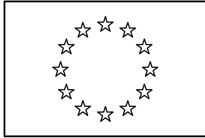

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 24.3.2009
SEC(2009) 567 final

Recommendation for a

COUNCIL DECISION

on the existence of an excessive deficit in Ireland

EXPLANATORY MEMORANDUM

1. THE APPLICATION OF THE STABILITY AND GROWTH PACT IN THE CURRENT CRISIS SITUATION

Many EU countries are presently facing general government deficits above the 3% of GDP reference value set in the Treaty. The often strong deterioration in the deficit as well as the debt positions must be seen in the context of the unprecedented global financial crisis and economic downturn. Several factors are at play. First, the economic downturn brings about declining tax revenue and rising social benefit expenditure (e.g. unemployment benefits). Second, recognising that budgetary policies have an important role to play in the current extraordinary economic situation, the Commission called for a fiscal stimulus in its November 2008 European Economic Recovery Plan (EERP), endorsed by the European Council in December. The Plan explicated that the stimulus should be timely, targeted and temporary and differentiated across Member States, with more room for manoeuvre for those Member States that have achieved sustainable public finance positions and improved their competitive positions. The Plan also called for structural reforms that support demand and promote resilience in the short term, while paying special attention to actions in the four priority areas of the Lisbon Strategy. Finally, several countries have taken measures to stabilise the financial sector, some of which impact on the debt position or constitute a risk of higher deficits and debt in the future, although some of the costs of the government support could be recouped in the future.

The Stability and Growth Pact requires the Commission to initiate the excessive deficit procedure (EDP) whenever the deficit of a Member State exceeds the 3% of GDP reference value. The amendments to the Stability and Growth Pact in 2005 aimed at ensuring that in particular the economic and budgetary background was taken into account fully in all steps in the EDP. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation, thereby ensuring long-term sustainability of public finances.

2. PREVIOUS STEPS IN THE EXCESSIVE DEFICIT PROCEDURE

Article 104 of the Treaty lays down an excessive deficit procedure (EDP). This procedure is further specified in Council Regulation (EC) No 1467/97 "on speeding up and clarifying the implementation of the excessive deficit procedure"[1], which is part of the Stability and Growth Pact.

According to Article 104(2) of the Treaty, the Commission has to monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the ratio of the planned or actual government deficit to gross domestic product (GDP) exceeds the reference value of 3% (unless either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value); and (b) whether the ratio of government debt to GDP exceeds the reference value of 60% (unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace).

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[1] OJ L 209, 2.8.1997, p. 6. Account is also taken of the Opinion of the Economic and Financial Committee on the "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005, available at: http://ec.europa.eu/economy_finance/other_pages/other_pages12638_en.htm

Article 104(3) stipulates that, if a Member State does not fulfil the requirements under one or both of these criteria, the Commission has to prepare a report. This report also has to "take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State".

On the basis of the data reported by the Irish authorities in the addendum to the October 2008 stability programme update submitted on 9 January 2009 and taking into account the Commission services' January 2009 interim forecast, the Commission adopted a report under Article 104(3) for Ireland on 18 February 2009[2].

Subsequently, and in accordance with Article 104(4), the Economic and Financial Committee formulated an opinion on the Commission report on 27 February 2009.

3. THE EXISTENCE OF AN EXCESSIVE DEFICIT

According to the updated stability programme, the general government deficit in Ireland reached 6.3% of GDP in 2008, thus exceeding the 3% of GDP reference value. The Commission report under Article 104(3) considered that the deficit was not close to the 3% of GDP reference value but that the excess over the reference value can be qualified as exceptional. In particular, it resulted from a severe economic downturn in the sense of the Treaty and the Stability and Growth Pact. According to the Commission services' January 2009 interim forecast, real GDP growth in Ireland is projected to have been strongly negative in the year 2008 (-2.0%, somewhat worse than the Irish authorities' forecast (at -1.4%) in the January 2009 addendum to the update of the stability programme). Furthermore, the excess over the reference value cannot be considered temporary. According to the Commission services' January 2009 interim forecast, taking into account the measures for the current year in the budget for 2009 (but not the 1% of GDP additional consolidation package announced in February 2009), the deficit would widen to 11% of GDP in 2009 and, on a no-policy change basis, worsen further to 13% of GDP in 2010. The deficit criterion in the Treaty is not fulfilled.

General government gross debt stood at 40.6% of GDP in 2008, remaining below the 60% of GDP reference value. However, according to the Commission services' January 2009 interim forecast the debt level should continue to rise quickly, resulting in a breach of the 60% of GDP reference value by 2010.

