



chapter 2

## The Economic and Fiscal Framework



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### Introduction<sup>1</sup>

The NDP 2007-2013 is framed in the context of an economy whose potential to grow, while still strong, is lower than in the recent past. Going forward, the over-arching economic priority is to consolidate the gains made over the last decade and to put in place the necessary conditions to ensure further economic progress into the future. The investment strategy under this Plan will form a key component in shaping these conditions.

### Economic Developments in Ireland 2000-2006

The economy recorded a solid performance over the period of NDP 2000-2006. GNP growth averaged an estimated 5.2% per annum over the period, broadly in line with that envisaged at the beginning of the last NDP. These growth rates are somewhat lower than those in the late 1990s and mainly reflected supply constraints, most notably in the labour market where conditions approaching full employment prevailed over most of the period.

In the early part of the decade, the economy showed considerable resilience in the face of a number of external shocks, including the global ICT shock and the outbreak of foot-and-mouth disease. The resilience was illustrated by the resulting very small increase in unemployment. Since then, the economy has performed well, although growth has become more reliant on domestic demand than heretofore, with new housing construction accounting for a disproportionately high share of output and employment.

In terms of the components of demand, personal consumption growth averaged 5.4% per annum over the period of NDP 2000-2006. This was slightly lower than under the previous Plan, and partly reflects a lower growth rate of household disposable income. Investment spending rose at an annual average rate of 6.2% over the period. Building and construction investment rose relatively strongly over the period, partly reflecting the demand for new housing.

On the external side, exports of goods and services rose at an annual average rate of 7.1% over the period. While still relatively strong, this growth was slower than the rates recorded under the previous Plan. This reflects a number of factors, including more modest demand growth in some of our trading partners, a gradual deterioration in cost competitiveness as well as some sector-specific issues. The growth rate of imports also slowed to an annual average rate of 7.3%, a decrease from the double-digit growth rates recorded in the previous Plan.

### Labour Market Trends

The 2000-2006 period was characterised by significant changes to the Irish labour market. Employment continued to expand at a robust pace, with growth averaging 3.4% per annum (the equivalent of around

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<sup>1</sup> Economic data covering the period 2000 — 2006 referred to in this Chapter should be regarded as estimates as full year data for 2006 are not yet available.

60,000 jobs per annum)<sup>2</sup>. As a result, by mid-2006, there were over 2 million people at work in Ireland for the first time in the history of the State.

The increase in employment was primarily facilitated by continuing increases in the labour force. This, in turn, was driven by the natural increase in the population of working age, higher participation rates and net inward migration<sup>3</sup>. This last component of labour force growth was particularly strong in later years, most notably since the accession of the 10 New Member States in 2004. Indeed, the latest data show that non-Irish nationals now account for 10% of the labour force. The unemployment rate remained low over the period, and, by the end of the previous Plan, the unemployment rate in Ireland was amongst the lowest in the EU.

## Prices, Earnings and Costs

During the 2000-2006 period, HICP inflation<sup>4</sup> in Ireland (the appropriate measure for international comparisons) averaged an estimated 3.6% per annum, compared to 2.2% in the euro area as a whole.

Wage inflation was also relatively high over this period. At the same time, the growth rate of labour productivity slowed, with an annual average growth rate of around 2% (in GNP terms). This slowdown reflected cyclical factors in the early part of the decade and the composition of growth in the mid-part of the decade, with output driven primarily by labour-intensive sectors such as construction and services.

Combined with the relatively strong wage growth, this lower productivity growth resulted in a rise in unit labour costs (i.e. the labour cost of producing a single unit of output) in Ireland and a consequent deterioration in our external competitiveness.

## Budgetary Developments and Policy

The Stability and Growth Pact (SGP) provides the overriding framework for Irish budgetary policy. Under the Pact, Ireland is obliged to keep the public finances, as measured by the General Government Balance, close to balance or in surplus in normal economic circumstances. During the course of the 2000-2006 Plan, Ireland fulfilled its obligations in accordance with the SGP and the level of General Government Debt fell from around 38% to about 25% of GDP over the period.

