Box E: Illustrative Medium-Term Expenditure Scenario

This Box updates the medium-term scenario for government expenditure contained in IFAC's June 2015 *Fiscal Assessment Report.*[1] In order to construct a medium-term scenario, government expenditure is split into five headline components: health, education, social payments (including social welfare pensions), national debt interest and other. The assumptions used in generating the scenario are set out below.

Health and Education

For health and education, pay and non-pay spending are modelled separately. The volumes of both pay and non-pay spending are linked to expected service demand arising from demographic changes. Price changes for pay and non-pay spending are indexed to relevant deflators. For health, service demand is proxied by the change in the number of under-65 equivalents in the population while for education demand is proxied by the change in the population of potential students. The pupil-teacher ratio is assumed to remain unchanged at its current level. Pay rates until 2018 in the public sector are assumed to grow in line with the increases contained in the June 2015 *Lansdowne Road Agreement.* Thereafter, public sector pay is assumed to grow in line with non-agricultural wages. The volumes of non-pay expenditure in health and education are assumed to grow in line with expected demand linked to demographics. Prices are indexed to the GDP deflator.

Social Payments

This element of expenditure can be split into four broad components:

i. Old age payments: These are assumed to grow in line with the change in the population aged over 65 with payment rates indexed to growth in prices.
ii. Child related payments: The volume is estimated using the change in the population aged under 17. Payment rates are assumed to grow in line with prices.
iii. Unemployment benefits are linked to macroeconomic dynamics rather than directly to demographics. The approach used is broadly the same as that applied by the Departments of Public Expenditure and Reform and Social Protection. This approach translated changes in unemployment to movements in the Live Register and then applies an average cost per individual.[2] The average cost term is indexed to price increases over the projection period.
iv. Other payments: these include disability payments, back to education allowance, back to work allowances and other social payments. This category is assumed to grow in line with the change in the total population and prices.

Capital Expenditure

The scenario uses the projections for capital spending over the medium term as set out in *Budget 2016.* The forecasts for capital spending in the Budget are based on the

[1] The construction of this scenario broadly follows the methodology set out in Barrett (2006).

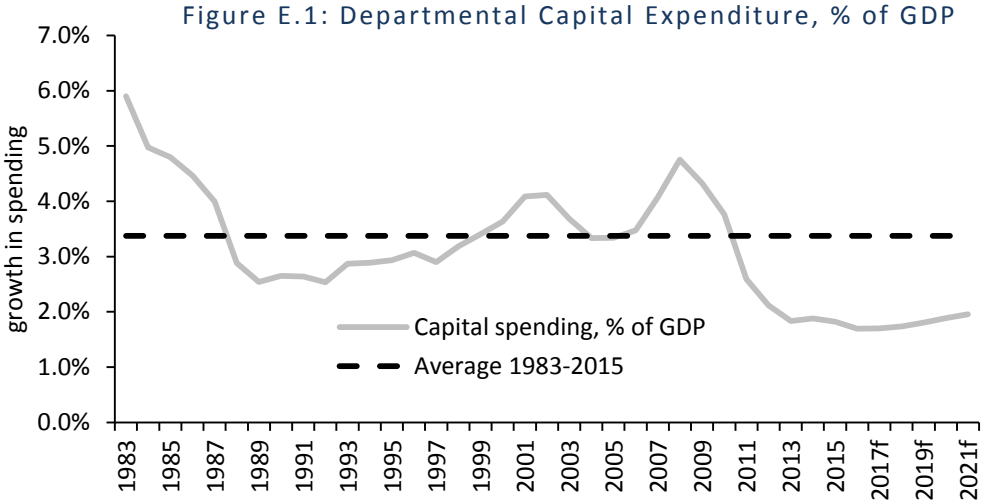
[2] This approach can be summarised as follows:

$$\mathrm{UB}_{t+1} = \mathrm{UB}_t + (\mathrm{LR}_{t+1} - \mathrm{LR}_t) * \mathrm{LRC}_t + (\text{New policy measures}) + \mathrm{J}_{t+1}$$

where, UB is the nominal sum of Jobseeker's Allowance and Jobseeker's Benefit, LR is the average annual number of persons on the Live Register, LRC is the average cost per Live Register Claimant and N is the net impact of new measures introduced in this area in the budget. The final term is assumed to be zero in the post 2016 period for this exercise.

