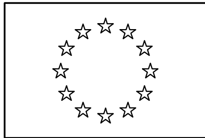

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 28.1.2004
SEC(2004) 86 final

Recommendation for a

COUNCIL OPINION

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

On the updated Stability Programme for Ireland, 2004-2006

(presented by the Commission)

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 (formerly 109c) of the Treaty (from 1 January 1999, 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].

Ireland submitted its fifth and most recent update of the stability programme, covering the period 2004-2006, on 3 December 2003. The Commission services have carried out a technical evaluation of this updated programme, taking into account the information provided in accordance with the Code of Conduct[3], the Autumn forecasts as well as subsequent evaluations, the commonly agreed methodology for the estimation of cyclically-adjusted balances, the recommendations in the Broad Economic Policy Guidelines and the principles laid down in the Communication of the Commission to the Council of 27 November 2002 on strengthening the co-ordination of budgetary policies[4]. This evaluation warrants the following assessment:

> The new update of the Irish stability programme was presented on the traditional first Wednesday of December (3 December 2003), together with the budget for the coming year. It largely complies with the data requirements of the "code of conduct on the content and format of stability and convergence programmes".
>
> Real GDP growth in 2003 is now expected to be lower than anticipated in the previous update (2.2% versus 3.5%), mainly reflecting a lower external contribution. The macroeconomic scenario in the programme is realistic and is broadly in line with that in the Commission's pre-budget autumn 2003 forecast. It envisages a gradual return, by 2005-2006, to growth around that generally accepted to be sustainable in the medium term, of some 5%. The potential growth rate derived with the agreed methodology applied to the data in the update initially exceeds, but, by the end of the programme, converges to this rate. HICP inflation is assumed to decline more rapidly over the period than in the Commission's forecast, from 4.0% in 2003 to 2% in the final two years of the programme, reflecting the implementation of the anti-inflation initiative under social partnership. The most dramatic drop is projected to occur in 2004.

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1 OJ L209, 2.8.1997. The documents referred to in this text can be found at the following web site http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

2 OJ C42, 17.2.1999

3 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.

4 COM (2002) 668 final, 27.11.2002

According to new estimates provided by the Irish Department of Finance in January 2004, the general government deficit in 2003 is expected to be 0.1% of GDP, which is better than previous estimates, including that submitted with the update itself (0.4% of GDP). The new outturn is 0.6pp lower than the target set in the previous update, owing to a tax overshoot, itself mainly reflecting a booming property market and temporary factors, as well as to lower than budgeted expenditure, especially on public investment and interest payments.

The budgetary strategy in the update envisages a widening of the deficit to 1.2% of GDP on average over the period 2004-2006. The deterioration results from a cut in the expenditure ratio due to primary expenditure control that is insufficient to offset the further significant decline in the revenue ratio. The latter reflects a one-off boost to revenues in 2003 (see below), technical assumptions and a decline in "other revenues" as a proportion of GDP rather than a programme of tax cuts. The primary surplus averages 0.2% of GDP in 2004-2006.

The bulk of the budgetary deterioration occurs in 2004, when the deficit is projected to widen to 1.1% of GDP (compared to 1.2% projected in the previous update) from 0.1% in 2003. This is mainly due to the mechanical effect of the one-off boost to revenues of advancing the date of payment of capital gains tax in 2003. For 2005 and 2006, deficits are projected of 1.4% of GDP (1.2% in the previous update) and 1.1% respectively. As in the previous update, the stability programme closes with a nominal deficit of just above 1% of GDP, even though, by then, the economy is forecast to have recovered to the medium-term sustainable growth rate. The update's budgetary projections seem plausible for 2004 but subject to some downward risk towards the end of the period.

The transition to sustainable growth in the medium term after the exceptionally high growth rates in the second half of the 1990s and the special features of the Irish economy imply that estimates of the Irish output gap are subject to an unusual margin of uncertainty. Subject to this caveat, the cyclically-adjusted deficit remains below 1% of GDP in each year, which implies continued respect of the safety margin against breaching the 3% of GDP reference value for the nominal deficit with normal macroeconomic fluctuations. Taking into account the impact of the one-off described above, the update envisages an improvement in the cyclically-adjusted balance by ½ percentage points to 0.4% of GDP in 2004. For 2005 and 2006, the update's projections imply deficits of 0.8% and 0.5% of GDP respectively in cyclically-adjusted terms. Although the close-to-balance requirement seems achieved by the end of the programme period, there are some risks stemming from the trend budgetary projections and a lack of information on the envisaged measures in the outer years of the programme. The key conclusion is that there is little to no improvement in the budgetary position in either nominal or cyclically-adjusted terms between 2004 and 2006.

However, the projection of continued deficits in both nominal and cyclically-adjusted terms needs to be qualified. First, as in all previous Irish stability programmes, the budgetary targets for the final two years incorporate sizeable contingency provisions against unforeseen developments. In the most recent update these provisions amount to 0.4% of GDP in 2005 and 0.8% in 2006. While past experience suggests that such provisions are likely to be used, at least partly, the budgetary position would improve significantly if they were not fully absorbed. Second, the low level of the primary surpluses projected in the update reflects a significant investment effort under the

National Development Plan, which keeps Exchequer-funded capital investment at close to 5% of GNP over the period 2004-2008.