In line with the provisions in the Treaty and the Stability and Growth Pact, the Commission also analysed in its report "relevant factors". According to the Stability and Growth Pact, these can only be taken into account in the steps leading to the decision on the existence of an excessive deficit if the deficit satisfies the double condition of closeness and temporariness. In the case of Ireland, the double condition is not met. Considered on their own merit, the relevant factors in the current case present a mixed picture.

The opinion of the Economic and Financial Committee in accordance with Article 104(4) of the Treaty is consistent with the assessment in the Commission report under Article 104(3).

The Commission, having taken into account its report under Article 104(3) and the opinion of the Economic and Financial Committee under Article 104(4), is of the opinion that an excessive deficit exists in Ireland. This opinion, adopted by the Commission on [24 March

[2] All EDP-related documents for Ireland can be found at the following website: http://ec.europa.eu/economy_finance/netstartsearch/pdfsearch/pdf.cfm?mode=_m2.

2009], is herewith addressed to the Council according to Article 104(5). The Commission recommends that the Council shall decide accordingly, in conformity with Article 104(6). In addition, the Commission is submitting to the Council a recommendation for a Council recommendation to be addressed to Ireland with a view to bringing the situation of an excessive deficit to an end according to Article 104(7).

4. RECOMMENDATIONS TO END THE EXCESSIVE DEFICIT SITUATION

According to Article 3(4) of Council Regulation (EC) No 1467/97, the Council recommendation under Article 104(7) has to establish a deadline of six months at most for effective action to be taken by the Member State concerned as well as a deadline for the correction of the excessive deficit, which "should be completed in the year following its identification unless there are special circumstances". Article 2(6) of the Regulation implies that the "relevant factors" considered in the Commission report under Article 104(3) of the Treaty have to be taken into account in deciding whether special circumstances exist. Article 3(4) of the Regulation specifies that the Council has to recommend that the Member State achieves a "minimum annual improvement of at least 0.5% of GDP as a benchmark, in its cyclically adjusted balance net of one-off and temporary measures, in order to ensure the correction of the excessive deficit within the deadline set in the recommendation".

In the case of Ireland, special circumstances are considered to exist. The large excess over the reference value in 2008 and further widening of the deficit expected in 2009 (in spite of the government's consolidation efforts) are due to the impact on revenues of the broad-based downturn amid the difficult international economic and financial situation, and in particular of the ongoing sharp adjustment in the housing market after its 2006 peak as well as to the increase in social spending in response to the quick rise in unemployment. The current recession with an unprecedented projected cumulative loss of real output of around 7% over 2008-09 is expected to be followed by a gradually strengthening recovery and a return to positive growth after 2010. However, the change in migration patterns and the lower investment profile, together with the need to regain competitiveness, are likely to entail a medium-term growth rate well below that observed in the years preceding the recession. In sum, the size of the required adjustment but especially the very weak economic background constitute special circumstances that warrant an extension of the deadline for the correction of the excessive deficit beyond 2010.

The January 2009 addendum to the October 2008 update of the stability programme envisages a reduction of the deficit below the 3% of GDP reference value by 2013. The reduction would start after 2009 as the deficit is targeted to widen from 6.3% of GDP in 2008 to 9.5% of GDP in 2009 in spite of the consolidation measures in the budget for 2009 and in the additional consolidation package of close to 1% of GDP specified in February 2009. Taking as a starting point the targeted deficit for 2009, a reduction below the reference value by 2013 would, according to the addendum, require a cumulative nominal adjustment of around 7% of GDP over the period 2010-2013 (or 1¾% of GDP per year on average) and 6% of GDP in structural terms (i.e. in cyclically-adjusted terms net of one-off and other temporary measures, based on Commission services' calculations using the information in the addendum)[3]. In its

[3] According to the Commission services, the 2009 deficit target includes a deficit-reducing one-off measure of 0.3% of GDP (from advancing the payment dates for corporation tax for large companies and capital gains tax), without which the deterioration between 2008 and 2009 would be even larger. The Irish authorities do not classify this measure as a one-off. The cumulative structural improvement over the 2010-2013 period according to the programme (i.e. without the one-off) amounts to 5¾% of GDP.

opinion of 10 March 2009 on the Irish stability programme and its addendum, the Council concluded that the budgetary targets are subject to downside risks throughout the programme period. First, significant risks stem from the lack of information on the envisaged measures to support the planned consolidation after 2009. The addendum envisages a consolidation path driven by, in indicative terms, a marked reliance on expenditure restraint, for instance in the area of social spending. Second, an important downside risk is related to the growth assumptions underlying the macroeconomic scenario, which appear to be favourable, especially in the outer years of the programme, with an average growth rate of 2.9% over the period 2011-2013.

