COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 19.2.2008
SEC(2008) 221 final

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 updated stability programme of Ireland, 2007-2010

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. GENERAL BACKGROUND

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. The 2005 reform of the Pact acknowledged its usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Stability and Growth Pact, stipulates that each Member State has to submit, to the Council and the Commission, a stability or convergence programme and annual updates thereof. Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes. The first stability programme of Ireland was submitted in December 1998. In accordance with the Regulation, the Council delivered an opinion on it on 18 January 1999 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. As regards updated stability and convergence programmes, the regulation foresees that these are assessed by the Commission and examined by the Committee and if necessary and following the same procedure as set out above, the updated programmes may be examined by the Council.

2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the most recent update of the stability programme of Ireland, submitted on 5 December 2007, and is recommending a Council opinion on it (see box for the main points covered by the assessment).

In order to set the scene against which the budgetary strategy in the updated stability programme is assessed, the following paragraphs summarise:

(1) the most recent assessment of the country’s position under the preventive arm of the Stability and Growth Pact (summary of the Council opinion on the previous update of the stability programme);

(2) the orientations for budgetary policies adopted by the April 2007 Eurogroup;

(3) the March 2007 update of the country-specific broad economic policy guidelines in the area of budgetary policies;

(4) the Commission’s assessment of the October 2007 implementation report of the national reform programme.

---

[1] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text are available at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

2.1. The assessment in the Council opinion on the previous update

In its opinion of 27 February 2007, the Council summarised its assessment of the previous update of the stability programme, covering the period 2006-2009, as follows: “The Council considers that the medium-term budgetary position is sound and the budgetary strategy provides a good example of fiscal policies conducted in compliance with the Stability and Growth Pact. Nonetheless, it would be prudent to maintain room for manoeuvre against any reversal of the current growth pattern which has been led by strong housing developments”. In the light of the projected increase in age-related expenditure, the Council invited Ireland to “continue to implement measures to improve the long-term sustainability of its public finances and to avoid pro-cyclical policies in the years ahead”.

2.2. Orientations for budgetary policies adopted by the Eurogroup in April 2007

On 20 April 2007, with a view to improving the coordination of fiscal policies in the euro area, Eurogroup ministers discussed national budgetary developments in 2007 and the preliminary policy outlook for 2008 and their implications for the euro area.

Reaffirming their adherence to the sound fiscal policy principles of the revised Stability and Growth Pact and to national fiscal rules, Ministers committed to (i) build on the better-than-expected budgetary outcomes in 2006 to pursue more ambitious budgetary targets than those set in the end-2006 updates of the stability programmes; (ii) implement their 2007 budgets as planned, avoiding expenditure overruns, and using unexpected extra revenues to reduce government deficit and debt; and (iii) carefully design fiscal policy plans for 2008 so as to accelerate the adjustment towards the MTO for Member States which have not reached it and for those which have reached it to avoid feeding macroeconomic imbalances overall[2].

2.3. March 2007 update of the country-specific broad economic policy guidelines in the area of budgetary policies

On 27 March 2007, the Council adopted a recommendation on the 2007 update of the broad guidelines for the economic policies of the Member States and the Community and on the implementation of Member States' employment policies[3]. In the area of budgetary policies, the Council stated that it would be important for Ireland to focus on "speed(ing) up progress in formulating concrete measures to reform pension arrangements". In addition, all euro area Member States were recommended to “make use of the favourable cyclical conditions to aim at or pursue ambitious budgetary consolidation towards their medium-term objectives in line with the Stability and Growth Pact, hence striving to achieve an annual structural adjustment of at least 0.5 % of GDP as a benchmark” and “to improve the quality of public finance by reviewing public expenditures and taxation, with the intention to enhance productivity and innovation, thereby contributing to economic growth and fiscal sustainability”.

---

2 The entire statement can be found at: www.gouvernement.lu/salle_presse/actualite/2007/04/20pm_krecke_berlin/MTBR_EG_conclusions-finalCLEAN.rtf

3 OJ L 92, 3.4.2007, p. 23.

2.4. The Commission assessment of the October 2007 implementation report of the national reform programme

On 11 December 2007, the Commission adopted its Strategic Report on the renewed Lisbon strategy for growth and jobs, which includes an assessment of the October 2007 implementation report of Ireland's national reform programme[4]. This can be summarised as follows.

