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COMMISSION OF THE EUROPEAN COMMUNITIES

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Recommendation for a

COUNCIL RECOMMENDATION TO IRELAND

with a view to bringing an end to the situation of an excessive government deficit

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 in 2008/09. 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 to reflect their different positions in terms of public finance sustainability and competitiveness and should be reversed when economic conditions improve. Finally, several countries have taken measures to stabilise the financial sector, some of which have impacted on the debt position or constitute a risk of higher deficits and debt in the future¹, 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, and 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”², which is part of the Stability and Growth Pact.

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

¹ See the Eurostat decision of 15 July 2009 on the statistical recording of public interventions to support financial institutions and financial markets during the financial crisis, Eurostat News Release No 103/2009.

² 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.

Commission services' January 2009 interim forecast, the Commission adopted a report under Article 104(3) for Ireland on 18 February 2009³.

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

On 24 March 2009 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), addressed to the Council, in accordance with Article 104(5), its opinion that an excessive deficit existed in Ireland.

Subsequently, acting upon a recommendation by the Commission, the Council decided on 27 April 2009 that an excessive deficit existed in Ireland in accordance with Article 104(6), and, also on a recommendation by the Commission, it addressed recommendations to Ireland in accordance with Article 104(7) with a view to bringing an end to the situation of an excessive government deficit by 2013. In its recommendations, the Council established a deadline of 27 October 2009 for effective action to be taken.

Regulation (EC) No 1467/97, Article 3(5), states that if effective action has been taken in compliance with a recommendation under Article 104(7) and unexpected adverse economic events with major unfavourable consequences for government finances occur after the adoption of that recommendation, the Council may decide, on a recommendation from the Commission, to adopt a revised recommendation under Article 104(7). To this end, the Commission has assessed recent macro-economic and budgetary developments as well as effective action taken by Ireland.

3. RECENT MACRO-ECONOMIC AND BUDGETARY DEVELOPMENTS

According to Article 3(5) of Council Regulation (EC) No 1467/97, the occurrence of unexpected adverse economic events with major unfavourable budgetary effects shall be assessed against the economic forecast underlying the initial Council recommendation, adopted on 27 April 2009.

		2008	2009	2010	2011
Real GDP (% change)	COM January 2009	-2.0	-5.0	0.0	n.a.
	COM autumn 2009	-3.0	-7.5	-1.4	2.6
Nominal GDP (% change)	COM January 2009	-2.3	-5.1	1.2	n.a.
	COM autumn 2009	-4.2	-9.7	-2.3	3.8
General government balance (% of GDP)	COM January 2009	-6.3	-11.0	-13.0	n.a.
	COM autumn 2009	-7.2	-12.5	-14.7	-14.7

According to the Commission services' January 2009 interim forecast underlying the initial Council recommendation, Irish real GDP was expected to decline by 5.0% in 2009 after -2% in 2008. However, in retrospect the drop in activity in 2008 was more pronounced than projected (-3%) and the situation continued to deteriorate in the months after the publication of the forecast, with real GDP estimated to have fallen by 9.3% and 7.4% year-on-year in the first and second quarter of 2009, respectively. Taking into account these figures and other available indicators, a fall in real GDP of around 7½% is now expected for 2009 according to

³ 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.

the Commission services' autumn 2009 forecast. The recession continues to be driven by domestic demand, which is now forecast to fall by over 12% in 2009, around 4 percentage points more than expected in January. In particular, the downsizing of the construction sector in the aftermath of the housing market bubble and the broader significant decline in investment continue. At the same time, private consumption is expected to record its strongest decline in over 25 years, due to an increase in precautionary savings and lower household disposable income on the back of the strong fall in employment and incipient nominal wage declines. These developments are also reflected in a stronger deterioration of labour market conditions than anticipated in January, with employment now expected to shrink by nearly 8% in 2009, as compared to 4% in the interim forecast. The unemployment rate in 2009 is now projected at around 12%, versus 10% in the interim forecast, which also has implications for public expenditure developments. Against the background of the significant adjustment in prices taking place in Ireland, the downward revision to the forecast for nominal GDP growth in 2009 is even more significant than for real GDP (-9.7% vs. -5.1% in the January interim forecast).

