook, the 2009 Budget presented to the Dáil (Irish Parliament) on Tuesday, 14 October, sets out a strategy to restore stability to the public finances over the medium-term, while preserving a high level of public capital investment. It involves the progressive reduction in the General Government deficit to below the SGP reference value by 2011 to be achieved by a combination of sustainable revenue and expenditure measures. The structural deficit will be improved by around 1½% of GDP in both 2010 and 2011.

3.3 The Public Finances in 2008

This deterioration in the fiscal situation in 2008 reflects the challenging economic environment, particularly the domestic economy, with a fall-off in real GDP growth from 6.0% in 2007 to -1.3% in 2008, unprecedented in the euro or wider EU areas.

A General Government Balance (GGB) of -0.9% of GDP was forecast in Budget 2008, last December. A GGB of -5.5% of GDP is now expected. An indication of the speed of the deterioration is evidenced by the fact that in the Spring forecast round the European Commission expected a GGB of -1.4% of GDP in Ireland this year. The change in the expected outturn General Government Balance for 2008 compared with the Budget estimate can be explained for the most part by the following factors:

- an estimated shortfall in tax revenue of €6½ billion, or 3.4% of GDP;
- a worsening in the accrual of tax receipts (VAT and PAYE) by a total of €400 million, or 0.25% of GDP;

- the buyout by the Government of the M50 Westlink toll bridge in August 2008, with a one-off cost of €550 million, or 0.3% of GDP; and
- a worsening in the surplus of the Social Insurance Fund, largely reflecting higher unemployment costs, of the order of €760 million or 0.4% of GDP.

The estimated shortfall in tax revenue of €6½ billion means that overall tax receipts are expected to be down 10.4% on the 2007 levels. The standard tax elasticity used to calculate the structural balance does not capture this impact, as it does not distinguish between domestically driven growth and externally driven growth, the former being more tax intensive. Almost three-quarters of the tax shortfall is due to lower than expected capital tax receipts, stamp duty receipts and Value Added Tax receipts, reflecting the slowdown in the housing market and weak consumer confidence.

Tax Revenue receipts have weakened as 2008 progressed. At the end of the first half of the year, taxes were €1,450 million behind target. In response to some spending pressures, mainly reflecting the weaker labour market, the Government announced in July a package of expenditure measures to save €440 million in 2008 and €1 billion in 2009. However, over the summer months taxes weakened further and by end September 2008 an expected shortfall in tax revenue of €6½ billion was announced. In response to the worsening position the Government brought forward the Budget from its traditional December date to 14 October in order to implement corrective measures as soon as possible. The Budget sets out a plan to stabilise and restore balance to the public finances on a sustainable basis.

3.4 Public Finance Projections 2009 – 2011

The poor tax performance in 2008 feeds into the base and this, coupled with a second year of negative growth, means that tax receipts would weaken further in 2009 on a no policy change basis. The fiscal outlook for Ireland over the period out to 2011 is challenging. A General Government deficit of 6.5% of GDP is forecast for 2009, followed by deficits of 4.7% in 2010 and 2.9% in 2011. The deficits in later years are based on the plan to achieve a current budget balance and bring the overall deficit below 3% of GDP by the end of the forecast period.

Recognising the significant adjustment required to restore balance to the public finances it was decided that at a time of such weak economic growth the adjustment can only be done over a number of years in order to avoid seriously depressing economic growth even further. Consequently, the Budget contains a commitment to deliver significant and steady progress in fiscal consolidation over the next three years through further measures in current expenditure, capital expenditure and tax revenue.

The medium-term strategy underpinning the Budget is designed with the clear intention of setting out to stabilise and restore balance to the public finances as soon as possible by, amongst other things, reducing and prioritising public expenditure and adjusting taxation levels to reflect the changed realities. This is delivered through a strict containment of the growth in current expenditure alongside a reprioritisation of capital spending and the introduction of a revenue raising tax package of €1.9 billion (1% of GDP) in 2009.

For subsequent years, a further package of policy measures of 1.2% of GDP in 2010 and an additional 0.4% of GDP in 2011 will be required. This package will be spread across current expenditure and taxation with the intention to minimise the impact on capital expenditure given the importance attached to enhancing our infrastructure. The details of such future packages will be outlined in subsequent Budgets in light of later information and the performance of the economy. It is accepted that the implementation of this fiscal medium-term plan will require ongoing monitoring and strong discipline by the Government. The success of the proposed fiscal consolidation is also significantly dependent on a recovery in economic growth at both domestic and international levels. The Budget aims to deliver an anticipated improvement of the order of 1½% of GDP in structural terms in 2010 and 2011.

Central Government day-to-day expenditure (i.e. gross voted current spending) grew by 10.4% year-on-year in 2008 and by an average of over 10% over the last five years. This rate of growth will fall to 3.6% in 2009 and average 2.5% over the period 2009 – 2011. Total Central Government gross spending (i.e. voted current plus capital spending) will grow by 1.8% in 2009 compared to 10.4% in 2008, and average 1.8% over the period 2009 – 2011.

A tax package of €1.9 billion (1% of GDP) was introduced in Budget 2009. The main revenue measures include the introduction of an income levy, increasing the VAT standard rate by a half percentage point, the increase in excise duties and changes in capital taxes. As is appropriate in order to support enterprise and employment, the tax burden remains low, with Exchequer tax revenue forecast at 26.8% of GNP (22.6% of GDP) in 2008. When account is taken of the Budget day tax increases, as well as the macroeconomic projections for 2009 and the trend evident in tax receipts in 2008, taxes are forecast to grow by 1% in 2009 over the expected outturn for 2008. As growth picks up towards trend growth, tax revenue is forecast to grow in line with nominal growth in 2010 and 2011 in the absence of policy change.

While investment in capital projects to enhance Ireland's productive capacity has been scaled back it is still at a very high level – over €8.2 billion (5.2% of GNP) will be spent in 2009. Maintaining capital investment at these high levels will help boost the productive capacity of the economy and thus ensure future improvements in living standards.