Ireland's national reform programme 2005-2008 identified its key priorities as follows: maintain a stable macroeconomic environment, sustainable public finances, and moderate inflation levels; within this fiscal framework, continue to prioritise public investment in economic and social infrastructure and other growth-enhancing expenditures; ensure that the economy will be in a position to meet anticipated long-run fiscal pressures, including those arising from the ageing of the population.

The Commission's assessment was that Ireland has been making very good progress in implementing its national reform programme over the 2005-2007 period. Against the background of strengths and weaknesses identified and the evidence on progress made, the Commission encouraged Ireland to focus on the areas of: pension reform; labour market participation; R&D investment; and the careful monitoring of developments in the housing market.

4 Communication from the Commission to the European Council, "Strategic report on the renewed Lisbon strategy for growth and jobs: launching the new cycle (2008-2010)" - COM(2007) 803, 11.12.2007.

Box: Main points covered by the assessment

As required by Article 5(1) (for stability programmes) and Article 9(1) (for convergence programmes) of Council Regulation (EC) No 1466/97, the assessment covers the following points:

- whether the economic assumptions on which the programme is based are plausible;
- the medium-term budgetary objective (MTO) presented by the Member State and whether the adjustment path towards it is appropriate;
- whether measures being taken and/or proposed to respect that adjustment path are sufficient to achieve the MTO over the cycle;
- when assessing the adjustment path towards the MTO, whether a higher adjustment effort is made in economic good times, whereas the effort may be more limited in economic bad times, and, for euro-area and ERM II Member States, whether the Member State pursues an annual improvement of the cyclically-adjusted balance, net of one-off and other temporary measures, of 0.5% of GDP as a benchmark to meet its MTO;
- when defining the adjustment path to the MTO (for Member States that have not yet reached it) or allowing a temporary deviation from the MTO (for Member States that have), the implementation of major structural reforms which have direct long-term cost-saving effects (including by raising potential growth) and therefore a verifiable impact on the long-term sustainability of public finances (subject to the condition that an appropriate safety margin with respect to the 3% of GDP reference value is preserved and that the budgetary position is expected to return to the MTO within the programme period), with special attention for pension reforms introducing a multi-pillar system that includes a mandatory, fully-funded pillar;
- whether the economic policies of the Member State are consistent with the broad economic policy guidelines.

The plausibility of the programme's macroeconomic assumptions is assessed by reference to the Commission services' autumn 2007 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances.

The assessment also examines:

- the evolution of the debt ratio and the outlook for the long-term sustainability of the public finances, which should be given "sufficient attention in the surveillance of budgetary positions" according to the Council report of 20 March 2005 on "Improving the implementation of the Stability and Growth Pact". A Commission Communication of 12 October 2006 sets out the approach to the assessment of long-term sustainability[5];
- the degree of consistency with the national reform programme, submitted by Member States in the context of the Lisbon strategy for growth and jobs, and its October 2007 implementation report. In its cover note of 7 June 2005 to the European Council on the broad economic policy guidelines for the period 2005-2008, the ECOFIN Council stated that the national reform programmes should be consistent with the stability and convergence programmes;
- compliance with the code of conduct[6], which inter alia prescribes a common structure and set of data tables for the stability and convergence programmes.

---

5 Communication from the Commission to the Council and the European Parliament, "The long-term sustainability of public finances in the EU" - COM(2006) 574, 12.10.2006 - and European Commission, Directorate-General for Economic and Financial Affairs (2006), "The long-term sustainability of public finances in the European Union", European Economy No 4/2006.

6 "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.

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 updated stability programme of Ireland, 2007-2010

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[7], 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:

(1) On [4 March 2008] the Council examined the updated stability programme of Ireland, which covers the period 2007 to 2010.

