Stand-Still Scenario for Government Spending, 2020–2023

June 2019

Irish Fiscal Advisory Council

This report can be downloaded at **www.FiscalCouncil.ie**

1. Summary

For this note, the Irish Fiscal Advisory Council (IFAC) estimates Government spending until 2023 based on a "Stand-Still" Scenario: that is the cost of maintaining today's level of public services and benefits in real terms over the medium term. The Stand-Still Scenario uses the latest available information on past expenditure, demographics, and macroeconomic forecasts to produce expenditure estimates for the period 2020–2023. The Council considers that estimates produced in this scenario could form an important input into the expenditure planning process, which can enrich the evidence base for budgetary decisions.

The Government's current medium-term spending projections do not fully accommodate Stand-Still Scenario estimates of demographic costs and inflationary pressures. There is an average shortfall of €610 million per year between expenditure increases in the *Stability Programme Update (SPU) 2019* and spending required in the Stand-Still Scenario. Thus, Stand-Still Scenario estimates of demographic pressures and of the cost of maintaining public services and benefits in real terms would only partially be accommodated, unless there are changes in policy or in macro drivers.

IFAC has its own definition of "Standing Still". Demographic changes are projected to add a yearly average of €750 million to current expenditure according to the Stand-Still Scenario, whereas official allocations for such increases amount to €450 million. This is mainly because official estimates treat fewer expenditure items as demographically sensitive. In addition, the Stand-Still Scenario indicates estimated average annual inflationary pressures of €1.38 billion. By comparison, there are no specified allocations for inflationary pressures contained in official allocations other than for public sector pay increases of €390 million in 2020 and €260 million in 2021. Such inflationary pressures are typically not provided for in advance and are instead dealt with on a year-by-year basis.

Budgetary plans can be made more robust when founded on a better understanding of the drivers of expenditure and how these are expected to evolve over the medium term. The Council welcomes the inclusion of medium-term expenditure estimates in *SPU 2019* which address commitments to

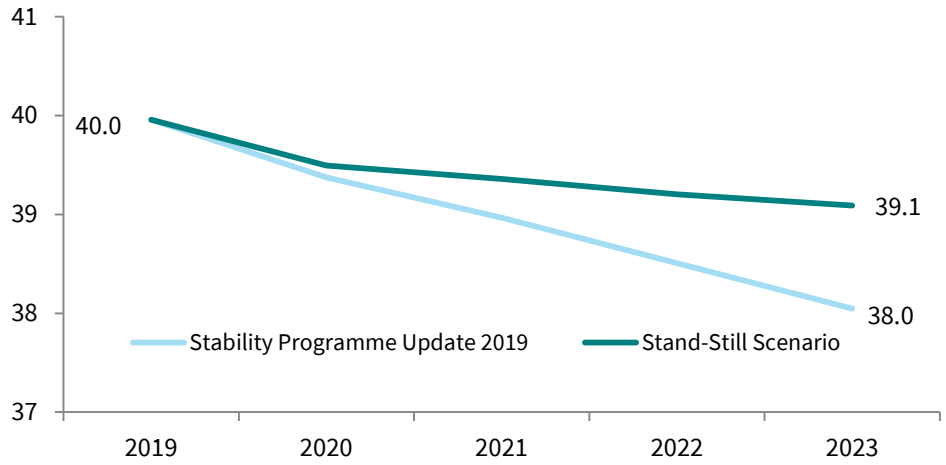
demographics, public service pay, and carryover costs. In addition to these, the Stand-Still Scenario considers inflation an important factor of expenditure development and it links public sector pay increases to economy-wide wage growth forecasts after 2020.[1]

[1] The current Public Service Stability Agreement concludes in December 2020 (WRC, 2017).

2. Stand-Still Scenario vs. Current Allocations

The Stand-Still Scenario can be used to examine the planning for spending pressures related to price changes and demand changes due to demographics. Figure 1 shows the Stand-Still Scenario estimates of non-interest Government expenditure as a percentage of GNI* and compares them to official medium-term expenditure projections as outlined in *SPU 2019*.[2]

Figure 1: Non-Interest Spending
Percentage of GNI*



Sources: *SPU 2019*; Stand-Still Scenario: *Revised Estimates 2019*, *SPU 2019*, CSO, Department of Expenditure and Reform, HIPE, HSE and internal IFAC calculations.
Note: Primary expenditure is general government expenditure excluding interest costs.