The General Government Balance has recorded a surplus every year since 1997 with the exception of 2002 when a small deficit was recorded. For 2006, the General Government Balance was again in surplus. This has been achieved while accommodating infrastructural investment of close to 5% of GNP, more than twice the EU average, putting aside 1% of GNP annually to help meet future pension costs and with a tax burden that is low by EU standards. Over the period of this Plan, Ireland will fully meet its commitment under the revised SGP but, more importantly, public finances must remain sound if: (i) the economic gains of the recent past are to be consolidated; and (ii) further gains are to be realised. Therefore, the key objective of fiscal policy during the period 2007-2013 will be to support sustainable economic growth so as to underpin the ambitious level of investment set out in this Plan.

A prudent budgetary policy will be implemented over the period of the Plan that does not add to inflationary pressures in the economy and that leaves flexibility for budgetary manoeuvre should an economic slowdown occur. Provision will also continue to be made for the challenge that an ageing population will pose in due course, notably through the annual transfer of 1% of GNP to the National Pensions Reserve Fund. This policy also requires that growth in day-to-day expenditure must be kept broadly in line with the increase in economic growth. In such circumstances, a key expenditure objective will be to achieve more with the resources already being used to realise maximum value for money.

<sup>2</sup> Quarterly National Household Survey data, referring to the second quarter of each year.

<sup>3</sup> A more detailed assessment of population trends nationally and regionally is set out in Chapter 3.

<sup>4</sup> HICP stands for Harmonised Index of Consumer Prices.

On the basis of the macroeconomic projections in Table 2.1 below and a generally prudent approach to budgetary policy as set out above, the 7 year investment programme in the Plan is affordable and will be compatible with stability in the public finances and compliance with the Stability and Growth Pact. As outlined in Chapter 1 and based on the economic outlook set out below, the next 7 years affords a window of opportunity to address investment crucial to national and regional competitiveness and the long term sustainability of the economy. Over the longer term, other pressures will build up on the public finances, notably in the health and pensions area, arising from an ageing population. It is important that this opportunity is used to decisively improve the productive capacity of the economy in light of the longer term demands that will be placed on it.

## **Economic Outlook 2007-2013**

It must be stressed that ultimately the ability of the State to fund the investment priorities in the Plan is dependent on continuation of stable economic and budgetary policies which deliver the requisite level of growth and resources. Key assumptions in this regard are set out in the following paragraphs.

### ***Domestic Prospects***

Against a reasonably favourable international backdrop, the outlook for the domestic economy over the period of the NDP 2007-2013 is broadly positive. The economy has the capacity to expand at an average rate of around 4 to 4½% per annum over this period. Such a rate of growth, if achieved, would be consistent with the maintenance of full employment. The programme of investment under the Plan will help to alleviate capacity constraints and greatly assist achievement of such a rate of growth.

Achieving such a growth rate is based on the assumption of no further significant loss in competitiveness. In this context, it is assumed that inflation averages 2% per annum over the period. In addition, it is assumed that housing output declines to more sustainable levels in a gradual manner. Any sharper than expected slowdown would have negative implications for growth.

### ***International Outlook***

The medium-term economic projections underpinning this Plan assume that the international environment will remain relatively benign. In particular, it is assumed that growth in our major trading partners will evolve in line with potential. Over the timeframe of this Plan, there will, of course, be periods of above-trend and below-trend growth in our major trading partners.

The international outlook is currently subject to a number of risks and vulnerabilities. Such risks, if they were to materialise, would have adverse consequences for the Irish economy. Perhaps the most identifiable risk concerns the evolution of the US current account deficit. It is generally accepted that this deficit will have to be corrected at some stage. The manner in which balance is restored could have adverse implications for the Irish economy, particularly if it involved sharp exchange rate changes. In addition, notwithstanding some easing in prices in recent months, oil price volatility, together with the potential for further price increases, presents very real threats to the global economy and, by extension, to the Irish economy. The current level of oil prices is mostly a demand-side phenomenon, with prices being driven by stronger demand from newly industrialising countries such as China and India. In these circumstances, relatively high prices are likely to persist in the short-to medium-term.

### ***Labour Market Prospects***

The labour force rose by 3.2% per annum over the period of the last Plan. Going forward, a further expansion of the labour force is expected, although the rate of increase is likely to moderate. While favourable demographics will continue to add to the pool of labour, participation rates are now high by EU standards, so that the scope for further significant increases in labour supply from this source is more limited than in the past. Net inward migration will also contribute to labour force growth and, while there is considerable uncertainty regarding the magnitude of these inflows going forward, it is assumed that they will not be as strong as in the very recent past.