The debt-to-GDP ratio will rise over the forecast period to 2011 but this is unavoidable given the economic circumstances. The debt-to-GDP ratio is projected at 47.5% of GDP in 2010 and 47.8% of GDP in 2011.

Overall, the measures set out in the Budget and outlined in this Stability Programme are geared to appropriately reducing the deficit on a sustainable basis over the period to 2011 while protecting the drivers of economic growth and employment in the Irish economy.

Table 7 – General Government Budgetary Prospects

	2007 €m	2007 % of GDP	2008 % of GDP	2009 % of GDP	2010 % of GDP	2011 % of GDP
Net Lending by sub-sector						
1. General government (=2+4+5) (=8)	444	0.2	-5.5	-6.5	-4.7	-2.9
2. Central government	172	0.1	-5.3	-5.9	-4.4	-2.7
4. Local government	-343	-0.2	-0.1	-0.1	-0.1	-0.1
5. Social Insurance Fund	616	0.3	-0.1	-0.4	-0.3	-0.1
General government						
6. Total Revenue (=16)	68,007	35.7	34.6	35.3	35.9	36.2
7. Total Expenditure (=24)	67,562	35.4	40.1	41.8	40.7	39.0
8. Net lending/borrowing (=6–7) (=1)	444	0.2	-5.5	-6.5	-4.7	-2.9
9. Interest expenditure (=20)	1,819	1.0	1.1	1.8	2.1	2.2
10. Primary balance (=8+9)	2,264	1.2	-4.4	-4.6	-2.6	-0.7
11. One-off & temporary measures	*420*	*0.2*	*-0.3*	*0.0*	*0.0*	*0.0*
Selected components of revenue						
12. Total taxes	49,550	26.0	24.0	24.4	24.8	25.2
a. Taxes on production and imports	25,155	13.2	12.2	12.1	12.3	12.2
b. Current taxes on income & wealth.	24,002	12.6	11.7	12.1	12.4	12.8
c. Capital taxes[7]	392	0.2	0.2	0.2	0.2	0.2
13. Social contributions	11,947	6.3	6.7	6.9	6.9	7.0
14. Property Income[8]	2,013	1.1	1.3	1.3	1.4	1.3
15. Other	4,497	2.4	2.5	2.7	2.8	2.6
16. Total Revenue (=12 to 15) (=6)	68,007	35.7	34.6	35.3	35.9	36.2
Tax Burden[9]	*62,015*	32.5	*31.0*	*31.5*	*32.0*	*32.5*
Selected components of expenditure						
17. Compensation of Employees + **18. Intermediate Consumption**	27,642	14.5	16.2	16.2	15.8	15.0
19. Total social payments	22,173	11.6	13.2	14.5	13.9	13.2
a. Social transfers in kind	3,460	1.8	2.1	2.2	2.2	2.1
b. Social transfers other than in kind	18,713	9.8	11.1	12.3	11.7	11.1
20. Interest Expenditure (=9)	1,819	1.0	1.1	1.8	2.1	2.2
21. Subsidies	1,120	0.6	0.6	0.6	0.6	0.6
22. Gross fixed capital formation	7,812	4.1	4.8	4.2	4.2	4.1
23. Other	6,996	3.7	4.2	4.3	4.1	4.0
24. Total Expenditure (=17 to 23) (=7)	67,562	35.4	40.1	41.8	40.7	39.0
Government Consumption	*30,031*	*15.8*	*17.8*	*17.8*	*17.2*	*16.5*

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

[7] Capital Acquisitions Tax only. Capital Gains Tax is included in '12.b Current Taxes on Income, Wealth, etc', and Stamp Duty is included in '12.a Taxes on Production and Imports'.

[8] Interest, dividends, rent, etc.

[9] Total Taxes plus Social Contributions plus taxes paid directly to EU.

3.5 Cyclically-Adjusted Budget Balance and Fiscal Stance

Estimates of the cyclically-adjusted budget balance (CABB) are presented below, and are based on the harmonised methodology developed jointly by the EU Commission and the Member States.

The cyclical component of the budget balance is obtained from estimates of the output gap together with estimates of the elasticity of the budget balance with respect to changes in the output gap. Therefore, because it is determined from two unobservable 'inputs', estimates of the cyclical component of the budget balance are subject to considerable uncertainty.

From an Irish perspective, two factors heighten this uncertainty. Firstly, estimates of the output gap are arguably more uncertain for Ireland than elsewhere, given the underlying structure of the economy (for instance, the openness of our factor markets) which makes it more difficult to accurately assess potential output and the associated output gap.

Perhaps more importantly (at least on this occasion), the sensitivity of tax revenue and of expenditure to changes in the output gap (and hence the sensitivity of the overall budget balance) are assumed constant. Clearly this is not the case in Ireland where the changing composition of growth (away from domestic demand) has had a major impact on tax revenue, both this year and in the recent past. Moreover, cyclically low tax receipts related to developments in the property market are not controlled for in the cyclical adjustment, with the result that structural balance does not fully capture the scale of the cyclical slowdown in tax revenue.

On the basis of these cyclical developments, the structural balance (defined here as the cyclically-adjusted balance excluding one-offs) amounts to -4.8% of GDP in 2009, -3.3% in 2010 and -1.9% in 2011.