This deterioration in economic activity has also been reflected in a worsening of the budgetary situation. In particular, the autumn forecast contains an upward revision of the general government deficit in 2009 by 1.5 percentage points of GDP to 12.5% of GDP vis-à-vis the January interim forecast, in spite of considerable revenue-increasing and expenditure-reducing measures taken in February 2009 and in the supplementary budget in April, together amounting to about 3.2% of GDP (including a one-off measure of 0.3% of GDP)⁴. The standard budgetary elasticity with respect to Irish output growth suggests an increase in the deficit ratio in 2009 by almost 2 pps. as a result of the downward revision in GDP growth. After netting out the effect of the above mentioned discretionary measures the actual impact of the deeper-than-expected contraction is estimated as more than twice what the standard budget elasticity with respect to the output gap would imply. This is primarily due to a more pronounced decline of spending on tax rich items e.g. housing and other durables than foreseen in the January interim forecast.

At the same time, according to the autumn forecast the outlook for 2010 has deteriorated since the publication of the January 2009 interim forecast, with real and nominal GDP now expected to fall by 1.3% and 2.0%, respectively. On the back of the downward revisions of the 2009 deficit projection and the growth outlook for next year, the general government deficit in 2010 is now expected to reach 14.7% of GDP on a no-policy-change basis, compared to 13.0% of GDP in the January 2009 interim forecast. The projections are made on a pre-budget basis, while incorporating the full effect of the deficit-reducing measures taken in the course of 2009 following the supplementary budget as well as the reduction of capital investment announced in the supplementary budget for 2010 detailed below. Therefore, the projected widening of the deficit in 2010 reflects cyclical and elasticity-related factors rather than expansionary discretionary measures.

Overall, it can be concluded that, assessed against the economic forecast underlying the initial Council recommendation, adopted on 27 April 2009, unexpected adverse economic events with major unfavourable budgetary effects have occurred in Ireland.

⁴ The February 2009 budgetary package (with expenditure-saving measures of 1% of GDP) was not included in the January 2009 interim forecast, but was considered in the April 2009 Council recommendations under Article 104(7).

4. ASSESSMENT OF EFFECTIVE ACTION TAKEN

According to Regulation (EC) No 1467/97 and the revised Code of Conduct⁵ a Member State should be considered to have taken effective action if it has acted in compliance with the 104(7) recommendation. The Code of Conduct states that the assessment of effective action should in particular take into account whether the Member State concerned has achieved the annual improvement of its cyclically-adjusted balance, net of one-off and other temporary measures, initially recommended by the Council. In case the observed adjustment proves to be lower than recommended, a careful analysis of the reasons for the shortfall should be made. In case of a multi-annual adjustment, the Code of Conduct specifies that the assessment should mainly focus on the measures taken in order to ensure an adequate fiscal adjustment in the year following the identification of the excessive deficit.

The Council, in its recommendations under Article 104(7) of the Treaty of 27 April 2009, stated that Ireland should ensure the correction of the excessive deficit by 2013 by implementing the planned average annual fiscal effort of at least 1.5 % of GDP from 2010, spell out the detailed measures for broad-based fiscal consolidation and strengthen the enforceable nature of its medium-term budgetary framework. The Council established a deadline of 27 October 2009 for the Irish government to adopt measures to achieve the 2009 deficit target and to specify the necessary measures to progress towards the correction of the excessive deficit. It underlined that the assessment of effective action would take into account economic developments compared to the outlook in the Commission services' January 2009 interim forecast.

In line with this recommendation and in response to the rapid deterioration of the fiscal situation that became visible over the first months of the year, the Irish authorities introduced an important consolidation package in a supplementary budget on 7 April 2009⁶. The measures contained in the budget have a permanent deficit-reducing effect of 1.9% of GDP in 2009, and an additional 1.3% of GDP in 2010, given the timing of the supplementary budget (the main tax measures have been effective from 1 May 2009).

On the revenue side, the budget includes tax-increasing measures for 2009 in an amount of 1.1% of GDP and a positive carry-over effect of about 1% in 2010. The main measures relate to changes to the health and income levies and pay-related social insurance with an effect of 0.8% of GDP in 2009 and a further 0.9% in 2010. Other small permanent measures should amount to 0.3% of GDP in 2009⁷. In addition, a one-off transfer of pension funds has a deficit-reducing impact of 0.3% of GDP in 2009. In spite of these revenue-increasing measures (as well as some measures already taken in the October 2008 budget), according to the Commission services' autumn 2009 forecast, a fall in revenue of 10.9% is expected for 2009 as a result of the downturn.

⁵ “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.

⁶ The supplementary budget is the fourth and most significant consolidation package in less than a year after the fiscal packages announced in July 2008, in the October 2008 budget for 2009 and in February 2009.