It is assumed, therefore, that the labour force will increase at an average rate of around 2 – 2½% per annum over the period of the Plan. These labour force projections take into account the likely effects of ongoing labour market reforms aimed at improving employability, participation, etc. The forecasts underpinning this Plan assume that, on average over the period, employment will expand broadly in line with the increase in the labour force, with the unemployment rate remaining relatively low. However, any internal or external shocks to the economy would have implications for labour market trends over this period.

### **Labour Productivity**

As outlined earlier, productivity growth slowed over the period of the 2000-2006 Plan. Going forward, it is assumed that an average productivity growth of around 2% per annum can be attained. Such rates of growth are lower than the historical average and reflect the increasing importance of labour-intensive services, together with the lower relative importance of manufacturing. Nevertheless, such a rate of labour productivity growth would still be reasonably high by international standards. This, in turn, reflects ongoing improvements in the average skills level and educational attainment of the workforce, as less well-educated older workers retire and are replaced by younger and better educated new labour market entrants. In addition, the relatively high level of investment in plant and machinery and in the stock of infrastructure will increase the output of those in employment, as will further technological progress.

The programme of investment and the priorities contained in this National Development Plan, as they relate to areas such as infrastructure, education, science and technology etc., will help to increase the potential of the economy to grow. Investing in both human and physical capital, as set out in the Plan, will help to increase living standards above what they would otherwise be and will improve the quality of life of Irish people and the overall productive capacity of the economy.

These priority investments will position the Irish economy to respond well to many of the challenges of a globalised economy. In general, the programme of investment contained in the Plan should generate a significant rate of return on the funds being invested.

Based on the above, the key macroeconomic projections for the period of the Plan are as follows:

**Table 2.1: Macroeconomic projections 2007-2013 (annual average)**

	<b>2007-2013 (per cent)</b>
Gross National Product (GNP)	4-4½
Consumer Prices	2
Employment	2-2½
Unemployment rate (per cent of labour force)	<5

### **Longer Term Provision**

Demographic projections indicate that the size and composition of Ireland's population will undergo considerable change over the coming decades. Most notably, a substantial increase in the number of older people is expected to occur so that by 2050 the proportion of the population aged 65 and over relative to the population aged 15-64 (the old age dependency ratio) will be in the order of 45%, nearly treble the 2004 figure of 16.4%. This implies that Ireland will move from having six people of working age for every older person to a ratio of just over two to one.

This projected “greying” of the population will pose significant economic and budgetary challenges. Foremost amongst these is a substantial increase in age-related public expenditure. Projections by the EU

Economic Policy Committee indicate that public spending on pensions, health and long-term care will increase from 10.6% of GDP in 2004 to 19.6% in 2050<sup>5</sup>.

In responding to these challenges, it should be borne in mind that much of the projected rise in the age-related expenditure burden will not materialise for some time yet. As such, a “window of opportunity” exists in which the public finances and the economy have time to adjust. Over the short to medium term, it is essential that Ireland takes advantage of this opportunity to put in place appropriate measures to cope with rising age-related spending and to boost the productive capacity of the economy.

To date, a range of Government initiatives which aim to address longer term expenditure pressures, while maintaining the welfare and living standards of older members of society into the future, have been introduced. These include the establishment of the National Pensions Reserve Fund and the decision to publish the Green Paper on Pensions Policy. Notwithstanding these initiatives, the low level of debt and sound budgetary position, Ireland is nonetheless considered to be at ‘medium risk’ in terms of the sustainability of our public finances<sup>6</sup>. Hence, additional policy responses will be required going forward. In particular, if Ireland is to successfully meet the longer term challenges implied by an ageing population, it must act early to improve the productive capacity of the economy. Doing so will help sustain economic growth into the future, which, in turn, will place the public finances in a better position to cope with age-related spending pressures.

Overall, these longer term issues underscore the need for appropriate investment in the short to medium term. By providing such investment, the NDP 2007-2013 will better equip the economy to meet the challenges ahead.

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<sup>5</sup> 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)*.

<sup>6</sup> European Commission (2006) *The Sustainability of Public Finances based on the 2005/06 Updates of Stability and Convergence Programmes*.