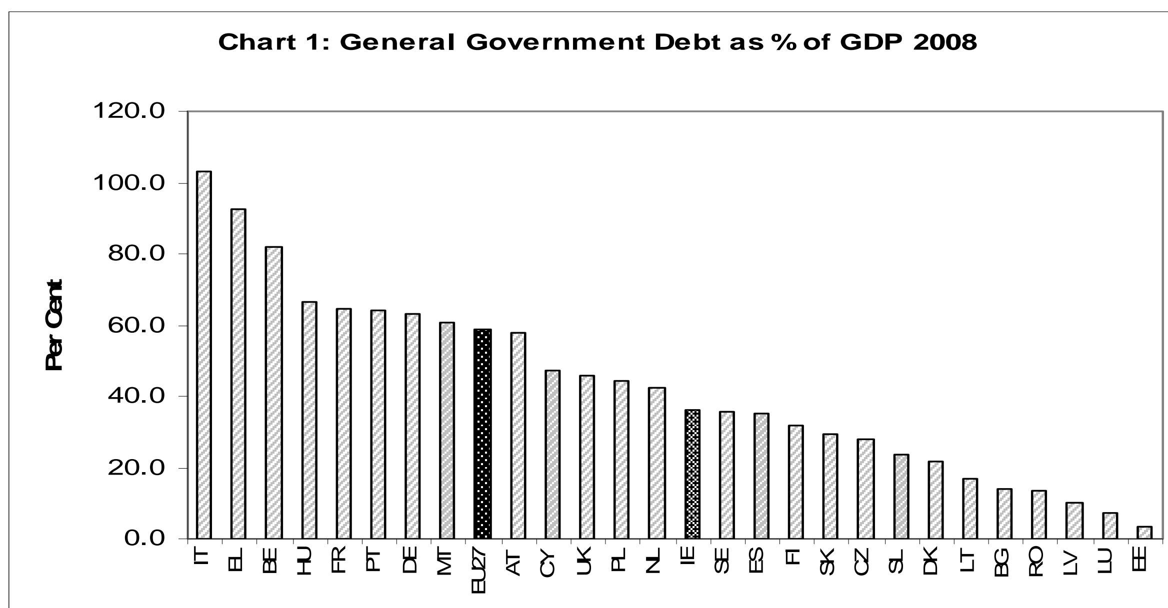
Table 8 – Cyclical Developments

% of GDP	2007	2008	2009	2010	2011
Economic Developments					
GDP growth	6.0	-1.3	-0.8	2.7	3.7
Potential GDP growth	4.9	3.3	2.2	2.0	2.6
- contribution of labour	1.7	1.1	0.6	0.4	0.9
- contribution of capital	2.1	1.3	0.8	0.9	0.9
- contribution of total factor productivity	1.0	0.8	0.8	0.8	0.8
Output gap (% potential output)	3.2	-1.3	-4.2	-3.6	-2.5
Cyclical budgetary component	1.3	-0.5	-1.7	-1.4	-1.0
Fiscal Developments					
Actual balance	0.2	-5.5	-6.5	-4.7	-2.9
Interest expenditure	1.0	1.1	1.8	2.1	2.2
Primary balance	1.2	-4.4	-4.6	-2.6	-0.7
One-off and other temporary measures	0.2	-0.3	0.0	0.0	0.0
Actual balance excluding one-offs	0.0	-5.2	-6.5	-4.7	-2.9
Cyclically Adjusted Fiscal Position					
Cyclically adjusted balance (CABB)	-1.1	-5.0	-4.8	-3.3	-1.9
Change in CABB		-3.9	0.2	1.5	1.4
Cyclically adjusted primary balance (CAPB)	-0.1	-3.9	-3.0	-1.2	0.3
Change in CAPB		-3.8	0.9	1.8	1.5
Structural Balance (= CABB exc. one-offs)	-1.3	-4.7	-4.8	-3.3	-1.9
Change in structural balance		-3.4	-0.1	1.5	1.4

Source: Department of Finance calculations.
Note that rounding can affect totals.

3.6 Debt Level and Developments

A General Government debt to GDP ratio of 36.0% is forecast for 2008. This is still amongst the lowest in the euro area and well below the present EU average debt level of just under 60% of GDP. When account is taken of the value of assets in the National Pensions Reserve Fund (NPRF), the debt-to-GDP ratio at end-2008, net of those assets, is estimated to be around 25%[10].



Source: European Commission Spring Forecasts 2008; Irish data: Department of Finance (estimates)

The debt-to-GDP ratio will rise over the forecast period to 2011 but this is unavoidable given the economic circumstances.

Table 9 – General Government Debt Developments

% of GDP	2007	2008	2009	2010	2011
Gross debt[11]	24.8	36.0	43.4	47.5	47.8
Change in gross debt ratio	0.1	11.2	7.4	4.1	0.3
Contributions to change in gross debt ratio					
Primary balance	1.2	-4.4	-4.6	-2.6	-0.7
Interest expenditure	1.0	1.1	1.8	2.1	2.2
Stock-flow adjustment[12]	2.0	5.2	1.1	1.2	0.0
Nominal GDP	-1.7	0.4	-0.2	-1.8	-2.6
Net Receipts of Social Security Funds	1.5	1.1	0.7	0.9	1.1
Other factors influencing the debt ratio:					
Privatisation receipts	n.a.	n.a.	n.a.	n.a.	n.a.
Increase in local authorities debt	0.2	0.1	0.1	0.1	0.1
p.m. implicit interest rate on debt	4.2	4.4	5.1	5.0	4.9

Source: Department of Finance

[10] See table 1.

[11] The General Government debt ratio is measured on a gross basis, so liquidity held at year end will affect the gross debt. This debt ratio does not take into account the value of the funds in the NPRF.

[12] Stock-flow adjustment is calculated as the change in gross debt ratio, less the GG Balance as % of GDP, less the contribution of nominal GDP growth.

Chapter 4 – Sensitivity Analysis and Comparison with Previous Updates

4.1 Summary

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

4.2 Alternative Scenarios and Risks

A number of points should be borne in mind when examining the results of the sensitivity analysis set out below. First, the estimates should be seen as indicative and are subject to considerable uncertainty. Second, it is assumed that there is no fiscal policy response to the changed budgetary position over the period. In reality such a response would occur if desirable in the interests of economic or budgetary sustainability. Finally, it should be noted that the results differ depending on the type of scenario modelled.

4.3 Sensitivity of Budgetary Projections to Different Scenarios and Assumptions

Two alternative causes of a 1% change in economic growth are modelled using the Economic and Social Research Institute's macroeconomic model HERMES. The results are presented in table 10.