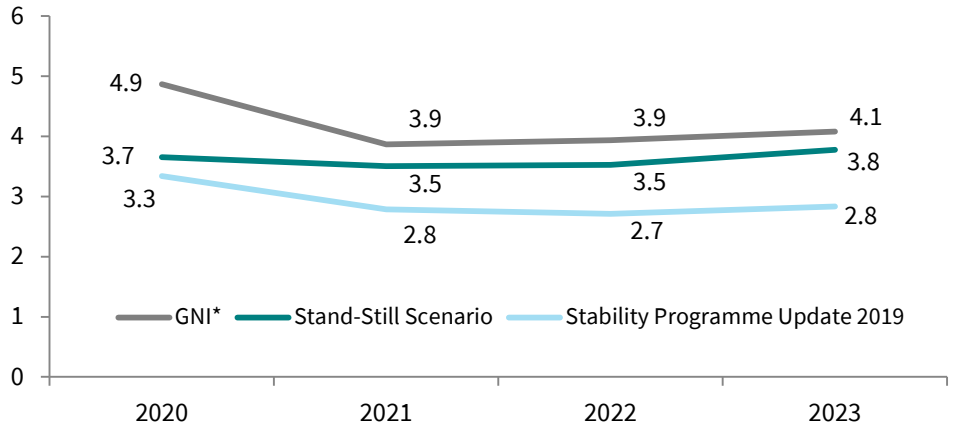
Stand-Still Scenario estimates for non-interest spending are consistently higher than projections by the Government. Primary expenditure plans outlined in *SPU 2019* imply a fall in non-interest spending from 40 per cent of GNI* to 38 per cent in 2023. By 2023, *SPU 2019* projections indicate primary expenditure of €90.4 billion, while the Stand-Still Scenario anticipates €92.8 billion (39.1 per cent of GNI*) to fully accommodate volume and price pressures.

Non-interest spending is projected to rise more rapidly in the Stand-Still Scenario compared to official *SPU 2019* projections for all of 2020-2023. Gross spending is projected to rise by 3.6 per cent per annum on average in the Stand-Still Scenario, whereas official *SPU 2019* projections indicate a rise of 2.9 per cent (Figure

[2] GNI* is designed to better capture income of Irish residents than GDP. For further information, see *SPU 2019,* Box 3. GNI* forecasts are taken from *SPU 2019*.

2). In both cases, growth in nominal GNI* outpaces spending growth, driving the ratio down.

Figure 2: Growth in Nominal GNI*and Primary Expenditure
Percentage change (year on year)



Sources: SPU 2019; Stand-Still Scenario: Revised Estimates 2019, SPU 2019, CSO, Department of Expenditure and Reform, HIPE, HSE and internal IFAC calculations.
Note: Primary expenditure is general government expenditure excluding interest costs.

Stand-Still Scenario estimates exceed official spending increases over the entire projection period. Table 1 shows expected yearly spending pressures and compares them to current voted expenditure projections in *SPU 2019*. Over the medium term, the Stand-Still Scenario consistently estimates higher increases to keep public services constant in real terms than what is officially projected. These gaps widen in later years.

The Government's projections include amounts set aside as "unallocated resources", but even these appear insufficient to meet estimated demographic and inflationary pressures. Officially projected expenditure increases in Table 1 include provisions for unallocated resources. These unallocated resources may be used to cover additional demographic and inflationary pressures, carryover costs of previous budgetary measures, and/or the provision of new services. However, their allocation between these categories is not yet clear. Comparing them to Stand-Still Scenario estimates suggests that even if all unallocated funds were to be used for demographic and inflationary pressures, a shortfall of official total expenditure increases relative to Stand-Still Scenario estimates would remain.