Bearing in mind the need to act promptly to address the fiscal situation in Ireland, and in accordance with the path for deficit reduction as specified in the January 2009 addendum to the October 2008 update of the stability programme– on which the Council gave its opinion on 10 March 2009 – aiming at correcting the excessive deficit by 2013 is appropriate. In 2009, the deficit target should be achieved. While the 2009 deficit projection of 11% of GDP in the Commission services' January 2009 interim forecast does not take into account the February 2009 additional consolidation package (estimated by the Commission to yield 0.8% of GDP in 2009), further consolidation efforts will be necessary to achieve the 2009 target. In view of the further deterioration of tax revenue trends, the government announced that additional consolidation measures would be taken in a supplementary budget in early April. Thereafter, additional annual efforts going beyond those foreseen in the stability programme addendum might be necessary to bring the deficit below the 3% of GDP reference value by 2013, if downside risks to the economic and budgetary targets were to materialize. They would also be instrumental to ensure that the rise in the debt ratio comes to a halt. However, contingent liabilities arising from the financial crisis, in particular from capital injections into banks and the government's bank guarantees (if called), could lead to more adverse debt developments.

The strategy's credibility hinges on the timely specification of the consolidation measures to achieve this consolidation path. Given the scale of the required adjustment, a broad-based consolidation effort will be necessary, addressing both the expenditure and the revenue side of the budget. In this context, the government has established a Commission on taxation and a "Special Review Group on Public Service Expenditure and Numbers" to examine the Irish taxation system and public expenditure programmes, respectively, and make recommendations for their improvement. The reports of these committees are expected in the summer of 2009. Implementing reforms to reduce current expenditure over the coming years will be necessary, while public investment priorities could be reconsidered in the light of the changed economic environment. At the same time, especially after the collapse of the housing market, broadening the narrow Irish tax base and aligning reduced expenditure levels with sustainable revenue streams will be essential.

In order to further enhance the credibility of the medium-term consolidation strategy, it will be crucial to address the weaknesses of the Irish budgetary framework. In particular, budgetary targets for the years beyond that covered by the budget, especially expenditure envelopes, can be changed in subsequent budgets. As already highlighted in the March 2009 Council opinion on the stability programme update, risks to the adjustment should be limited by strengthening the binding nature of the medium-term budgetary framework as well as by closely monitoring adherence to the budgetary targets throughout the year.

Enhanced surveillance under the EDP, which seems necessary in view also of the deadline for the correction of the excessive deficit, will require regular and timely monitoring of the

progress made in the implementation of the fiscal consolidation strategy to ensure the correction of the excessive deficit.

Comparison of key macroeconomic and budgetary projections

		2007	2008	2009	2010	2011	2012	2013
Real GDP (% change)	**SP Jan 2009**	**6.0**	**-1.4**	**-4.0**	**-0.9**	**2.3**	**3.4**	**3.0**
	COM Jan 2009	6.0	-2.0	-5.0	0.0	n.a.	n.a.	n.a.
Output gap[1] (% of potential GDP)	**SP Jan 2009**	**4.4**	**0.5**	**-3.5**	**-4.1**	**-3.4**	**-1.6**	**-0.5**
	COM Jan 2009[3]	4.4	0.1	-4.5	-4.2	n.a.	n.a.	n.a.
General government balance (% of GDP)	**SP Jan 2009**[2]	**0.2**	**-6.3**	**-9.5**	**-9.0**	**-6.4**	**-4.8**	**-2.6**
	COM Jan 2009	0.2	-6.3	-11.0	-13.0	n.a.	n.a.	n.a.
Primary balance (% of GDP)	**SP Jan 2009**	**1.2**	**-5.2**	**-7.3**	**-6.4**	**-3.5**	**-1.7**	**0.7**
	COM Jan 2009	1.2	-5.2	-8.7	-10.3	n.a.	n.a.	n.a.
Cyclically-adjusted balance[1] (% of GDP)	**SP Jan 2009**	**-1.5**	**-6.5**	**-8.1**	**-7.4**	**-5.0**	**-4.1**	**-2.4**
	COM Jan 2009	-1.5	-6.3	-9.1	-11.3	n.a.	n.a.	n.a.
Structural balance[4] (% of GDP)	**SP Jan 2009**	**-1.7**	**-6.2**[5]	**-8.1**[5]	**-7.4**	**-5.0**	**-4.1**	**-2.4**
	COM Jan 2009	-1.5	-6.3	-9.4	-11.3	n.a.	n.a.	n.a.
Government gross debt (% of GDP)	**SP Jan 2009**	**24.8**	**40.6**	**52.7**	**62.3**	**65.7**	**66.2**	**64.5**
	COM Jan 2009	24.8	40.8	54.8	68.2	n.a.	n.a.	n.a.