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

	2009	2010	2011
Baseline GDP Growth (%)	-0.8	2.7	3.7
GGB Range (% GDP)	-6.5	-4.7	-2.9
1% change in the rate of growth due to a change in interest rates			
Cumulative impact of 1% change in growth on GGB (% GDP)	Up to 0.3 pp	Up to 0.3 pp	Up to 0.4 pp
GGB Range (% GDP)	-6.8 to -6.2	-5.0 to -4.4	-3.3 to -2.5
1% change in the rate of growth due to a change in world growth			
Cumulative impact of 1% change in growth on GGB (% GDP)	Up to 0.2 pp	Up to 0.3 pp	Up to 0.3 pp
GGB Range (% GDP)	-6.7 to -6.3	-5.0 to -4.4	-3.2 to -2.6

Source: Department of Finance

These estimates suggest that a 1% lower growth rate resulting from higher interest rates would lead to a deterioration in the GGB of about 0.4 percentage points of GDP in the short-run. This finding is broadly symmetrical in that higher growth as a result of lower interest rates would improve the GGB by a similar amount. The impact on the GGB in the first two years is around 0.3 percentage points of GDP (relative to the baseline), with the magnitude rising to 0.4 percentage points in the third year as higher interest rates feed through into industrial costs.

A change in world demand conditions would also have an impact on the growth rate of the Irish economy and hence on the public finances. Estimates suggest that a 1% increase in domestic growth resulting from stronger world output would improve the GGB by around 0.3 percentage points of GDP in the short-run. The impact in the first year is smaller (0.2 percentage points of GDP relative to the baseline) as it is assumed to take some time before the private sector is able to react and take advantage of the unexpected rise in world demand. The magnitude of the effect increases as such adjustment takes place - to about 0.3 percentage points of GDP in the second and third years.

4.4 Comparison with Previous Update

Table 11 compares this Stability Programme Update with the Programme of December 2007. A decline in GDP of -1.3% in 2008 is now estimated, compared to a forecast for growth of 3.0%, in last year's Stability Programme Update. GDP forecasts for 2009 and 2010 have also been revised. GNP in 2008 is now estimated to be -1.6%, compared to a forecast of 2.8% in last year's Update.

The General Government Balance in 2008 is now projected at -5.5% of GDP, compared with -0.9% anticipated in the last Update.

Table 11 – Divergence from the Previous Update

	2007	2008	2009	2010	2011
Real GDP growth (%)					
Previous update	4.8	3.0	3.5	4.1	-
latest update	6.0	-1.3	-0.8	2.7	3.7
Difference	1.2	-4.3	-4.3	-1.4	-
General Government balance (% of GDP)					
Previous update	0.5	-0.9	-1.1	-1.0	-
latest update	0.2	-5.5	-6.5	-4.7	-2.9
Difference	-0.3	-4.6	-5.4	-3.7	-
General Government Gross Debt (% of GDP)					
Previous update	25.1	25.9	27.6	28.7	-
latest update	24.8	36.0	43.4	47.5	47.8
Difference	-0.3	10.1	15.8	18.8	-

Source: Department of Finance

Chapter 5 – Quality of Public Finances

5.1 Introduction

This chapter and chapter 7 outline a range of measures to sustain improvement in the efficiency and outcomes of public spending and taxation in line with the objectives of the Stability and Growth Pact and the Lisbon strategy for growth and jobs. Recent developments in relation to reform and modernisation of the public service are also outlined.

5.2 Policy Strategy

Government policy seeks to build for the future by raising Ireland's productive capacity, particularly in terms of public infrastructure and ensuring high levels of high-quality employment, and in doing so to improve quality of life and achieve a more equitable society. In pursuit of these objectives, while taking account of the overall position, fiscal policy has been directed towards:

- Underpinning incentives to reward effort and enterprise, consolidating the progress made in recent years;
- Ensuring that the share of national resources devoted to public investment will continue to be maintained at a high level;
- Maintaining key day-to-day public services through greater efficiencies and better prioritisation of resources;
- Maintaining a pro-enterprise environment and rewarding work while increasing the fairness of the tax system.

Delivery of the medium-term economic policy and investment framework as set out in the National Development Plan 2007 – 2013 is the key priority for the Government to raise our productivity, enhance our competitiveness and secure our future prosperity.

The Government remains committed to these objectives, but in the light of the evolving budgetary and economic position the current focus must be on further improving value for money and re-prioritising a more limited amount of resources.

5.3 Revenue Strategy

The Government aims to develop efficient and effective taxation policies which support and promote the Government's economic, social and environmental objectives. Within this context the main priorities are to raise the revenue needed to meet budgetary plans while supporting labour market flexibility, ensuring an equitable tax burden - particularly with regard to the lower paid, broadening the tax base and ensuring that taxation incentives are properly focused.

In this context the Government announced the establishment of a Commission on Taxation in February 2008 to review the structure, efficiency and appropriateness of the Irish taxation system. The Commission was asked, in the context of maintaining an equitable incidence of taxation and a strong economy, to consider the structure of the taxation system and specifically to:

- consider how best the tax system can support economic activity and promote increased employment and prosperity while providing the resources necessary to meet the cost of public services and other Government outlays in the medium and longer term;
- consider how best the tax system can encourage long term savings to meet the needs of retirement;
- examine the balance achieved between taxes collected on income, capital and spending;

- review all tax expenditures with a view to assessing the economic and social benefits they deliver and to recommend the discontinuation of those that are unjustifiable on cost/benefit grounds;
- consider options for the future financing of local government; and
- investigate fiscal measures to protect and enhance the environment including the introduction of a carbon tax.

The Commission is due to report on the results of its examination and consideration and to make such recommendations as, and when, it thinks fit to the Minister for Finance but not later than 30 September 2009.

Efficiency of Tax Collection
At 31 March 2008, the total tax debt outstanding was €1,286 million which represents 1.9% of gross receipts collected by the Office of the Revenue Commissioners in 2006. This is one of the lowest percentages of any tax administration world-wide and compares to a total debt of 4.0% of gross receipts in 2000, 14% in 1995 and 26% in 1990.

Of that tax debt of €1,286 million, 14% is under control, generally through an agreed instalment arrangement where the liable entity is given additional time to pay. 37% is under active collection while a further 19% is currently at enforcement. The remainder, 30% is under appeal and is not currently available for collection.

In the period since 1998, the Revenue Commissioners have collected over €2.4 billion in one-off receipts from a number of special investigations up to the end of September 2008.