(2) After more than a decade of buoyant economic growth, per capita income in the Irish economy is among the highest in the European Union. This development was supported initially by strong export growth and more recently by rapidly rising domestic demand. During this period, public finances improved considerably, thereby allowing an impressive reduction in the public debt ratio. The economy is now facing a transition to a period of lower growth characterised by a deterioration in competitiveness because of recent adverse productivity and price developments, exacerbated by its exposure to the US and UK economies. On the domestic side, the growth slowdown reflects a return to more sustainable levels of activity in the residential construction sector, weakening asset values and rising unemployment. These developments could prove challenging for public finances, in spite of their overall strong position, given the foreseen weakening in tax revenues and the expectations for higher spending in upgrading public services generated by a prolonged period of budgetary surpluses. The outlook for the public finances in the

---

[7] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text can be found at the following website: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

short and medium term also places additional urgency on addressing concerns about their long-term sustainability associated with population ageing.

(3) The macroeconomic scenario underlying the programme envisages that real GDP growth will fall from 4.8% in 2007 to 3.5% on average over the remainder of the programme period. Assessed against currently available information[8], this scenario appears to be plausible. It reflects mainly a large adjustment in the housing sector, offset to a certain extent by a continued recovery in net exports. The programme's projection for inflation appears to be somewhat on the low side for 2008 given recent developments in food and energy prices, but plausible thereafter. Inflation and competitiveness prospects in the outer years of the programme are supported by an improvement in productivity and the downward impact of a slowing labour market on wage pressures. The stability programme also envisages a fall in the external deficit, which is consistent with a weakening of domestic demand.

(4) For 2007, the general government surplus is estimated at 0.5% of GDP in the December 2007 stability programme against a target of 1.2% of GDP in the previous update and 0.9% of GDP in the Commission services' autumn 2007 forecast. This downward revision reflects higher-than-programmed expenditure and a revenue shortfall, both of which were partly offset by a positive 2006 base effect. Higher-than-planned spending occurred especially in government current expenditure on goods and services and capital grants. The revenue shortfall reflected in particular the deterioration in the housing market. The opinion of the Council on the previous update of the stability programme[9] was that "the medium-term budgetary position is sound … Nonetheless, it would be prudent to maintain room for manoeuvre against any reversal of the current growth pattern which has been led by strong housing sector developments". The 2007 budget outturn, entailing a sizable reduction of the structural surplus, reduced the room for manoeuvre into 2008. Although the structural balance remained better than the MTO, expenditure overruns in 2007 meant that budgetary implementation was not fully in line with the April 2007 Eurogroup orientations for budgetary policies.

(5) Despite the weakening of the budgetary position in 2007, the medium-term objective (MTO), which is a balanced position in structural terms (i.e. in cyclically-adjusted terms net of one-off and other temporary measures), was reached by a large margin. The strategy outlined in the programme implies a weakening of the structural balance in 2008. Calculated according to the commonly agreed methodology, the structural surplus of ½% of GDP in 2007 is expected to turn into a deficit of around ½% of GDP in 2008 and to gradually worsen in subsequent years to a deficit of ¾% of GDP in 2010. The headline balance is projected to fall from a surplus of 0.5% of GDP in 2007 to a deficit around 1% over the remainder of the programme period. Starting from the worse-than-expected outturn in 2007 (by ¾ percentage point of GDP) and against a weaker macroeconomic background, the headline budgetary targets for 2008-2009 are clearly lower than in the previous update (by 1¾ percentage points of GDP). For 2008, the programme projects the revenue ratio to fall further as the composition of growth becomes less tax-rich, while expenditure is expected to rise reflecting the impact of

---

[8] The assessment notably takes into account the Commission services' autumn forecast and the Commission assessment of the October 2007 implementation report on the national reform programme.

[9] OJ C 70, 27.3.2007, p. 1.

spending decisions in 2007 and earlier years, as well as those announced in Budget 2008. The budgetary projections for 2009 and 2010 explicitly incorporate unallocated contingency provisions of, respectively, 0.4% and 0.8% of GDP. In 2009 and 2010, the revenue ratio is expected to continue declining, albeit less rapidly, while the expenditure ratio is projected to broadly stabilise in 2009 and to decline in 2010. Despite the deteriorating economic and fiscal environment, investment spending is expected to be increased as a percentage of GDP over the programme period which should help the long-term productive potential of the economy.

