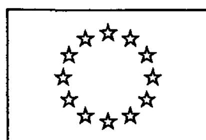

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 30.1.2003
SEC (2003) 126 final

EU RESTRICTED

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 5 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the 2002 update of Ireland's Stability Programme, 2003-2005

(presented by the Commission)

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EXPLANATORY MEMORANDUM

Council Regulation (EC) No. 1466/97, on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[1], stipulated that countries participating in the single currency were to submit stability programmes to the Council and the Commission by 1 March 1999. In accordance with Article 5 of this Regulation, the Council had to examine each stability programme based on the assessments prepared by the Commission and the Committee set up by Article 114 of the Treaty, the Economic and Financial Committee. The Commission adopted a recommendation on each programme. On the basis of this recommendation and after having consulted the Economic and Financial Committee, the Council delivered an opinion, following its examination of the programme.

Ireland's first stability programme covering the period 1999-2001 was submitted on 2 December 1998 and assessed by the Council on 18 January 1999[2].

According to the Regulation, the updated stability programmes, to be presented annually, may also be examined by the Council in accordance with these same procedures. The first annual update, covering the period 2000-2002, was submitted on 1 December 1999 and examined by the Council on 31 January 2000[3]. The second update, covering the period 2001-2003, was submitted on 6 December 2000 and examined by the Council on 12 February 2001[4]. The third update, covering the period 2002-2004, was submitted on 5 December 2001 and examined by the Council on 12 February 2002[5].

Ireland submitted the fourth and most recent update, covering the period 2002-2005, on 4 December 2002. The Commission services have carried out a technical evaluation of this update, namely, taking into account the Communication of the Commission to the Council of 27 November 2002 on strengthening the co-ordination of budgetary policies[6]. This evaluation warrants the following assessment:

> The new update of the Irish stability programme was presented in December, as customary together with the budget for the coming year. It broadly complies with the data requirements of the revised "code of conduct" on the content and format of stability and convergence programmes[7]. However, compliance would be strengthened by explaining the nature and significance of the large "contingency provisions" included in the public finance projections for the final two years of the programme. This makes it difficult to identify the true targets of the programme, thereby complicating the assessment of the adjustment planned in the medium term.
>
> The economic policies as reflected in the planned measures in the programme update broadly comply with the Broad Economic Policy Guidelines for 2002. Specifically, the measures to improve the management and control of public expenditure, as outlined in the update, are in line with the Broad Economic Policy Guidelines but the

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1 OJ L209, 02.08.1997
2 OJ C42, 17.02.1999
3 OJ C60, 02.03.2000
4 OJ C77, 09.03.2001
5 OJ C51, 26.02.2002
6 COM (2002) 668 final of 27.11.2002.
7 *Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes*, document EFC/ECFIN/404/01 - REV 1 of 27.06.2001 endorsed by the ECOFIN Council of 10.07.2001.

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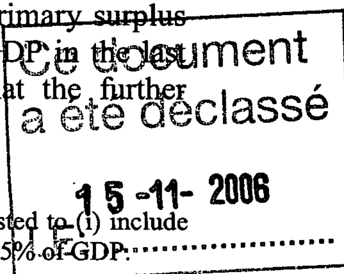
recommendation to develop a norm-based framework to guide spending in the medium term has not been implemented.

Following the very large deterioration in the budget balance recorded in 2001, when the surplus ratio fell by about three percentage points of GDP to 1.6%, the estimated outcome for 2002, according to the latest budgetary data provided by the Irish Department of Finance, is a deficit of 0.1% of GDP. Although better than in recent estimates, including that submitted with the update itself, this result falls short, by about half a percent of GDP, of the objective in last year's programme, for which a large tax undershoot is mainly to blame[8]. This is in spite of an upward revision to the rate of GDP growth, which is now estimated at 4½% (from 3.9% in the previous update), and to the rate of inflation (measured by the GDP deflator), which has continued to exceed 5% (compared to 3.8% in the previous update). Following the exceptionally high growth recorded by the Irish economy in the second half of the 1990s, and notwithstanding the relative slowdown since 2001, the output gap, derived from an application of the agreed production function methodology to the data in the programme, is estimated to be still positive and significant. The corresponding cyclically-adjusted balance (which, after taking account of an approximately neutral impact of one-off measures, broadly coincides with the underlying balance) is estimated to have become significantly negative (about 1% of GDP), compared with the "close-to-balance" requirement of the Stability and Growth Pact. The fiscal stance implemented in 2002 is thus judged to have been significantly expansionary, in contrast with a specific budgetary recommendation for that year in the Broad Economic Policy Guidelines. The estimate of the output gap, however, presents unusual margins of uncertainty in the case of Ireland, due to the special features of the economy, particularly the very large contribution to overall productivity growth from a relatively restricted number of sectors, covering a small proportion of the workforce. General government debt is estimated to have been 34.1% of GDP in 2002, a more rapid reduction on the 2001 debt ratio than anticipated in the previous update (2.6 versus 2.1 percentage points of GDP).