5.4 Expenditure Policy

The Irish Government's expenditure policy for 2009 and subsequent years is focussed on the need to reduce the rate of growth in public expenditure to a sustainable level more in line with the level of revenues generated within the economy, as quickly as is economically prudent.

In the 1990s and the earlier part of this decade, when Ireland's rate of economic growth was very strong, the focus of expenditure policy was on improving public services, enhancing the quality of life, and on investing in public infrastructure in order to raise the productive capacity of the economy. This was achieved while maintaining strong fiscal surpluses over most of that period. The sharp economic downturn has had a significant negative effect on the economy, leading to a significant fall-off in tax revenues as against projections. In response to this situation, the focus of national budgetary management has squarely shifted to slowing the rate of growth in day-to-day expenditure, more in line with the available resources, while maintaining priority investment in core economic infrastructure.

Last year's Budget saw the beginning of the downward shift in current expenditure growth, and that downward transition is even more marked in Budget 2009, as table 12 below shows. This significant deceleration has been achieved despite a major increase in social welfare supports for those seeking work. In this regard, the number of people on the Live Register (i.e. the register of claimants for Jobseeker's Allowance and Jobseeker's Benefit) rose from a figure of 170,000 going into 2008 to a projected average figure of 290,000 for 2009 – on its own, this trend accounts for an increase of almost €1.4 billion or 2½% of the total current expenditure allocation for 2009.

Table 12 - Annual Growth in Current Expenditure (%) 2005 – 2009

2005	2006	2007	2008	2009
10.3	10.6	12.3	10.4	3.6

Note: Outturn figures used for all years apart from 2008 (forecast outturn) and 2009 (Estimate).

Consistent with the need to deliver public services within more constrained levels of expenditure growth, the then Tánaiste and Minister for Finance announced in Budget 2008 an Efficiency Review of administrative spending across the whole public service, and a range of efficiency and other savings measures was subsequently announced by the Government in July 2008. The efficiency measures include a number of structural improvements, including a 3% reduction in public service payroll costs and an extensive programme of rationalising State agencies. Further details on these measures are set out in chapter 7.

Against this policy background, the Government took the unprecedented step of bringing forward the announcement of the 2009 Budget from December to October, and has set out the further expenditure decisions, including the major scaling-back of current expenditure growth in 2009, and the deferment of some capital investment programmes. For the years 2009 – 2011, expenditure policy will be focussed fully on stabilising the public finances in line with the requirements of the Stability & Growth Pact.

5.5 Review of Capital Expenditure

In the context of the Government announcing the efficiency savings and other expenditure reductions in July 2008, the Government agreed that capital expenditure programmes amounting to €310 million in 2009 would be re-scheduled to a later date, and that the Minister for Finance would conduct a review of all existing capital proposals. The purpose of the review was to re-prioritise the more limited available resources on targeted investment in core economic infrastructure, to provide a basis for sound and sustained recovery from the current economic downturn.

Arising from the capital review, further savings of over €900 million have been identified for 2009, and the multi-annual capital envelopes for the period 2009 – 2013 have been revised accordingly. Even after these adjustments, Exchequer capital investment will be maintained at around 5% of GNP in each of the next five years. This sustained commitment to capital investment over the medium term will facilitate those investments under the National Development Plan which are necessary for our future prosperity and which will position Ireland to take advantage of an eventual global economic upswing.

On this basis, total capital investment, factoring in PPPs and investments financed by user charges, will represent a very significant proportion of GNP by international standards, as summarised in the table below.

Table 13 - Expenditure under the Multi-Annual Capital Investment Framework 2009 – 2013

Year	*2009*	*2010*	*2011*	*2012**	*2013**
Exchequer capital, €m	8,231	8,297	8,193	9,672	9,159
Exchequer capital, % of GNP	*5.2%*	*5.0%*	*4.7%*	*5.3%*	*4.7%*
PPP (incl. user charges), €m	957	1,783	2,139	2,387	2,173
Total (Exchequer + PPP), €m	**9,188**	**10,080**	**10,331**	**12,059**	**11,333**
Total, % of GNP	*5.8%*	*6.1%*	*6.0%*	*6.6%*	*5.8%*

Totals may vary slightly due to rounding.
* 2012 and 2013 figures use technical projections for GNP, rather than formal forecasts.

5.6 National Reform Programme 2008 – 2010

We are in the process of preparing Ireland's National Reform Programme 2008 – 2010, which, by bringing together a broad range of appropriate policies and initiatives, will seek to sustain Ireland's strong economic growth and employment performance as its overall contribution to the Lisbon Agenda over the period to 2010. We recognise that there is a need to ensure that NRP related expenditure is consistent with the overall budgetary strategy outlined in the stability programme. In this context we would note that all NRP 2008 – 2010 related expenditure will be drawn from within the Exchequer funding voted to Government Departments and Agencies as part of the annual budgetary exercises for each of the years encompassed by the NRP. These voted provisions are in turn determined within the context and parameters of the Stability and Convergence Programmes (SCP).

Therefore, Ireland's NRP expenditure will originate from within a series of annual and multi-annual envelopes, the scale of which will be determined within the confines specified by the SCP.

Chapter 6 - Sustainability of Public Finances

6.1 Summary

The sustainability of Ireland's public finances will come under considerable pressure in the decades ahead. This follows from our changing demographic profile which, in line with the international experience, will see the share of older people rise and the share of the working age population fall. This shift to an older population will give rise to a substantial increase in age-related public expenditure - projections show a doubling of spending on pensions, health and long-term care by mid-century. A further consequence of demographic change is that the task of financing such spending will fall to a diminishing share of the population.

These changes in the composition of the population imply a mismatch between the spending pressures facing the public finances and their ability to meet these pressures. Indeed, the European Council and the European Commission consider Ireland to be at 'medium' risk when it comes to the long-run sustainability of the public finances[13]. As such - and notwithstanding existing initiatives - safeguarding the public finances into the future will require additional policy responses and potentially difficult choices on our part. In making these choices, it will be important to recognise the trade-offs that exist so as to put in place an appropriate policy mix. This should aim to secure the sustainability of the public finances with minimum disruption to the wider economy.