(6) The risks to the budgetary projections in the programme appear broadly balanced in 2008. However, in subsequent years, there is a lack of information about what broad measures will be taken so that current spending growth will be contained below nominal GDP growth, especially as regards the public wage bill and social transfer payments, both of which have increased substantially in recent years as a percent of GDP. Furthermore, there are also risks on the revenue side associated with previous commitments to reduce tax and social contribution rates. Moreover, while the inclusion of the contingency provisions in the budgetary projections could reflect prudent planning, it cannot be excluded that they may be used for future revenue-reducing and/or expenditure-increasing measures. Against these factors should be weighed Ireland's good track record as the outturns for the fiscal balance have generally been better than projected in recent stability programmes.

(7) In view of this risk assessment, the budgetary stance in the programme may be insufficient to maintain the MTO after 2008. While the MTO would be broadly reached in 2008, the fiscal stance thereafter could imply that the structural balance moves away from the MTO, which would not be in line with the Stability and Growth Pact – and not in line with the April 2007 Eurogroup orientations for budgetary policies – unless the margins foreseen in the programme as contingency provisions remain unused, implying a significantly better tax position and/or greater spending containment than shown in the programme. Should that be the case, the structural effort should be strengthened to remain at the MTO and be in line with the Pact.

(8) Ireland appears to be at medium risk with regard to the sustainability of public finances. The long-term budgetary impact of ageing is well above the EU average, mainly as a result of a relatively high projected increase in pension expenditure over the coming decades, influenced in part by the maturing of the pension system. Yet, the gross debt ratio is well below 60% of GDP in 2007 and, in order to pre-fund part of future pension expenditure, assets are accumulated in the National Pension Reserve Fund. The budgetary position in 2007 as estimated in the programme, although worse than in the previous programme, still contributes to offset the projected long-term budgetary impact of the ageing population. However, this is not sufficient to cover future spending pressures. In addition, developments in the structural balance as projected in the programme until 2010 could put the sustainability of public finances at greater risk. Therefore, maintaining high primary surpluses over the medium term and implementing further measures aimed at curbing the substantial increase in age-related expenditures would contribute to reducing risks to the sustainability of public finances.

(9) The stability programme seems to be consistent with the October 2007 implementation report of the national reform programme. The stability programme does not give detailed information about how the budgetary impact of the measures embodied in the

implementation report is taken into account in the programme. Nevertheless, both documents point to the central role of the Stability and Growth Pact as providing the framework for sustainable fiscal policies in Ireland, while implementation of the National Development Plan 2007-2013 (for investment, especially in infrastructure) is highlighted in both documents as being the government's key priority.

(10) The budgetary strategy in the programme is broadly consistent with the country-specific broad economic policy guidelines included in the integrated guidelines and the guidelines for euro area Member States in the area of budgetary policies issued in the context of the Lisbon strategy.

(11) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme has some gaps in the required and optional data[10].

The overall conclusion is that Ireland is facing several macroeconomic challenges in its transition to a period of lower economic growth, mainly linked to a return to more sustainable activity in the housing sector. Slowing domestic demand has been accompanied by losses in recent years in export market shares, pointing to price competitiveness challenges. The fiscal position is expected to register a noticeable deterioration in 2007-2008, from a sound surplus in 2006. While Ireland is expected to continue to register a surplus in 2007, the programme foresees that the structural position will turn into a deficit in 2008 which will increase somewhat thereafter. The risks attached to the budgetary projections are broadly neutral in 2008, but from 2009, in the absence of adequate expenditure containment, outcomes could be worse than projected. While the MTO would be broadly reached in 2008, keeping to the MTO thereafter might be possible if the margins foreseen in the programme as contingency provisions remain unused. Furthermore, regarding the long-term sustainability of the public finances, while the public debt is low, Ireland is at medium risk because of the projected impact of population ageing on pension expenditure. The challenge for the authorities will be to deal with macroeconomic risks, while at the same time avoiding a deterioration of the fiscal situation.

In view of the above assessment and also in the light of the April 2007 Eurogroup orientations for fiscal policies, Ireland is invited to:

(i) keep to the MTO in 2008 and thereafter, by maintaining firm control over expenditures;

(ii) in view of the significant projected increase in age-related expenditure, improve the long-term sustainability of public finances by implementing further pension reforms.