⁷ These include stricter rules for interest relief on mortgages and rented residential property (0.1% of GDP in 2009), increases in stamp duty (on insurance policies) (0.05%) and in excise duties (on certain transport fuels and on tobacco) (0.05%), as well as other smaller capital taxation measures (0.1% of GDP).

On the expenditure side, savings announced in the supplementary budget amount to 0.8% of GDP in 2009. The package includes savings on social transfers and capital expenditure, each yielding 0.3% of GDP, and other measures with net expenditure-reducing effect of 0.2% in 2009. Although unemployment benefits and debt-servicing costs are higher than foreseen in January, according to the Commission services' autumn 2009 forecast, total general government expenditure is expected to grow by only 0.8% in 2009 (after 11.1% in 2008), compared to 6.1% in the Commission services' January 2009 interim forecast on account of the expenditure-reducing measures in the February 2009 package and in the supplementary budget.

Overall, the general government deficit is now expected to reach 12.5% of GDP in 2009 according to the Commission services' autumn 2009 forecast (slightly more than the 12.0% of GDP reported by the Irish authorities in the October 2009 EDP notification)⁸ and in excess of the 9½% target set in the January addendum to the stability programme and the 10¾% target set in the April supplementary budget. However, as mentioned above, the worsening of the deficit in 2009 is exclusively due to a much worse than anticipated downturn and revenue falling significantly beyond what could be expected on the basis of standard elasticities and has occurred in spite of significant consolidation measures.

Regarding the following years, the April 2009 supplementary budget outlines the Irish authorities' multi-annual strategy for bringing the deficit to the 3% of GDP threshold by 2013. In particular, it was envisaged that the deficit should remain unchanged at 10¾% of GDP in 2010 before being reduced to 8½% in 2011, 5½% in 2012 and 3% in 2013. In a tentative first step towards strengthening the medium-term fiscal framework, the supplementary budget also contains the nominal consolidation packages needed to achieve the deficit targets for 2010 and 2011, thereby departing from past practice. While no measures underlying the nearly 2½% of GDP consolidation efforts in each of these years are specified, it is stated that slightly more than half of the savings in 2010 and nearly two thirds of those in 2011 would come from the expenditure side (and the rest from taxation), with capital spending accounting for somewhat more than a third of the expenditure side savings. These measures are fully reflected in the supplementary budget's deficit targets for 2010 and 2011. For 2012 and 2013, the supplementary budget states that, while additional consolidation will be required to ensure correcting the excessive deficit by 2013, "the scale and nature of these measures will depend to a great extent on the strength of the economic cycle".

To further inform the government's multi-annual consolidation strategy and specifically to prepare the ground for the budget for 2010, which is likely to be adopted on 9 December 2009, two important reports have been prepared and presented to the finance minister. The report from the "Special Review Group on Public Service Expenditure and Numbers" published on 16 July 2009 contains broad-based proposals for substantial cuts in public current expenditure totalling over 3% of GDP in a full year. The main saving proposals include cuts in social welfare rates in line with the current decline in the cost of living, a 20% reduction in child benefits, reduction of public sector employment, merging or discontinuation of state agencies and the closing down of at least one entire State department. The Commission on Taxation published a report on the Irish tax system on 7 September 2009. The

⁸ According to Council Regulation (EC) No 479/2009, Member States have to report to the Commission, twice a year, their planned and actual government deficit and debt levels. The most recent notification of Ireland can be found at:
http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/procedure/edp_notification_tables.

report issues over 200 recommendations, mainly focusing on ways to broaden the tax base in a revenue-neutral way in a medium-term perspective. Among the quantitatively most important proposals are the introduction of a property tax, a carbon tax and water charges. Further, it is proposed to tax most social welfare payments and to increase the progressivity of the income tax system. By contrast, Ireland's 12.5% corporate tax rate is to remain unchanged.

In line with the no-policy change assumption, the Commission services autumn forecast's deficit projections for 2010 and 2011 (14.7% of GDP in both years) only take account of the savings in public investment but not of the as yet unspecified taxation and current expenditure measures accounting for 2% and 2¼% of GDP in 2010 and 2011, respectively. However, both projections include a positive carry-over effect of 2½% of GDP for 2010 from measures taken in the course of 2009.

Starting from the estimated 12.5% of GDP deficit outcome in 2009 in the Commission services' autumn 2009 forecast, as from 2010 an annual average fiscal consolidation effort of around 2¾% of GDP in structural terms would now be necessary to bring the budget deficit below the 3% of GDP reference value by 2013.