Notes:

[1] Output gaps and cyclically-adjusted balances from the programmes as recalculated by Commission services on the basis of the information in the programmes.

[2] The targets for the general government balance include as yet unspecified additional annual consolidation measures of 2¼% of GDP in 2010, 2% in 2011, 1¾% in 2012, and 1½% in 2013. The additional consolidation measures for 2009 (1% of GDP) are in the process of being specified.

[3] Based on estimated potential growth of 4.0%, 2.2%, -0.4% and -0.4% respectively in the period 2007-2010.

[4] Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0.3% of GDP in 2008 (deficit-increasing) according to the most recent programme and 0.3% in 2009 (deficit-reducing) according to the Commission services' January 2009 interim forecast.

[5] Note that the structural deficit amounts to 6.5% of GDP in 2008 and 8.4% of GDP in 2009 if the Commission services' assessment of one-offs is used (see preceding footnote).

Source:

Stability programme (SP); Commission services' January 2009 interim forecasts (COM); Commission services' calculations.

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THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 104(6) thereof,

Having regard to the recommendation from the Commission,

Having regard to the observations made by Ireland,

Whereas:

(1) According to Article 104 of the Treaty Member States shall avoid excessive government deficits.

(2) The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation.

(3) The excessive deficit procedure (EDP) under Article 104, as clarified by Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure[4] (which is part of the Stability and Growth Pact), provides for a decision on the existence of an excessive deficit. The Protocol on the excessive deficit procedure annexed to the Treaty sets out further provisions relating to the implementation of the EDP. Council Regulation (EC) No 3605/93[5] lays down detailed rules and definitions for the application of the provision of the said Protocol.

(4) The 2005 reform of the Stability and Growth Pact sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run. It aimed at ensuring that in particular the economic and budgetary background was taken into account fully in all steps in the EDP. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation.

(5) Article 104(5) of the Treaty requires the Commission to address an opinion to the Council if the Commission considers that an excessive deficit in a Member State exists or may occur. Having taken into account its report in accordance with Article 104(3) and having regard to the opinion of the Economic and Financial Committee in accordance with Article 104(4), the Commission concluded that an excessive deficit exists in Ireland. The Commission therefore addressed such an opinion to the Council in respect of Ireland on [24 March 2009][6].

[4] OJ L 209, 2.8.1997, p. 6.
[5] OJ L 332, 31.12.1993, p. 7.
[6] All EDP-related documents for Ireland can be found at the following website: http://ec.europa.eu/economy_finance/netstartsearch/pdfsearch/pdf.cfm?mode=_m2.

(6) Article 104(6) of the Treaty states that the Council should consider any observations which the Member State concerned may wish to make before deciding, after an overall assessment, whether an excessive deficit exists. In the case of Ireland, this overall assessment leads to the following conclusions.

(7) According to the updated stability programme, the general government deficit in Ireland reached 6.3% of GDP in 2008, thus exceeding the 3% of GDP reference value. The deficit was not close to the 3% of GDP reference value but the excess over the reference value can be qualified as exceptional. In particular, it resulted from a severe economic downturn in the sense of the Treaty and the Stability and Growth Pact. According to the Commission services' January 2009 interim forecast, real GDP growth in Ireland is projected to have been strongly negative in the year 2008 (-2.0%, somewhat worse than the Irish authorities' forecast (at -1.4%) in the January 2009 addendum to the update of the stability programme). Furthermore, the excess over the reference value cannot be considered temporary. According to the Commission services' January 2009 interim forecast, taking into account the measures for the current year in the budget for 2009 (but not the 1% of GDP additional consolidation package announced in February 2009), the deficit would widen to 11% of GDP in 2009 and, on a no-policy change basis, worsen further to 13% of GDP in 2010. The deficit criterion in the Treaty is not fulfilled.

(8) General government gross debt stood at 40.6% of GDP in 2008, remaining below the 60% of GDP reference value. However, according to the Commission services' January 2009 interim forecast the debt level should continue to rise quickly, resulting in a breach of the 60% of GDP reference value by 2010.

(9) According to Article 2(4) of Council Regulation (EC) No 1467/97, "relevant factors" can only be taken into account in the steps leading to the Council decision on the existence of an excessive deficit in accordance with Article 104(6) if the double condition - that the deficit remains close to the reference value and that its excess over the reference value is temporary - is fully met. In the case of Ireland, this double condition is not met. Therefore, relevant factors are not taken into account in the steps leading to this decision.

HAS ADOPTED THIS DECISION:

Article 1

From an overall assessment it follows that an excessive deficit exists in Ireland.

Article 2

This decision is addressed to Ireland.

Done at Brussels,

For the Council
The President