Lastly, it should be borne in mind that these challenges will not materialise in full for some time yet. Thus, we have a reasonable, but by no means indefinite, period in which to take action to address them.

6.2 Long-Term Budgetary Prospects including the Implications of Ageing

The latest demographic projections from the Central Statistics Office[14] and EUROSTAT[15] indicate that the size and composition of Ireland's population will undergo considerable change in the coming decades. In particular, a marked increase in the number of older people is set to occur so that by mid-century, the population share of those aged 65 and over - which currently stands at 11% - is expected to have more than doubled. In contrast, the share of the working age population is projected to gradually decline from around 69% to below 60%. This means that we will move from having six people of working age for every older person today, as opposed to two people of working age for every older person by mid-century.

These changes in our demographic profile will have significant implications for the evolution of the public finances. Foremost amongst these is a substantial rise in age-related public expenditure. Projections carried out at EU level by the Economic Policy Committee and the European Commission provide an estimate of the magnitude of the impact that Ireland might expect in this respect (table 14). These projections indicate that public spending on pensions, health and long-term care will increase from 10.5% of GDP in 2005 to 19.6% by 2050. Although potential savings are projected in the areas of education and unemployment benefit expenditure, at 0.9 percentage points of GDP these are relatively minor.

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[13] European Council (2008) *Council Opinion on the Updated Stability Programme of Ireland, 2007 – 2010* and European Commission (2008) *Ireland: Macro Fiscal Assessment, An Analysis of the December 2007 Update of the Stability Programme.*

[14] CSO (2008) *Population and Labour Force Statistics 2011– 2041* - M2F1 scenario extended out to 2050.

[15] EUROSTAT (2008) *EUROPOP 2008.*

Table 14 – Long-Term Sustainability of Public Finances

% of GDP unless otherwise stated	2005	2010	2020	2030	2040	2050
Age-Related Spending Projections (Economic Policy Committee & European Commission)[16]						
Total age-related expenditures (1) = (2)+(7)+(8)+(9)+(10)	15.2	15.4	17.1	18.8	20.7	23.3
Total pension expenditure (2) = (3)+(6)	4.6	5.2	6.5	7.9	9.3	11.1
Social security pensions (3) = (4)+(5)	3.4	3.8	4.5	5.5	6.8	8.4
Old-age and early pensions (4)	2.3	2.5	3.3	4.2	5.5	7.1
Other pensions (5)	1.1	1.2	1.3	1.3	1.3	1.3
Occupational pensions (Public Service) (6)	1.2	1.4	2.0	2.4	2.6	2.7
Health care (7)	5.3	5.5	5.9	6.4	6.9	7.3
Long-term care (8)	0.6	0.6	0.6	0.7	0.9	1.2
Education expenditure (9)	4.0	3.5	3.4	3.2	3.0	3.1
Other age-related expenditures (Unemployment benefit) (10)	0.7	0.6	0.6	0.6	0.6	0.6
Pension reserve fund assets	8.0	11.1	18.1	26.0	28.3	21.9
Underlying Assumptions (Economic Policy Committee & European Commission)[17]						
Labour productivity growth (y-on-y %)	3.3	3.8	2.2	1.7	1.7	1.7
Real GDP growth (y-on-y %)	5.7	5.2	3.0	2.1	1.4	1.6
Participation rate males aged 20-64 (%)	86.2	87.3	88.4	88.1	87.7	88.3
Participation rate females aged 20-64 (%)	64.5	68.5	73.3	75.3	75.3	75.6
Total participation rates aged 20-64 (%)	75.4	77.9	80.9	81.7	81.5	82.0
Unemployment rate aged 20-64 (%)	3.6	3.1	3.1	3.1	3.0	3.1
Population aged 65+ over total population (%)	11.2	11.8	14.8	18.4	22.2	26.2
Real interest rate (%)	3.0	3.0	3.0	3.0	3.0	3.0

Pension projections undertaken at national level as part of the Green Paper on Pensions present a picture of rising costs similar to the above. Over the period to 2050, the Green Paper projects that spending on Social Welfare and Public Service pensions will increase from around 5% of GDP to 13%[18]. While the assets accumulated in the National Pensions Reserve Fund are expected to go some way towards easing funding concerns in this respect, it is estimated that they will fall short of future liabilities.

A further consequence of demographic change is that the task of financing increasing age-related spending will fall to a diminishing share of the population. By 2050, not only will pension, health and long-term care costs have significantly increased, but there will be just two people of working age per older person. Taken together, these trends imply that it will become increasingly difficult to finance public expenditure from available public funds.

While technical long-run projections of the type presented here are subject to appreciable margins of error, they have considerable value in demonstrating the likely scale and timing of the coming fiscal challenge.

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

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

[18] Green Paper on Pensions (chapter 3) - www.pensionsgreenpaper.ie.

6.3 Sustainability Implications of Ageing

The magnitude of the fiscal challenge Ireland faces in the decades ahead is such that the European Council and the European Commission consider us to be at 'medium' risk when it comes to the long-run sustainability of our public finances. Reflecting this assessment, the Council issued the following invitation to Ireland in early 2008: 'in view of the significant projected increase in age-related expenditure, improve the long-term sustainability of public finances by implementing further pension reforms'[19].

While a number of initiatives have already been taken in this respect (see section 6.4), additional policy responses will be required if we are to safeguard the public finances into the future. In this context, it should be borne in mind that Ireland's demographic profile will remain relatively favourable for some time yet. Thus, we have a reasonable, but by no means indefinite, period in which to decide how best to address future challenges. In broad terms, the available options are to:

- Raise taxes and / or reduce non age-related spending;
- Ease age-related spending pressures;
- Raise the retirement age;
- Increase the share of the population at work;
- Improve the economy's productive capacity and competitiveness;
- Increase private savings.

Overall, given the scale of the task, it is unlikely that any one of these options will be sufficient to secure the long-term sustainability of the public finances. Instead, a combination of some or all will be required. When considering which policy responses to pursue in this regard, due attention should be paid to the impact of the various options and their timing on the wider economy.