Overall, taking into account economic developments compared to the outlook in the Commission services' January 2009 interim forecast, it can be concluded that Ireland has taken effective action as required by the Council recommendation of 27 April 2009.

5. 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 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”.

The authorities have taken effective action in 2009 to contain the fiscal deterioration. However, the unexpected adverse economic events with major unfavourable budgetary effects which have occurred in Ireland, led to a revision of the deficit target for 2009 to 12½% of GDP despite the significant consolidation efforts. Furthermore, the growth outlook for 2010 appears more unfavourable than projected in the Commission services' January 2009 interim forecast. This warrants an extension of the deadline for the correction of the excessive deficit from 2013 to 2014.

In the April 2009 supplementary budget, the authorities aimed for a correction of the excessive deficit by 2013. However, these plans have become outdated in the light of subsequent developments. Projections for real GDP growth, which should according to the supplementary budget average 3.6% over the period 2011-2013, might turn out to be somewhat optimistic. Furthermore, a negative base effect for the targets in 2010-2013 stems from the above-mentioned upward revision of the deficit target for 2009 from 10¾% to around 12% of GDP.

Against this background, bringing the deficit below 3% of GDP by 2014 will require significant consolidation efforts. A credible and sustainable adjustment path would require the Irish authorities to in particular specify consolidation measures in the budget for 2010 in line

with the package announced in the April 2009 supplementary budget, and ensure an average annual structural budgetary adjustment of 2% of GDP over the period 2010-2014⁹. In addition, the Irish authorities should specify the measures that are necessary to achieve the correction of the excessive deficit by 2014 cyclical conditions permitting and accelerate the reduction of the deficit if economic or budgetary conditions turn out better than currently expected.

Assuming that risks from financial rescue operations do not materialise, implementing the consolidation efforts outlined above would contribute to bringing it back on a declining path that approaches the reference value at a satisfactory pace by restoring an adequate level of the primary surplus. According to the April 2009 supplementary budget, government gross debt was projected to increase from 59% of GDP in 2009 to 79% in 2012, before slightly receding to 77% in 2013, implying a breach of the 60% of GDP debt reference value from 2010 onwards. However, according to the October 2009 EDP notification, debt is now expected to reach around 64% of GDP in 2009, so that the reference value would already be breached this year. Stock-flow adjustments have historically been positive in Ireland. Since the establishment of the National Pension Reserve Fund (NPRF) in 2001 to pre-fund future pension payments, the government has made an annual contribution of 1% of GNP to the fund¹⁰. Additionally, in 2008 and 2009, the authorities have - given the uncertainty in capital markets - chosen to build up a precautionary liquidity buffer through bond issues exceeding their financing needs in those years. This buffer is expected to stand at around 14% of GDP at the end of 2009. Going forward, further debt increases could result from contingent liabilities arising from the financial crisis, in particular from possible further capital injections into banks (debt) and the government's bank guarantees (which would also affect the deficit, if called). In this connection it should be noted that, according to Eurostat's preliminary views on the accounting treatment of the National Asset Management Agency (NAMA) and related majority privately-owned special purpose vehicle (SPV)¹¹, the bonds (around 30% of GDP) expected to be issued by an SPV associated to the NAMA to finance the purchase of loan books from certain financial institutions are not recorded as government debt.

⁹ In line with the initial recommendations under Article 104(7) issued by the Council on 27 April 2009, where due consideration was given to the special circumstances and the EERP framework, an average annual structural budgetary adjustment is recommended. As in the initial recommendations the required adjustment should take into account the fiscal room for manoeuvre. This is assessed on the basis of all factors relevant for achieving the fiscal policy objectives, starting with the level of the general government deficit and gross debt as well as other indicators, such as the current account position, the level of contingent liabilities of the financial sector, interest payments, risk premia and the expected change in age-related expenditure in the medium term. In particular, in Ireland, due consideration was given to the need to act promptly to address the fiscal situation in Ireland - specifically given the then elevated sovereign bond spreads and risks to the long-term sustainability of the public finances, also in view of the rapid projected increase in debt, albeit from a low level, and the high contingent liabilities resulting from financial rescue operations - while also considering the size of the required adjustment and especially the very weak economic background. In calculating the average annual budgetary adjustment, the 2011 deficit in the Commission services' autumn 2009 forecast is taken as the starting point. The total structural budgetary adjustment needed to reach the nominal deficit target of 3% by the deadline is then calculated by assuming a gradual closure of the output gap by 2015.