10 In particular, where required data are concerned, only short-term interest rates were not provided. On the optional data side, gaps include sectoral balance and government expenditure by function.

Comparison of key macro economic and budgetary projections

		2006	2007	2008	2009	2010
Real GDP (% change)	**SP Dec 2007**	**5.7**	**4.8**	**3.0**	**3.5**	**4.1**
	COM Nov 2007	5.7	4.9	3.5	3.8	n.a.
	SP Dec 2006	*5.4*	*5.3*	*4.6*	*4.1*	*n.a.*
HICP inflation (%)	**SP Dec 2007**	**2.7**	**2.8**	**2.4**	**2.0**	**1.8**
	COM Nov 2007	2.7	2.8	2.2	2.0	n.a.
	SP Dec 2006	*2.7*	*2.6*	*2.0*	*1.7*	*n.a.*
Output gap[1] (% of potential GDP)	**SP Dec 2007**	**-0.2**	**-0.5**	**-1.3**	**-1.5**	**-0.7**
	COM Nov 2007[2]	-0.5	-0.7	-1.2	-1.3	n.a.
	SP Dec 2006	*-1.2*	*-1.6*	*-2.2*	*-2.5*	*n.a.*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**SP Dec 2007**	**-4.2**	**-4.4**	**-3.9**	**-3.5**	**-3.1**
	COM Nov 2007	-4.0	-4.5	-4.3	-4.2	n.a.
	SP Dec 2006	*-3.4*	*-4.3*	*-4.0*	*-3.5*	*n.a.*
General government balance (% of GDP)	**SP Dec 2007**	**2.9**	**0.5**	**-0.9**	**-1.1**	**-1.0**
	COM Nov 2007	2.9	0.9	-0.2	-0.6	n.a.
	SP Dec 2006	*2.3*	*1.2*	*0.9*	*0.6*	*n.a.*
Primary balance (% of GDP)	**SP Dec 2007**	**3.9**	**1.4**	**0.0**	**-0.1**	**0.0**
	COM Nov 2007	3.9	1.8	0.7	0.4	n.a.
	SP Dec 2006	*3.3*	*2.3*	*1.8*	*1.6*	*n.a.*
Cyclically-adjusted balance[1] (% of GDP)	**SP Dec 2007**	**3.0**	**0.7**	**-0.4**	**-0.5**	**-0.7**
	COM Nov 2007	3.1	1.2	0.3	0.0	n.a.
	SP Dec 2006	*2.8*	*1.8*	*1.8*	*1.6*	*n.a.*
Structural balance[3] (% of GDP)	**SP Dec 2007**	**2.9**	**0.5**	**-0.4**	**-0.5**	**-0.7**
	COM Nov 2007	3.1	1.2	0.3	0.0	n.a.
	SP Dec 2006	*2.7*	*1.8*	*1.8*	*1.6*	*n.a.*
Government gross debt (% of GDP)	**SP Dec 2007**	**25.1**	**25.1**	**25.9**	**27.6**	**28.7**
	COM Nov 2007	25.1	25.2	26.9	28.5	n.a.
	SP Dec 2006	*25.1*	*23.0*	*22.4*	*21.9*	*n.a.*

Notes:

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

[2] Based on estimated potential growth of 5.9%, 5.2%, 4.1% and 3.8% respectively in the period 2006-2009.

[3] Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0.1% of GDP in 2006 and 0.2% in 2007 (all surplus-increasing) according to the most recent programme and 0.0% of GDP in 2006 and 0.0% in 2007 in the Commission services' autumn forecast. According to information presented by the national authorities, they represent the impact of (i) additional revenue secured through special investigations by the tax authorities, and (ii) the payment of an exit tax associated with special savings accounts (SSIAs). These one-offs were excluded in the autumn forecast in the absence of detailed information. No information on one-offs in the period 2008-2010 is provided in the programme.

Source:

Stability programme (SP); Commission services' autumn 2007 economic forecasts (COM) which were completed on a pre-budget basis; Commission services' calculations (based on pre-budget estimates)