General government debt is estimated to have amounted to one-third of GDP in 2003, the second lowest level in the EU. Over the period 2004-2006, both the primary balance and the interaction between the average interest rate and GDP growth continue to contribute to lowering the debt ratio, but this is broadly offset by sizeable stock-flow adjustments. The latter largely reflect the impact of the National Pensions Reserve Fund, which was set up to pre-fund future pensions liabilities and receives 1% of GNP annually from general government resources. Without the accumulation of assets in this fund, the debt ratio would be falling throughout the period.

The update reviews the government's structural reform programme which focuses on safeguarding a low tax burden and improving public services and infrastructure. It also outlines further measures to improve the control and management of public expenditure such as the extension of multi-annual budgeting to all capital spending. These policy measures are in line with the recommendations in the Broad Economic Policy Guidelines 2003-2005 to enhance the efficiency of public spending, improve the medium-term budgetary framework and prioritise the roll-out of the infrastructural elements of the National Development Plan.

On the basis of current policies, Ireland is on a sustainable path but some risks may emerge in the long run. The budgetary strategy outlined in the programme is based on the accumulation of reserve funds to pay future pension liabilities, further pension reform and measures to increase efficiency in health care sector. Some risks may emerge if a policy of budget balance is not pursued over the long term even if the possible financing gap can be easily covered.

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

Recommendation for a

COUNCIL OPINION

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

On the updated Stability Programme for Ireland, 2004-2006

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 coordination of economic policies[5], 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 [10 February 2004] the Council examined the updated stability programme of Ireland, which covers the period 2004 to 2006. The updated programme largely complies with the data requirements of the revised "code of conduct on the content and format of stability and convergence programmes".

The budgetary strategy underlying the update is based on stemming the pace of deterioration in the government balance compared to the recent past. This is achieved through expenditure control producing a cut in the expenditure-to-GDP ratio, which does not suffice to offset a further marked decline in the revenue ratio. The latter reflects a one-off related to capital gains tax (artificially boosting 2003 revenues at the expense of 2004), technical assumptions and decreasing "other revenues" as a share of GDP, rather than a programme of tax cuts. At the same time, a significant programme of public investment is being implemented.

The update projects real GDP growth to accelerate from an estimated 2.2% in 2003 to 3.3% in 2004 and to 5% on average in 2005-2006. HICP inflation is forecast to decline rapidly from 4% in 2003 to 2.3% in 2004 and to stabilise at 2% thereafter. On the basis of currently available information, the macro-economic scenario underlying the update seems realistic.

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[5] OJ L209/1, 2.8.1997. The documents referred to in this text can be found at the following web site http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

The update targets a general government deficit of 1.1% of GDP in 2004, compared to an expected deficit of 0.1% in 2003. In cyclically-adjusted terms, based on Commission calculations according to the commonly agreed methodology, and taking account of the one-off related to capital gains tax, there is an improvement by ½ percentage points to 0.4% of GDP. For 2005 and 2006, the projections are for deficits of 1.4% and 1.1% of GDP respectively in nominal terms and 0.8% and 0.5% of GDP respectively in cyclically-adjusted terms. The debt ratio is projected to stabilise at one-third of GDP.

Although the Stability and Growth Pact's medium-term objective of a budgetary position of close to balance seems achieved by the end of the programme period, there are some risks stemming from the trend budgetary projections and a lack of information on the envisaged measures in the outer years of the programme. Some further qualifications must be made. First, as in all previous updates, the budgetary projections for the final two years incorporate "contingency provisions" against unforeseen developments which eventually may not be fully spent. Second, the estimation of the output gap and hence of the cyclically-adjusted balance presents unusual margins of uncertainty due to the special features of the Irish economy; at the same time, it must be noted that the projected nominal deficits of just above 1% of GDP in 2005-2006 coincide with the return to Ireland's sustainable growth rate. Finally, it has to be noted that the projected balances reflect to a significant extent the implementation of an intensive programme of public investment, with a government investment-to-GDP ratio of 3.8% on average over the programme period, compared to an EU-average of 2.4% in 2003. The budgetary stance in the programme should provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations.

On the basis of current policies, there is a risk of budgetary imbalances emerging in the future due to an ageing population. However, it has to be noted that the Irish debt ratio is currently quite low and that assets are being built up at a rate of 1% of GNP annually in the National Pensions Reserve Fund. Securing an adequate primary surplus is essential to ensure that the public finances are on a sustainable footing.

The economic policies as reflected in the updated programme are broadly consistent with the recommendations in the Broad Economic Policy Guidelines, specifically those with budgetary implications. In particular, the system of multi-annual budgeting has been extended to all capital spending, the reform of health care system should address value for money concerns and further progress is being made with the roll-out of the National Development Plan.