¹⁰ In 2009, the contribution exceptionally amounted to around 1.8% of GDP, since the 2010 contribution was advanced in order to fund capital injections to two Irish banks via the NPRF.

¹¹ See http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/documents/Irish_letter_19_10_2009.pdf and the annexed materials on http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/eurostat_advice

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 enforceable nature of its medium-term budgetary framework as well as closely monitoring adherence to the budgetary targets throughout the year. With the specification in the April supplementary budget of the nominal consolidation packages needed to achieve the deficit targets for 2010 and 2011, a tentative first step in the right direction has been made.

The long-term budgetary impact of ageing in Ireland is well above the EU average, mainly as a result of a relatively high projected increase in pension expenditure over the coming decades. The budgetary position in 2009 compounds the budgetary impact of population ageing on the sustainability gap. Improving the primary balance over the medium term and further reforms to the social security system would contribute to reducing the risk to the long-term sustainability of public finances as defined by the Commission Communication¹² on 'Long-term sustainability of public finances for a recovering economy' and endorsed by the ECOFIN Council¹³ on 10 November 2009.

Budgetary consolidation measures should secure a lasting improvement in the general government balance, while being geared towards enhancing the quality of the public finances and reinforcing the growth potential of the economy. In particular, considering the suggested improvements to the expenditure and taxation systems laid down in the summer 2009 reports of the Commission on taxation and the Special Review Group on Public Service Expenditure and Numbers, reforms should be geared towards broadening the narrow Irish tax base and reducing current expenditure over the coming years, while reconsidering public investment priorities in the light of the changed economic environment. In addition, Ireland should foster a swift adjustment to sustainable medium-term growth by productivity-enhancing measures and adequate wage policies which will help restore competitiveness.

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. In this context, a separate chapter in the updates of the Irish stability programme which will be prepared between 2009 and 2014 could usefully be devoted to this issue.

¹² Available at: http://ec.europa.eu/economy_finance/publications/publication15996_en.pdf.

¹³ Available at: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/111025.pdf.

Comparison of key macroeconomic and budgetary projections

		2007	2008	2009	2010	2011	2012	2013
Real GDP (% change)	COM autumn 2009 forecast	6.0	-3.0	-7.5	-1.4	2.6	n.a.	n.a.
	April 2009 supplementary budget	n.a.	n.a.	-7.7	-2.9	2.7	4.2	4.0
Output gap (% of potential GDP)	COM autumn 2009 forecast ¹	4.9	-0.1	-7.2	-7.8	-5.4	n.a.	n.a.
	April 2009 supplementary budget	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
General government balance (% of GDP)	COM autumn 2009 forecast	0.3	-7.2	-12.5	-14.7	-14.7	n.a.	n.a.
	April 2009 supplementary budget	n.a.	n.a.	-10.7 ³	-10.8	-8.6	-5.6	-3.0
Primary balance (% of GDP)	COM autumn 2009 forecast	1.1	-6.1	-10.2	-11.3	-10.6	n.a.	n.a.
	April 2009 supplementary budget	n.a.	n.a.	-8.5	-7.7	-4.8	-1.5	1.2
Cyclically-adjusted balance (% of GDP)	COM autumn 2009 forecast	-1.7	-7.1	-9.6	-11.5	-12.5	n.a.	n.a.
	April 2009 supplementary budget	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Structural balance ² (% of GDP)	COM autumn 2009 forecast	-1.7	-7.1	-10.1	-11.5	-12.5	n.a.	n.a.
	April 2009 supplementary budget	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Government gross debt (% of GDP)	COM autumn 2009 forecast	25.1	44.2	65.8	82.9	96.2	n.a.	n.a.
	April 2009 supplementary budget	n.a.	n.a.	59 ⁴	73	78	79	77

Notes:

¹ Based on estimated potential growth of 3.8%, 1.8%, -0.5%, -0.7% and 0.0% respectively in the period 2007-2011.

² Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures have a deficit-increasing effect of 0.5% of GDP for 2009 according to the Commission services' autumn 2009 forecast.

³ According to the October 2009 notification, a deficit of 12.0% of GDP is now planned for 2009.

⁴ According to the October 2009 notification, a debt ratio of 63.4% of GDP is now planned for 2009.

Source:

April 2009 supplementary budget; Commission services' autumn 2009 forecasts (COM); Commission services' calculations.