Table 1: Comparison Stand-Still Scenario and Official Projections

Changes in € billion, year on year (gross voted current expenditure)

	2020	2021	2022	2023
IFAC Stand-Still Scenario	**1.70**	**2.05**	**2.28**	**2.49**
of which:				
Demographics	0.76	0.72	0.76	0.76
Inflationary pressures	0.94	1.33	1.52	1.73
of which:				
Increases due to wages	0.39	0.64	0.71	0.80
Non-wage inflation	0.55	0.69	0.82	0.93
Total Increases in *SPU 2019* (allocated + unallocated)	**1.45**	**1.44**	**1.56**	**1.60**
of which:				
Demographics	0.45	0.46	0.46	0.46
Public Sector Pay	0.39	0.26		
Carryover	0.31			
Unallocated Resources and Other Increases*	0.30	0.72	1.10	1.14
Shortfall of Total Increases in *SPU 2019* Relative to Stand-Still Scenario	**-0.25**	**-0.61**	**-0.73**	**-0.89**

Sources: Official allocations and projected increases: *SPU 2019*, Department of Expenditure and Reform, *Mid-Year Expenditure Report 2018* and *Budget 2019 Expenditure Report*; Stand-Still Scenario: *Revised Estimates 2019*, *SPU 2019*, CSO, Department of Expenditure and Reform, HIPE, HSE and internal IFAC calculations.
Notes: Public Sector Pay includes allocations for the Public Service Stability Agreement and New Entrants.
*Unallocated resources are a provision for the cost of new measures and carryover cost of *Budget 2019* measures not yet allocated to any Vote. Other increases are not clearly allocated to demographics, inflationary pressures, and/or policy changes.

The handling of inflationary pressures differs between the Stand Still Scenario and official projections. Unlike the official projections, which only consider pay agreements, the Stand-Still Scenario considers the implications of broader inflationary pressures to ensure that its projections "stand still" in *real* terms. That includes increasing social welfare spending areas in line with the Harmonised Index of Consumer Prices (HICP). Such indexation is not automatic. Official projections leave inflationary pressures to be dealt with on a year-by-year basis as part of the budgetary process. The Stand-Still Scenario estimates indexation costs at €250 million in 2020, rising to €608 million in 2023 as HICP forecasts increase.

The Stand-Still Scenario indicates continued pay pressures in 2021–2023. After the expiration of the current public sector pay agreement (including the Public Service Stability Agreement and New Entrants provisions), the Stand-Still Scenario projects pay increases in line with forecasts for economy-wide average wage growth in 2021–2023.[3] By contrast, official projections only provide for public sector pay increases until 2020 and associated carryover costs into 2021, leading to a wider difference between Stand-Still estimates and official pre-commitments for subsequent years (Table 1).

Compared to prices, demographic spending pressures remain relatively stable at around €750 million per year. This can be interpreted as the underlying population structure changing smoothly over the medium term. Official allocations for demographics amount to about €450 million per year.[4] Around a third of the additional €300 million estimated as required annually in the Stand-Still Scenario is due to the fact that the Stand-Still Scenario considers demand pressures within social welfare other than child-related benefits and pensions, while official forecasts do not identify these areas as demographically sensitive. Another €100 million of the difference can be attributed to the Stand-Still Scenario estimates including public sector pensions, whereas official forecasts of demographic pressures only include pension expenditure of the Social Protection Vote (state pensions and widow(er)'s/surviving civil partner pensions).

The Appendix describes the Stand-Still Scenario methodology and drivers in more detail. Estimates only draw on gross voted current expenditure, which is assumed to be most affected by demand pressures. As capital expenditure is less demand-driven than some current services, the Stand-Still Scenario uses capital expenditure plans set out in the latest official projections by the Department of Public Expenditure (in this case *SPU 2019*). The Appendix gives further information on the methodology.

[3] Forecasts for growth in average non-agricultural wages and for price inflation (HICP and GNP deflator) are taken from *SPU 2019*.

[4] Official forecasts of demographic pressures are based on Connors, Duffy and Newman (2016).

3. Detailed Stand-Still Scenario results

Table 2: Stand-Still Scenario by Area of Spending
Changes in € billion, year on year (gross voted current expenditure)

	2020	2021	2022	2023
Pensions*	0.49	0.57	0.68	0.73
Health (incl. LTC)	0.48	0.59	0.65	0.70
Social welfare (incl. SIF, excl. pensions)	0.26	0.30	0.35	0.40
Education	0.26	0.32	0.32	0.34
Remainder of gross voted	0.22	0.27	0.29	0.31
IFAC Stand-Still Scenario	**1.70**	**2.05**	**2.28**	**2.49**

Sources: *Revised Estimates 2019, SPU 2019*, CSO, Department of Expenditure and Reform, HIPE, HSE and internal IFAC calculations.
*Includes: State pension contributory, public sector pension, widow(er)s' and surviving civil partners' pension contributory, and state pension non-contributory.