Government's *Infrastructure and Capital Investment Plan 2016-2021* announced in September 2015. Figure E.1 shows the path of capital expenditure as a share of GDP under the new plan. The forecasts imply a small rise in capital spending by the end of the decade; however, the chart shows that capital spending is projected to remain at very low levels by historical standards over the forecast horizon.

Figure E.1: Departmental Capital Expenditure, % of GDP

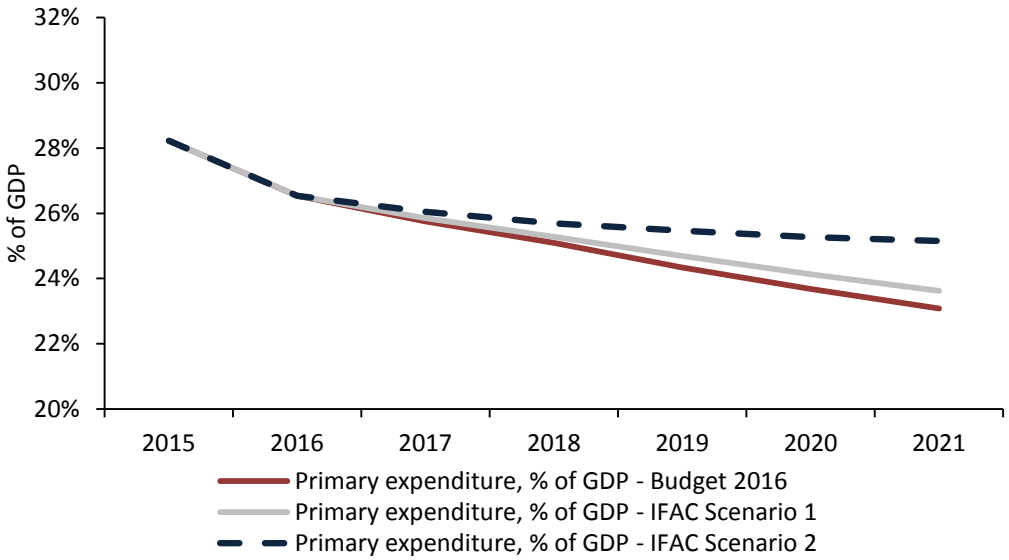


Source: Budget 2016, Budget and Economic Statistics (Department of Finance).

National Debt Interest

The Exchequer deficit is given by the gap between expenditure and revenue. National debt interest is calculated as the difference between the Exchequer balance projected in this scenario and the relevant figure underpinning *Budget 2016*, multiplied by the average interest rate. The gives the additional interest payments for a given year which is added to the interest bill on the outstanding stock of debt for the previous year to arrive at the figure for total national debt interest.

FIGURE E.2: COMPARISON OF PRIMARY EXPENDITURE UNDER ALTERNATIVE SCENARIOS



Note: Scenario 1 allows for demographic change with no indexation. Scenario 2 allows for demographic change plus indexation.
Source: Internal IFAC calculations.

Figure E.2 shows how the illustrative scenario is built up. Firstly, adjustments for demographics are included; then provisions for increases in the cost of providing public services are made through indexation. The results in Figure E2 show that allowing only for demographic costs and the current public service pay agreement out to 2018 (Scenario 1) returns a spending profile broadly in line with the *Budget 2016* projections. The Budget forecasts include approximately €0.4 billion per annum of spending increases for demographic pressures. Allowing for demographics and accommodating estimated increases in the cost of providing public services over time (Scenario 2) would result in expenditure being significantly higher than projected in *Budget 2016*. Primary government expenditure as a share of GDP would be around 2 percentage points of GDP higher by 2021 compared to the projections in *Budget 2016.*