COUNCIL RECOMMENDATION TO IRELAND

with a view to bringing an end to the situation of an excessive government deficit

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 104(7) thereof;

Having regard to the recommendation from the Commission;

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 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.
- (4) On 27 April 2009 the Council decided, in accordance with Article 104(6), that an excessive deficit exists in Ireland and issued recommendations to correct the excessive deficit by 2013 at the latest, in accordance with Article 104(7) of the Treaty and Article 3 of Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure¹⁴. This would have implied an average annual fiscal effort of at least 1½% of GDP over the period 2010-2013. The Council also established a deadline of 27 October 2009 for effective action to be taken.
- (5) According to Article 3(5) of Council Regulation (EC) No 1467/97, if effective action has been taken and unexpected adverse economic events with major unfavourable consequences for government finances occur after the adoption of that recommendation, the Council may decide, on a recommendation from the Commission and before taking into account the relevant factors mentioned in Article 2(3) of Regulation (EC) No 1467/97, to adopt a revised recommendation under Article 104(7).

¹⁴ OJ L 209, 2.8.1997, p. 6.

- (6) Irish real GDP was expected to decline by 5.0% in 2009 after -2% in 2008 according to the Commission services' January 2009 interim forecast underlying the initial Council recommendation. However, in retrospect the drop in activity in 2008 was steeper than projected (-3%) and the situation deteriorated further after the publication of the forecast. A fall in real GDP of around 7½% is now expected for 2009 according to the Commission services' autumn 2009 forecast, driven by a stronger decline in domestic demand than expected in January. The economic deterioration has also been reflected in a budgetary worsening. The autumn forecast contains an upward revision of the general government deficit in 2009 by 1.5 percentage points to 12.5% of GDP vis-à-vis the January interim forecast, in spite of considerable consolidation measures taken in February 2009 and in the supplementary budget in April, of about 3.2% of GDP. The deterioration of the government deficit is largely due to a more pronounced decline of spending on tax rich items e.g. housing and other durables than foreseen in the January interim forecast. On the back of the downward revisions of the 2009 deficit projection and of the outlook for real GDP growth next year (-1.4%), the deficit is now expected to reach 14.7% of GDP in 2010 on a no-policy-change basis, compared to 13.0% of GDP in the January 2009 interim forecast. The projections are made on a pre-budget basis, while incorporating the full effect of the deficit-reducing measures taken in the course of 2009 following the supplementary budget and the reduction of capital investment announced in the supplementary budget for 2010. Therefore, the projected widening of the deficit in 2010 reflects cyclical and elasticity-related factors rather than expansionary discretionary measures. In view of the above, unexpected adverse economic events with major unfavourable consequences for government finances can be considered to have occurred after adoption of the recommendation under Article 104(7).
- (7) The Council established a deadline of 27 October 2009 for the Irish government to adopt measures to achieve the 2009 deficit target and to specify the necessary measures to progress towards the correction of the excessive deficit. In line with this recommendation and in response to the rapid deterioration of the fiscal situation, the Irish authorities introduced a consolidation package with a permanent deficit-reducing effect of 1.9% of GDP in 2009 in a supplementary budget on 7 April 2009. On the revenue side, the budget contains tax-increasing measures for 2009 in an amount of 1.1% of GDP, including changes to the health and income levies and pay-related social insurance. On the expenditure side, the announced savings amount to 0.8% of GDP in 2009, including savings on social transfers and capital expenditure. According to the Commission services' autumn 2009 forecast, the general government deficit is expected to reach 12.5% of GDP in 2009, thereby exceeding the Irish authorities' target (9½% in the January addendum to the stability programme revised to 10¾% target in the April supplementary budget). Although unemployment benefits and debt-servicing costs are higher than foreseen in January, total general government expenditure is now expected to grow by only 0.8% in 2009 (after 11.1% in 2008 and compared to 6.1% in the Commission services' January 2009 interim forecast) on account of the supplementary budget's expenditure-reducing measures. Therefore, the worsening of the deficit in 2009 is exclusively due to a worse than anticipated downturn causing revenue to fall by an expected 10.9%, significantly beyond what could be expected on the basis of standard elasticities, and in spite of significant consolidation measures. Regarding the following years, the supplementary budget outlines a nominal deficit path for bringing the deficit to 3% of GDP by 2013. In a tentative first step towards strengthening the medium-term fiscal framework, it also quantifies the nominal consolidation packages of nearly 2½% of GDP each needed to

achieve the deficit targets for 2010 and 2011, without however specifying the underlying measures. On a no-policy change basis, i.e. excluding the supplementary budget's as yet unspecified taxation and current expenditure measures accounting for 2% and 2¼% of GDP in 2010 and 2011, the Commission services autumn forecast's projects a deficit of 14.7% of GDP for both those years, where the projected widening of the deficit in 2010 reflects cyclical and elasticity-related factors rather than expansionary discretionary measures. Overall, taking into account economic developments compared to the outlook in the Commission services' January 2009 interim forecast, it can be concluded that Ireland has taken effective action as required by the Council recommendation of 27 April 2009.