Health and pensions are the two biggest areas of spending increases over the medium term in the Stand-Still Scenario. Table 2 shows the Stand-Still Scenario increases by area of spending. Health and long-term care (LTC) and pensions are associated with higher increases due to population ageing. Education spending is assumed to depend on changes in younger age cohorts, while overall social welfare payments are related to general population growth. As such, they do add to demographic pressures over the course of 2020–2023, but less so relative to spending areas more affected by older cohorts. Education accounts for the relatively lowest source of demographic pressure, due to the projected gradual decrease in the primary school age cohort (Table 3). Official forecasts are based on similar trends for educational enrolment (see Department of Expenditure and Reform, 2018b; and Connors *et al.*, 2016).

Stand-Still Scenario estimates on health pressures may be seen as conservative. The Council expects health expenditure pressures due to demographics and prices to be substantial (Tables 2 and 3). Price pressures can mainly be attributed to strong forecast economy-wide wage growth. Nonetheless, expenditure estimates are rather conservative, given that after several years of savings in the health sector following the financial crisis, health expenditure rose by more than demographic growth and economy-wide wage growth in 2018. If assuming that this excess growth is (at least partly) due to an expansion of public health services, the Stand-Still Scenario estimates may well be on the lower end of

actual future health expenditure increases, since they treat the age-specific demand of health services as "standing still".

Table 3: Stand-Still Scenario Breakdown of Demographics and Inflationary Pressures

Changes in € billion, year on year (gross voted current expenditure)

	2020	2021	2022	2023
Increases due to demographics	**0.76**	**0.72**	**0.76**	**0.76**
Pensions*	0.36	0.37	0.41	0.41
Health (incl. LTC)	0.18	0.17	0.20	0.21
Social Welfare (incl. SIF, excl. pensions)	0.12	0.10	0.10	0.10
Education	0.10	0.08	0.05	0.04
Increases due to inflationary pressures	**0.94**	**1.33**	**1.52**	**1.73**
Pensions*	0.13	0.20	0.27	0.33
Health (incl. LTC)	0.31	0.41	0.45	0.49
Social Welfare (incl. SIF, excl. pensions)	0.13	0.20	0.25	0.30
Education	0.15	0.25	0.27	0.30
Remainder of Gross Voted	0.22	0.27	0.29	0.31
Total Stand-Still Scenario	**1.70**	**2.05**	**2.28**	**2.49**

Sources: *Revised Estimates 2019, SPU 2019*, CSO, Department of Expenditure and Reform, HIPE, HSE and internal IFAC calculations.
*Includes: State pension contributory, public sector pension, widow(er)s' and surviving civil partners' pension contributory, and state pension non-contributory.

Inflationary pressures are set to increase over the entire forecast period. Table 3 shows increasing pressures due to wage and price inflation over 2020–2023 across all areas of spending. Pay-related costs are assumed to pick up after 2020 for reasons mentioned in Section 2. This mostly affects education and health spending, given the large share of pay expenditure in these two areas. Increases due to price inflation, the second inflationary pressures driver, go up more steadily over the entire estimation period, with HICP forecast in *SPU 2019* to gradually increase from 1.1 per cent in 2020 to 2.3 per cent in 2023 and with the GNP deflator forecast at 1.7 per cent for 2020–2023.

Stand-Still Scenario demographic spending pressures can be further decomposed. Almost half of pension expenditure increases due to demographics can be attributed to the contributory state pension, the largest pension expenditure item. Close to 30 per cent can be allotted to estimates for public sector pensions,

while the remaining 20 per cent are due to other pension payments. Regarding health expenditure, estimated demographic pressures in the Primary Care Reimbursement Scheme and in long-term residential care combined account for as much as changing demographics in the acute hospitals area alone.