6.4 Policy Strategy

To date a range of measures designed to take account of long-term fiscal pressures, along with the welfare needs of older members of society, have been put in place. These include:

- Partial pre-funding of future Social Welfare and Public Service pension costs through the *National Pensions Reserve Fund*. The value of the Fund at end-June 2008 was in the region of 10% of GDP;
- *Reform of Public Service pension provision* which has, in relation to most new public servants, allowed for the raising of the minimum pension age from 60 to 65 and for the removal of a compulsory retirement age. Additional reform options deriving from the Report of the Commission on Public Service Pensions (2000) were at an advanced stage of assessment in the second half of 2008, while constituent parts of a possible new phase of reform were identified in the Green Paper on Pensions;
- A range of *incentives to encourage private pension provision*;
- The *Health Service Reform Programme*;
- The *Fair Deal* which puts the financing of individuals' long-term care needs on a fair and equitable basis. Legislative proposals in support of the Fair Deal have recently been published and the intention is that, following enactment of the legislation, the scheme would be implemented in mid-2009;
- Investment in the knowledge base and productive capacity of the economy under the *National Development Plan 2007 – 2013*.

Notwithstanding the above, it is recognised that further policy responses will be required going forward, particularly in the area of pensions. To this end, the Government is developing a *framework*

[19] European Council (2008) *Council Opinion on the Updated Stability Programme of Ireland, 2007 – 2010.*

for longer term pensions policy as a follow up to the consultation process on the Green Paper. This framework will be an important step in responding to the Council's invitation to 'improve the long-term sustainability of public finances by implementing further pension reforms'. Moreover, as part of its terms of reference, the *Commission on Taxation* will examine how the tax system can best 'encourage long-term savings to meet the needs of retirement'; as well as considering how it can best 'support economic activity and promote increased employment and prosperity while providing the resources necessary to meet the cost of public services and other Government outlays in the medium and longer term'.

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, within a medium-term budgetary framework consistent with the Stability and Growth Pact, and outlines the Efficiency Review of public expenditure. These reforms and reviews enhance public accountability and underline the Government's aim to secure maximum value for money in public services. An update of developments related to public service pay and modernisation is also provided.

7.2 Reform of the Budgetary and Estimates Process

In May 2008, the Minister for Finance engaged with the Finance and Public Services Committee of the Dáil (the lower house of parliament) on the economic and fiscal background to the current and following two years as set out in the Stability Programme Update. This practice will be continued on the basis of today's Budget and this Stability Programme Update, and has been established as a regular feature of the annual budgetary process.

The Annual Output Statements (AOSs), introduced in 2007, are designed to make explicit the public service outputs expected to be delivered with the public funds being allocated by the Dáil each year. The AOS framework has been further developed in 2008, with closer alignment between AOS Programmes and the High-Level Goals set out in the Departmental Statements of Strategy. The 2008 round of AOSs now includes information on performance against output targets for the previous year, as well as establishing new output targets for the year ahead. The AOS framework has also been formally integrated into the procedures of parliamentary scrutiny, and the Minister for Finance has engaged with the Dáil Select Committees, the primary users of the AOSs, with a view to obtaining their feedback on how the framework can be further refined and made more effective.

The OECD Review of the Public Service, *Towards an Integrated Public Service,* which was published in April 2008, commented favourably on the Irish budgetary reform initiatives, including the new AOSs, and called for greater integration among the existing range of initiatives. The views of the OECD, including their specific recommendations regarding the improvement of the AOS framework, will be important guiding principles for future development in this area.

7.3 Efficiency Review of Public Expenditure

The then Tánaiste and Minister for Finance announced in Budget 2008 an Efficiency Review of administrative spending across the whole public service, underlining the Government's determination to secure maximum value for money in public services, and to release resources for frontline service delivery. Arising from this initiative, and in the light of the continued weakening in the public finances, the Government announced a range of expenditure savings measures in July 2008, including:-

- a 3% reduction in the public sector pay bill;
- a comprehensive programme of agency rationalisation;
- various efficiency measures / cost savings in both 2008 and 2009, including administrative savings, reduced expenditure on consultancy, advertising and public relations, and procurement savings; and
- a review of existing capital projects, and the deferment of some non-essential capital programmes, to ensure that resources are focused on the priority investment in core economic infrastructure.

These initiatives are carried through and delivered upon in the 2009 Budget, with specific actions outlined under each heading.

Rationalisation of Agencies
The Efficiency Review requested Departments to examine possible inefficiencies due to the multiplicity of bodies and agencies. In particular, Departments considered duplication, overlap or similarity of functions, the scope for amalgamation of bodies and the scope for abolition or reduction of particular bodies. In approaching this task, the Government took a principles-based, citizen-centred approach, having regard to the findings of the OECD Review, *Towards an Integrated Public Service.* The result of the process is a programme of agency rationalisation whereby the number of State agencies and other bodies will be reduced by 41, with an ongoing review of other bodies to examine further scope for rationalisation.

In addition, on foot of the publication of the OECD Review in April 2008, a Task Force on the Public Service was appointed to develop an Action Plan for the Public Service. The Task Force is preparing a comprehensive framework for renewal of the public service which takes account of the OECD's conclusions, including an appropriate framework for the establishment and operation and governance of State agencies. The Task Force's report, which is expected shortly, will form part of a comprehensive programme of renewal in this area.

3% Saving in Public Service Payroll
The Government decided in July that a 3% payroll reduction would be made to the public service payroll bill, with projected savings of €10 million in 2008 and €190 million in 2009. The payroll reduction applies across the entire public sector, with the exception of certain sectors of the Health and Education areas. To meet the requirement, a range of measures are being put in place including the immediate curtailing or suspending of staff recruitment, control of premium pay, management of vacancies, the organisation of work processes and the levels at which work is carried out.

7.4 Public Service Pay – Modernisation and Service Delivery

The Government and Social Partners have reached a draft Agreement on a successor to the first module of *Towards 2016*. The terms of the draft Agreement are set out below.

Date of Implementation and Duration
Except where otherwise agreed at local level this Agreement should come into force on the expiry of the first module of *Towards 2016* in each individual employment or industry and shall last for 21 months. In the public service it will come into effect on 1 October 2008.