- (8) Since the Irish authorities are considered to have taken effective action in compliance with the Council recommendations of 27 April 2009 under Article 104(7) and unexpected adverse economic events with major unfavourable consequences for government finances can be considered to have occurred in Ireland, revised recommendations under Article 104(7) for Ireland are justified.
- (9) In spite of the effective action, the above mentioned events have led to a revision of the deficit target for 2009. Starting from the estimated 12.5% of GDP deficit outcome in 2009 in the Commission services' autumn 2009 forecast, as from 2010 an average annual structural budgetary adjustment of around 2¾% of GDP would now be necessary to bring the deficit below the 3% of GDP reference value by 2013. Furthermore, the growth outlook for 2010 appears more unfavourable than underlying the initial recommendations. In view of the above, a new deadline for correction of the excessive deficit in Ireland by 2014 at the latest is appropriate. This correction would represent an average annual structural budgetary adjustment of 2% of GDP between 2010 and 2014¹⁵.
- (10) Bringing the deficit below 3% of GDP by 2014 will require significant consolidation efforts. A credible and sustainable adjustment path would require the Irish authorities to in particular specify consolidation measures in the budget for 2010 in line with the package announced in the April 2009 supplementary budget and ensure an average annual structural budgetary adjustment of 2% of GDP over the period 2010-2014. The Irish authorities should specify the measures that are necessary to achieve the correction of the excessive deficit by 2014 cyclical conditions permitting and

¹⁵ In line with the initial recommendations under Article 104(7) issued by the Council on 27 April 2009, where due consideration was given to the special circumstances and the EERP framework, an average annual structural budgetary adjustment is recommended. As in the initial recommendations the required adjustment should take into account the fiscal room for manoeuvre. This is assessed on the basis of all factors relevant for achieving the fiscal policy objectives, starting with the level of the general government deficit and gross debt as well as other indicators, such as the current account position, the level of contingent liabilities of the financial sector, interest payments, risk premia and the expected change in age-related expenditure in the medium term. In particular, in Ireland, due consideration was given to the need to act promptly to address the fiscal situation in Ireland - specifically given the then elevated sovereign bond spreads and risks to the long-term sustainability of the public finances, also in view of the rapid projected increase in debt, albeit from a low level, and the high contingent liabilities resulting from financial rescue operations - while also considering the size of the required adjustment and especially the very weak economic background. In calculating the average annual budgetary adjustment, the 2011 deficit in the Commission services' autumn 2009 forecast is taken as the starting point. The total structural budgetary adjustment needed to reach the nominal deficit target of 3% by the deadline is then calculated by assuming a gradual closure of the output gap by 2015.

accelerate the reduction of the deficit if economic or budgetary conditions turn out better than currently expected.

- (11) According to the October 2009 EDP notification, the government gross debt ratio is expected to reach around 64% of GDP in 2009, so that the 60% of GDP reference value would be breached. In addition to annual contributions to pre-fund future pension payments, the authorities have chosen to build up a precautionary liquidity buffer with debt-increasing effect. Going forward, the debt ratio is expected, on a no-policy change basis, to increase to around 96% of GDP in 2011 according to the Commission services' autumn 2009 forecast. Further debt increases could result from contingent liabilities arising from the financial crisis, in particular from possible further capital injections into banks and the government's bank guarantees (which would also affect the deficit, if called). Assuming that risks from financial rescue operations do not materialise, implementing the consolidation efforts outlined above would contribute to bringing it back on a declining path that approaches the reference value at a satisfactory pace by restoring an adequate level of the primary surplus.
- (12) 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 enforceable nature of its medium-term budgetary framework as well as closely monitoring adherence to the budgetary targets throughout the year. With the specification in the April supplementary budget of the nominal consolidation packages needed to achieve the deficit targets for 2010 and 2011, a tentative first step in the right direction has been made.
- (13) The long-term budgetary impact of ageing in Ireland is well above the EU average, mainly as a result of a relatively high projected increase in pension expenditure over the coming decades. The budgetary position in 2009 compounds the budgetary impact of population ageing on the sustainability gap. Improving the primary balance over the medium term and further reforms to the social security system would contribute to reducing the risk to the long-term sustainability of public finances as defined by the Commission Communication¹⁶ on 'Long-term sustainability of public finances for a recovering economy' and endorsed by the ECOFIN Council¹⁷ on 10 November 2009.
- (14) Enhanced surveillance under the EDP, which seems necessary in view 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. In this context, a separate chapter in the updates of the Irish stability programme which will be prepared between 2009 and 2014 could usefully be devoted to this issue.
- (15) In general, budgetary consolidation measures should secure a lasting improvement in the general government balance, while being geared towards enhancing the quality of the public finances and reinforcing the growth potential of the economy. In particular, considering the suggested improvements to the expenditure and taxation systems laid