Appendix: Overview of Methodology

IFAC's Stand-Still Scenario is an illustrative exercise and not an alternative expenditure forecast to that outlined in *SPU 2019.* It is important to note that the Council is not suggesting automatic or semi-automatic indexation of payments. Instead, the Scenario provides information as an input into the policy decision process through which expenditure plans are produced. The Stand-Still approach does not consider possible efficiency gains or Government policy changes that could lead to expenditure savings over the timeframe. Rather, the Scenario illustrates the cost of maintaining today's level of public services in the absence of such efficiency measures and/or policy changes.

The Stand-Still Scenario is based on:

1) **A cohort-component model for estimating demographic changes**

2) **A macro-simulation (cell-based) model for estimating changes in expenditure based on the demographic assumptions taken from (1) and other macro drivers, such as inflation.**[5]

The Council's demographic model (1) follows the evolution of each population cohort over time, based on *Census 2016* data of the Central Statistics Office (CSO). Population flows are determined by assumptions on future fertility (from European Commission, 2018), mortality (from CSO's population projections) and net migration (from *SPU 2019*). The resulting growth rates per cohort are in turn used in IFAC's macro simulation model.

The macro-simulation model (2) involves two steps. First, to account for demand pressures, demographically sensitive expenditure items are projected forward by the change in the relevant population share. For example, expenditure on secondary education teachers is grown by the yearly percentage change in 13–18 year-olds. Second, these expenditure projections are adjusted for relevant price pressures to allow for changes in the cost of providing public services. Appendix Table A lists the drivers used by broad area of spending.

[5] This note outlines the methodology currently (May 2019) used in constructing the Stand-Still Scenario. In the iterative process of improving and extending the model, further changes may be made to this methodology. Any such changes will be included in future notes.

Government expenditure is split into five areas: health, education, pensions, social welfare (including the Social Insurance Fund, SIF), and other expenditure. Within each of these areas, pay and non-pay expenditure are modelled separately to account for different price pressures. In all cases, pay rates are expected to rise in line with the Public Service Stability Agreement 2018–2020 (see WRC, 2017 and Department of Expenditure and Reform, 2019). Thereafter, public sector pay is assumed to grow just as economy-wide average non-agricultural wages. Non-pay expenditure is projected to rise with general price inflation (based on the HICP or GNP deflator).

Health spending projections for the Primary Care Reimbursement Service (PCRS), Nursing Home Support Scheme (NHSS), and older persons' services are modelled separately. To account for age-related cost paths, the Stand-Still uses detailed data from the Hospital In-Patient Enquiry Scheme (HIPE) to estimate expenditure pressures. In future and subject to data availability, it may be worth explicitly modelling other services for older people (notably Household Care packages) and Mental Health services. Given the high labour intensity in the health sector—almost of half of current and capital expenditure is pay—wage growth is a key price driver here.[6] Implicitly, this assumes that for retention of staff, wages need to follow private-sector pay irrespective of efficiency gains.[7]

Education spending projections are divided between primary, secondary, and tertiary education. The volume driver of expenditure is the expected demand for education, i.e., the demographic change in the relevant age cohort, reflecting the population of potential students. Analysis by level of education is relevant given the projected move of the spike in children born after the last economic crisis from primary to secondary education in the years to come. On the other hand, the skills development programme, aimed at ages 24–65, faces a comparatively stable target group. Note that any future changes to the pupil-teacher ratio (currently not legislated for) would be seen as a policy decision and thus the ratio is assumed to stay at its current level. Likewise, education participation rates are implicitly held constant.

[6] See Department of Public Expenditure and Reform (2018a).

[7] This theory is known as the Baumol cost disease. See, for example, Wren *et al.* (2017).

Social protection expenditure is separated into five components: old-age payments, child-related payments, unemployment benefits, other working-age payments and other social welfare. Old-age payments are grown by the population change above the pensionable age while child-related payments consider the population younger than 18. Unemployment benefits are linked to the economic environment rather than demographics; the approach employs a conversion rate to translate changes in the unemployment rate to movements in the Live Register to determine the volume pressures.[8] Regarding price pressures, all social welfare payments are tied to price changes (HICP) to keep standards of living as at 2018.