The macroeconomic scenario in the programme envisages a return, by 2005, to growth around that generally accepted to be sustainable in the medium term, of around 5%. The potential growth rate derived with the agreed methodology initially exceeds, but, by the end of the programme, converges to this rate. In 2003 and 2004, the economy is expected to continue to grow at a lower rate, close to 4%. Inflation (measured by the GDP deflator) is assumed to decline gradually through the programme period to 2½% in the final year of the programme, but there is little improvement in 2003 on account of an indirect tax hike in the budget. The projected pace of the recovery is slower than in the Commission's pre-budget Autumn 2002 forecast.

The new programme further deepens and extends the downward shift in the projected path for the general government balance outlined in the previous programme. The headline balance is projected to continue to deteriorate in 2003 and 2004, with the deficit rising to 0.7% and 1.2% of GDP respectively and with the primary surplus falling to 0.9% and 0.3% of GDP; the deficit stabilises at 1.2% of GDP in the last year of the programme. The deterioration stems from the fact that the further



[8] For this assessment, the target in the previous update (+0.7% of GDP) has been adjusted to (i) include UMTS receipts of 0.2% of GDP and (ii) exclude a transfer from the Central Bank of 0.5% of GDP.

significant decline in the revenue ratio well outweighs a modest drop in the expenditure ratio, which itself reverses recent trends thanks to restrained primary expenditure growth. While a persistently negative interest rate–growth rate differential ensures that the gross debt ratio, currently the second lowest in the EU, initially continues to decline, although at a reduced pace, a very small rise is projected in the last two years of the programme period. However, excluding the build-up of assets of the National Pension Reserve Fund, the debt ratio would be falling throughout the programme period.

The projected path of rising budget deficits in the programme needs to be qualified.

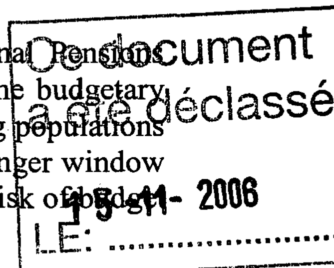
First, subject to the above-mentioned caveats about the measurement of the output gap, the relatively subdued pace of the projected recovery would imply that actual output growth falls short of potential growth. As a result, in spite of the ongoing deterioration in the nominal balances, the underlying deficit is estimated to have peaked in 2002 and to move closer to balance towards the end of the programme period. Specifically, a tightening of fiscal policy of about ½ percentage point of GDP is foreseen in 2003, when the budget implements a cut in capital expenditure, a marked reduction in the growth rate of current expenditure and an overall stabilisation of the tax burden. In any case, the targets in the programme respect the safety margin against breaching the 3% of GDP threshold for the deficit ratio.

Second, as in all previous stability programmes, the budgetary targets for the final two years incorporate "contingency provisions" against unforeseen developments; in the most recent update they amount to 0.4% of GDP in 2004 and 0.8% in 2005. While past experience suggests that such provisions might be used, the budgetary position would improve significantly if they were not.

The low level of the primary surpluses projected in the programme reflects the impact of multi-annual measures, particularly the investment programme expected to peak with the National Development Plan 2000-2006. The programme targets imply an underlying deficit of around ½% of GDP in each year (including contingency provisions). Bearing also in mind the particularly low level of the debt ratio and the overall manageable profile of future age-related expenditure, the Commission considers that, in line with its Communication of 27 November 2002 referred to above, running such a limited deficit in underlying terms may be considered fundamentally consistent with the Stability and Growth Pact.

The update reviews the government's structural reform programme. In view of the substantial progress made in recent years, direct tax relief in 2003 is implemented on a relatively modest scale and is supplemented by some tax-base broadening measures. Regarding expenditure, current and capital allocations have been increased significantly in recent years to improve public services and to address infrastructural needs through the further implementation of the National Development Plan. The update also outlines a range of measures to improve the management and control of public expenditure.

With its low debt level and gradual build-up of assets in the National Pensions Reserve Fund, Ireland is in a relatively strong position to cope with the budgetary impact of ageing populations. Moreover, the budgetary impact of ageing populations will take place later than in other EU countries and as such there is a longer window of opportunity to put effective policies in place. Nonetheless, there is a risk of budget



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imbalances in the long run on the basis of current policies. A financing gap may emerge over time if age-related spending as a share of GDP approaches the average level for the EU and if the tax ratio is left unchanged. To ensure that public finances are on a sustainable footing, it is thus important to develop sustainable financing arrangements for social welfare expenditure and to avoid the perpetuation of underlying deficits. The deficit position envisaged in the update for the year 2005 does not seem to be ambitious enough a budget target in light of the projected budgetary impact of ageing populations.

Based on this assessment, the Commission has adopted the attached recommendation for a Council opinion on the 2002 update of Ireland's Stability Programme and is forwarding it to the Council.