Public Service Pay Terms
It is agreed by the parties that the following basic pay terms shall apply in the Public Sector:
- A Pay Pause of 11 months from the expiry of the last phase of the first module under *Towards 2016.*
- An increase of 3.5% from 1 September 2009; and
- An increase of 2.5% from 1 June 2010 – except for those earning up to and including €430.49 per week (€22,463 per annum) on commencement of the second phase where a 3% increase will apply.

The public service paybill remains the biggest single element in public expenditure accounting for around half of all current expenditure. Each 1% increase in the public service paybill costs around €190 million. In light of the deterioration of the public finances it was important that a significant pay pause was achieved. The draft Agreement provides for a pay pause of 11 months in the public service and the first payment of the new agreement will not be due until 1 September 2009. It is also important that the ongoing modernisation and enhancement of public services are continued.

As with the previous Agreement, a performance verification process will apply and the payment of the phases of the Agreement will be contingent on the satisfactory implementation of the agenda for modernisation set out in the Agreement, maintenance of stable industrial relations and the absence of industrial action.

The new Agreement will help provide the stability that the economy needs now. It will demonstrate confidence in the Irish economy both domestically and internationally to investors, savers, employers and consumers alike.

Modernisation and Service Delivery

In approaching the recent Partnership talks the Government recognised that while significant progress has been made in advancing the modernisation agenda, many more changes are both awaited and needed. In particular, there must be a more customer-focussed approach to the delivery of public services, with an increased focus on service delivery over internal reforms and a shift in emphasis from organisational inputs to outputs and outcomes for the citizen. The modernisation process must deliver results that are clear, useful and verifiable to the user and put the public at the centre of our public services.

The parties to the partnership process support the development of a more customer-focussed approach to the delivery of public services and acknowledge that there are challenges that must be addressed if the public service is to meet the needs and expectations of our citizens. The agreement recognises that the public service must review continuously its systems, processes and procedures, to ensure that it is responsive and efficient and that it provides high quality, value for money services. There will be a need for changes in skill mix; in how services are delivered; when and where they are delivered; and by whom they are delivered. Therefore, in accordance with the provisions of *Towards 2016*, the parties acknowledge the requirement for developing the range of service delivery options, for utilising shared services in areas such as HR, ICT and financial management and for developing cross-organisational solutions as a way of addressing problems of service delivery on a 'whole of Government' basis.

In approaching the talks the Government was also mindful of the recommendations of the OECD Review of the Public Service, *Towards an Integrated Public Service*, which concluded that we are on a sound trajectory of modernisation but could further improve the yield from reforms by renewing focus on their pace and sequencing in order to make them more mutually reinforcing. As mentioned above, the Government established a Task Force to develop a new Action Plan for the public service of the 21st Century in the light of the OECD Review. Its report is expected shortly.

While the detailed implementation of the Action Plan will require discussions with all relevant interests, the parties to the agreement commit themselves to implementation of the basic principles emerging from the OECD report. In particular, they accept the need identified by the OECD to give more emphasis to the public service as an integrated system with a greater focus on meeting the needs of citizens. This will require that people within the different elements of the public service system work in a more consistent, co-ordinated, networked way across the traditional sectoral and organisational boundaries. It also means that Departments, Offices, and Agencies will have to interact with each other in new ways to ensure integrated action in policy-making, delivery and implementation.

ANNEX 1:

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

	2007	**2007**	**2008**	**2009**	**2010**	**2011**
	€ million	*rate of change*	*rate of change*	*rate of change*	*rate of change*	*rate of change*
Real GNP	158,756	4.1	-1.6	-1.0	2.4	3.5
Nominal GNP	161,210	5.7	-2.0	0.2	3.9	5.5
Real GDP	187,971	6.0	-1.3	-0.8	2.7	3.7
Nominal GDP	190,603	7.5	-1.7	0.4	4.3	5.8
Components of real GDP						
Private consumption expenditure	88,975	6.3	0.7	0.5	1.7	2.4
Government consumption expenditure	25,761	6.0	3.9	0.7	0.6	0.4
Gross domestic fixed capital formation	48,203	1.2	-19.2	-17.2	3.5	5.5
Changes in stocks (% GDP)	-111	-0.1	0.3	0.2	0.1	0.1
Exports of goods and services	151,273	6.8	2.5	2.5	3.4	3.7
Imports of goods and services	127,611	4.1	-0.8	-1.0	2.2	2.3
Contributions to real GDP growth*						
Final domestic demand		4.1	-4.1	-3.3	1.6	2.3
**Changes in stocks ** **		-0.7	0.3	-0.1	-0.1	0.0
External balance of goods and services		2.6	2.5	2.7	1.3	1.5

* Figures subject to rounding.
** includes statistical discrepancy in 2007.
Source: CSO (2007), Department of Finance (2008 – 2011)

Table 1b – Price Developments

	2007	2008	2009	2010	2011
	rate of change	*rate of change*	*rate of change*	*rate of change*	*rate of change*
GDP deflator	1.4	-0.4	1.2	1.6	2.1
Private consumption deflator	2.9	3.6	2.4	1.8	2.1
HICP	2.8	3.4	2.2	1.8	1.6
Export price deflator (goods and services)	0.1	-1.4	0.4	1.0	1.7
Import price deflator (goods and services)	2.6	1.8	1.2	1.5	1.6

Source: CSO (2007), Department of Finance (2008 – 2011)

Table 1c – Labour Market Developments

	2007 (000)	2007 %	2008 %	2009 %	2010 %	2011 %
Employment, persons	2,117	3.6	0.0	-0.9	0.5	1.2
Unemployment rate (%)	100.5	4.5	5.8	7.3	7.0	6.5
Labour Productivity, per employee (GDP)		2.3	-1.3	0.2	2.1	2.4

Source: CSO (2007), Department of Finance (2008 – 2011)

Table 1d – Sectoral Balances

	2007	2008	2009	2010	2011
	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending/borrowing vis-à-vis rest of world	-5.4	-5.4	-3.4	-3.3	-2.6
Statistical discrepancy	1.0	1.0	1.0	0.9	0.9

Source: CSO (2007), Department of Finance (2008 – 2011)