¹⁶ Available at: http://ec.europa.eu/economy_finance/publications/publication15996_en.pdf.

¹⁷ Available at: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/111025.pdf.

down in the summer 2009 reports of the Commission on taxation and the Special Review Group on Public Service Expenditure and Numbers, reforms should be geared towards broadening the narrow Irish tax base and reducing current expenditure over the coming years, while reconsidering public investment priorities in the light of the changed economic environment. In addition, Ireland should foster a swift adjustment to sustainable medium-term growth by productivity-enhancing measures and adequate wage policies which will help restore competitiveness.

- (16) In addition, in view of the importance of achieving its medium-term objective (MTO) to provide an adequate safety margin against cyclical downturns and to ensure convergence of the debt ratio towards a prudent level, also taking into account implicit liabilities related to ageing, Ireland should also ensure that budgetary consolidation towards the MTO is sustained after the excessive deficit will have been corrected.

HEREBY RECOMMENDS:

- (1) Recognising that Ireland's budgetary position in 2009 resulted from the interplay of the severe recession and the free play of automatic stabilisers on the one hand and significant consolidation efforts on the other (as part of which some moderate recovery measures were taken), which is an appropriate response to the European Economic Recovery Plan, the Irish authorities should put an end to the present excessive deficit situation by 2014.
- (2) The Irish authorities should bring the general government deficit below 3% of GDP in a credible and sustainable manner by taking action in a medium-term framework. Specifically, to this end, the Irish authorities should:
 - (a) specify consolidation measures in the budget for 2010 in line with the package announced in the April 2009 supplementary budget;
 - (b) ensure an average annual structural budgetary adjustment of 2% of GDP over the period 2010-2014, which should also contribute to bringing the government gross debt ratio back on a declining path that approaches the 60% of GDP reference value at a satisfactory pace by restoring an adequate level of the primary surplus;
 - (c) specify the measures that are necessary to achieve the correction of the excessive deficit by 2014 cyclical conditions permitting and accelerate the reduction of the deficit if economic or budgetary conditions turn out better than currently expected.
- (3) In addition, the Irish authorities should seize any opportunity beyond the structural adjustment, to accelerate the reduction of the gross debt ratio back towards the 60% of GDP reference value.
- (4) To limit risks to the adjustment, Ireland should strengthen the enforceable nature of its medium-term budgetary framework as well as closely monitor adherence to the budgetary targets throughout the year.
- (5) To reduce the risks to the long-term sustainability of public finances, the Irish authorities should pursue further reforms to the social security system as soon as possible.

- (6) The Council establishes the deadline of [2 June] 2010 for the Irish government to take effective action to specify consolidation measures in the budget for 2010 in line with the package announced in the April 2009 supplementary budget and to outline the measures that will be necessary to progress towards the correction of the excessive deficit. The assessment of effective action will take into account economic developments compared to the economic outlook in the Commission services' autumn 2009 forecast.

The Irish authorities should report on progress made in the implementation of these recommendations in a separate chapter in the updates of the stability programmes which will be prepared between 2009 and 2014.

Further, the Council invites the Irish authorities to implement reforms with a view to raising potential GDP growth. This includes reforms conducive to enhancing the quality of public finances. In particular, reforms should be geared towards broadening the narrow Irish tax base and reducing current expenditure over the coming years, while reconsidering public investment priorities in the light of the changed economic environment. In addition, Ireland is invited to foster a swift adjustment to sustainable medium-term growth by productivity-enhancing measures and adequate wage policies which will help restore competitiveness.

This recommendation is addressed to Ireland.

Done at Brussels,

*For the Council
The President*