Pension spending projections comprise contributory and non-contributory state pensions as well as public sector pensions. Volume changes in state pension payments are set to move in line with the rise in pensionable age from 66 to 67 in 2021. Similar to social welfare payments, pensions are to increase with HICP inflation.[9]

Capital spending and non-voted spending are assumed to progress in line with the Government's existing plans. As capital expenditure is less demand driven than some current services the Stand-Still Scenario uses the capital expenditure plans set out in *SPU 2019*.

[8] The conversion rate is taken from Lavelle (2018).

[9] Note that in budget documents, state pensions are attributed to the social protection vote, while public sector pensions are included in each vote for its respective retirees.

Table A: Drivers by broad Area of Expenditure

	Demographic cohort	Non-pay price driver	Pay price driver
Education			For all areas of expenditure: Central Pay Agreement Provision information for 2020 (taken from *Budget 2019 Expenditure Report*), average non-agricultural wages for 2021–2023
Primary school	4–12		
Secondary school	13–18	GNP deflator	
Tertiary education	19–24	(all education)	
Skills development	25–64		
Health			
Acutes, PCRS	Entire population	GNP deflator	
NHSS	70+	(all health)	
Pensions			
	66+, change to 67+ in 2021	HICP (all pensions)	
Social Welfare			
Working-age supports	18–66, change to 18–67 in 2021		
Children	0–17		
Illness, disability, carers and rent supplement	Entire population	HICP (all social welfare)	
Household benefits package	70+		
Free travel and fuel allowance	Same as pensions		
Remainder of gross voted			
	n.a.	GNP deflator	

Bibliography

Connors, J., Duffy, R. and F. Newman, (2016). Budgetary Impact of Changing Demographics 2017-2027. Staff Paper, Department of Public Expenditure and Reform, September 2016.

Department of Finance, (2019). Stability Programme Update 2019. April 2019. Dublin. Available at: https://www.gov.ie/en/publication/e97b68-stability-programme-update-2019-april-2019/

Department of Finance, (2018). Budget 2019. October 2018. Dublin. Available at: http://www.budget.gov.ie/Budgets/2019/2019.aspx

Department of Public Expenditure and Reform, (2019). Application of Additional Increments awarded in Relation to New Entrants under the Public Services Stability Agreement 2018-2020. Circular 07/2019. Dublin. Available at: https://circulars.gov.ie/pdf/circular/per/2019/07.pdf

Department of Public Expenditure and Reform, (2018a). Revised Estimates for Public Services 2019. Dublin, December 2018.

Department of Public Expenditure and Reform, (2018b). Pay Expenditure Drivers at Primary and Second Level. Spending Review 2018.

European Commission, DG Economic and Financial Affairs, (2018). The 2018 Ageing Report: Economic and Budgetary Projections for the EU Member States (2016-2070). European Economy Institutional Paper 079, May 2018.

European Commission, DG Economic and Financial Affairs, (2017). The 2018 Ageing Report: Underlying Assumptions & Projection Methodologies. European Economy Institutional Paper 065, November 2017.

Lavelle, O., (2018). Budget 2019: Analysis of Live Register Related Expenditure. Department of Expenditure and Reform, October 2018. Available at: http://www.budget.gov.ie/Budgets/2019/Documents/Live_Register_Related_Expenditure.pdf

Lawless, J., (2018). Spending Review 2018: Hospital Inputs and Outputs: 2014 to 2017. Department of Expenditure and Reform, July 2018. Available at: https://assets.gov.ie/3835/061218103543-cb456a756553477c822b27a91c0b0af7.pdf

Meirmans, J., (2018). Trends in public Social Care Service Provision and Expenditure for Older Persons. Spending Review 2018, Department of Public Expenditure and Reform, July 2018.

Meirmans, J., (2017). Nursing Homes Support Scheme: Trends and Figures. IGEES Staff paper, Department of Public Expenditure and Reform, October 2017.

Workplace Relations Commission (WRC), (2017). Public Service Stability Agreement 2018–2020. Dublin, June 2017.

Wren, M-A., Keegan, C., Walsh, B.. Bergin, A., Eighan, J., Brick, A., Connolly, S., Watson, D. and J. Banks, (2017). Projections of Demand for Healthcare in Ireland 2015-2030. First Report from the Hippocrates Model. ESRI Research Series No. 67, October 2017.