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Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 5 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the 2002 update of Ireland's Stability Programme, 2003-2005

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[9], and in particular Article 5 (3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On [18 February 2003] the Council examined the 2002 update of Ireland's stability programme, which covers the period 2003-2005. The update broadly complies with the data requirements of the revised "code of conduct" on the content and format of stability and convergence programmes[10]. However, compliance would be strengthened by explaining the nature and significance of the large "contingency provisions" included in the public finance projections for the final two years of the programme. The economic policies as reflected in the planned measures in the programme update broadly comply with the Broad Economic Policy Guidelines for 2002.

The Council welcomes the commitment of the Irish government to let the Stability and Growth Pact provide the framework for its budgetary policy. However, it notes that, following the very large deterioration in the budget balance in 2001, and in spite of an upward revision to GDP growth and inflation for 2002, the projected budgetary outcome is a deficit of 0.1% of GDP, half a percent of GDP worse than planned in last year's programme. In cyclically-adjusted terms, the deficit in 2002 becomes significantly worse, compared with the "close-to-balance" requirement of the Stability and Growth Pact, although the estimate of the output gap presents unusual margins of uncertainty due to the special features of the Irish economy. The implicit expansionary stance implemented in 2002 was not in line with a specific budgetary recommendation for that year in the Broad Economic Policy Guidelines.

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9 OJ L209, 02.08.1997

10 *Revised Opinion of the Economic and Financial Committee on the content and format of stability and converge programmes*, document EFC/ECFIN/404/01 – REV 1 of 27.6.2001 endorsed by the Ecofin Council on 10.7.2001.

The programme's macroeconomic scenario assumes a gradual recovery towards growth around that generally accepted to be sustainable in the medium term, of around 5%. The potential growth rate derived by the Commission based on the data in the programme initially exceeds, but, by the end of the programme, converges to this rate. The projected downward path of inflation ought to be attained, otherwise there would be a significant risk to competitiveness and price stability if wage expectations fail to adapt to the changed economic environment.

The Council observes that the new programme further deepens and extends the downward shift in the projected path for the general government balance that was outlined in the previous programme. The actual balance is projected to continue to deteriorate in 2003 and 2004 (with the deficit rising to 0.7% and 1.2% of GDP respectively and the primary surplus falling to 0.9% and 0.3% of GDP). The deficit stabilises at 1.2% of GDP in the last year of the programme. The Council notes with concern that this coincides with a return to Ireland's sustainable growth in the medium term. The reason for the deterioration over the programme period is that the trend decline in the revenue ratio outweighs the modest drop in the expenditure ratio achieved through expenditure restraint. Excluding the build-up of assets in the National Pension Reserve Fund, the debt ratio would continue to fall throughout the period, rather than record a marginal rise to 35% towards the end of the programme period.

The Council notes that important considerations bear on the examination of the budgetary position in the programme. First, subject to the above-mentioned uncertainties about the measurement of the output gap, the underlying deficit is estimated to have peaked in 2002 and to move closer to balance towards the end of the programme period, in spite of the ongoing deterioration in the actual balances. Specifically, a tightening of fiscal policy of about ½ percentage point of GDP is foreseen in 2003, when the budget implements a cut in capital expenditure, a marked reduction in the growth rate of current expenditure and an overall stabilisation of the tax burden. In any case, the targets in the programme respect the safety margin against breaching the 3% of GDP threshold for the deficit ratio. The Council urges the Irish authorities to ensure that the budgetary stance is implemented as planned in the programme.

Second, as in all previous stability programmes, the budgetary targets for the final two years incorporate "contingency provisions" against unforeseen developments. Should these contingency provisions (0.4% and 0.8% of GDP in 2004 and 2005 respectively) not be used, this would result in a significant improvement in the budgetary position projected for the medium term and the 'close-to-balance' requirement of the Stability and Growth Pact would be broadly respected throughout the programme period. The Council therefore recommends the Irish authorities not to make use of the contingency provisions, barring exceptional circumstances.

The low level of the primary surpluses projected in the programme reflects the impact of multi-annual measures, particularly the investment programme expected to peak with the National Development Plan 2000-2006. The programme targets imply an underlying deficit of around ½% of GDP in each year (including contingency provisions). Having also regard to the particularly low level of the debt ratio and the overall manageable profile of future age-related expenditure, the Council concludes that such a limited deficit in underlying terms may be considered fundamentally consistent with the Stability and Growth Pact.

The update reviews the government's structural reform programme, which focuses on lowering the tax burden, broadening the tax base, improving public services and addressing infrastructural needs through the further implementation of the National Development Plan.

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The Council welcomes the range of measures, outlined in the programme, to improve the management and control of public expenditure and urges the Irish authorities to supplement this with the development of a comprehensive norm-based framework to guide public spending in the medium term.

With its low debt level and gradual build-up of assets in the National Pensions Reserve Fund, Ireland is in a relatively strong position to cope with the budgetary impact of ageing populations. Nonetheless, the Council notes the risk of budget imbalances in the long run on the basis of current policies. A financing gap may emerge over time if age-related spending as a share of GDP approaches the average level for the EU and if the tax ratio is left unchanged. To ensure that public finances are on a sustainable footing, it is thus important to develop sustainable financing arrangements for social welfare expenditure and to avoid the perpetuation of underlying deficits.

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