COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 18.2.2009
SEC(2009) 183 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, 2008-2013

EN EN

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. In particular, it introduced greater flexibility in the application of the rules governing the excessive deficit procedure, notably with regard to definition of "exceptional circumstances" and the setting of deadlines for the correction of an excessive deficit. 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.

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 14 October 2008 (and its addendum, submitted on 9 January 2009) and has adopted a recommendation for a Council opinion on it.

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

(1) the Commission Communication of 26 November 2008 (“A European Economic Recovery Plan”);

(2) 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).

2.1. The Commission Communication of 26 November 2008 (“A European Economic Recovery Plan”)

In view of the unprecedented scale of the global financial and economic crisis, the European Commission has called for a European Economic Recovery Plan (EERP)[2]. The plan proposes a co-ordinated counter-cyclical macro-economic response to the crisis in the form of an ambitious set of actions to support the economy consisting of (i) an immediate budgetary impulse amounting to € 200 bn. (1.5% of EU GDP), made up of a budgetary expansion by Member States of € 170 bn. (around 1.2% of EU GDP) and EU funding in support of

[1] OJ L 209, 2.8.1997, 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] Communication from the Commission to the European Council of 26 November 2008 - COM(2008) 800.

immediate actions of the order of € 30 bn. (around 0.3 % of EU GDP); and (ii) a number of priority actions grounded in the Lisbon Strategy and designed to adapt our economies to long-term challenges, continuing to implement structural reforms aimed at raising potential growth. The plan calls for the fiscal stimulus to be differentiated across Member States in accordance with their positions in terms of sustainability of government finances and competitive positions. In particular, for Member States outside the euro area with significant external and internal imbalances, budgetary policy should essentially aim at correcting such imbalances. The plan was agreed by the European Council on 11 December 2008. In this context, Member States were asked to submit an addendum to their updated stability or convergence programme, so as to reflect the measures taken in the context of the Recovery Plan. The examination of how measures (budgetary measures as well as structural measures) contribute to the recovery process in the short term is made in the opinions of stability or convergence programmes.

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

In its opinion of 4 March 2008, the Council summarised its assessment of the previous update of the stability programme, covering the period 2007-2010, as follows. "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 should 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 this assessment, the Council invited Ireland 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".

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, 2008-2013

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[3], 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 [10 March 2009] the Council examined the updated stability programme of Ireland[4], which covers the period 2008 to 2013.

(2) After more than a decade of strong economic growth which had become increasingly driven by domestic demand, Ireland is now going through a severe recession. The downturn was caused by the sharp correction in the housing market and has since spread to the wider economy, aggravated by the global financial crisis and the recession in Ireland's main trading partners. These developments have also led to a very sharp deterioration of the public finances (with the general government balance going from a small surplus in 2007 to a deficit of 6.3% of GDP in 2008). Against this background, the authorities' policy response aims to integrate some measures to strengthen purchasing power and support an orderly adjustment in the property market into a broader fiscal consolidation strategy while refocusing public investment on key projects. The key challenge for the years ahead is the implementation of a credible and sustainable fiscal consolidation strategy with a view to restoring market confidence, while at the same time redirecting resources from construction to more productive sectors and regaining competitiveness through measures enhancing productivity growth and adequate wage policies. The continued fragility of the financial sector might hamper the adjustment process in the short run and put further strain on the

---

3 OJ L 209, 2.8.1997, 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.

4 Including the addendum submitted on 9 January 2009.

public finances. With a view to improving their long-term sustainability, reforming the pension system is another important challenge.

(3) The macroeconomic scenario underlying the programme envisages that the contraction of real GDP by 1.4% in 2008 will be followed by further declines by 4.0% in 2009 and 0.9% in 2010 before growth recovers to an average rate of 2.9% over the rest of the programme period. When assessed against currently available information[5], these growth assumptions appear broadly plausible up to 2010. From 2011 onwards, the projected economic growth appears rather optimistic. The programme's projections for inflation appear realistic. The same applies to the outlook for the external deficit and competitiveness.

(4) For 2008, the general government deficit is estimated at 6.3% of GDP in the Commission services' January 2009 interim forecast, against a target of 0.9% of GDP set in the previous update of the stability programme[6]. This significantly worse-than-expected outturn reflects both a considerable tax shortfall and some expenditure overruns[7]. Tax revenue targets were not met due to the permanent loss of housing boom related revenue and lower-than-expected economic activity more generally. While in July 2008 some measures were taken to limit the increase in expenditure, spending growth was higher than planned, especially in social transfers, interest expenditure and public investment. Social transfers are fulfilling their role as automatic stabilisers, as reflected in higher unemployment-related spending.

(5) The general government deficit is targeted to widen to 9.5% of GDP in 2009, mainly reflecting the economic slump. While the government plans some measures providing support to the economy in reaction to the downturn, in the order of 0.5% of GDP, they are more than compensated by revenue-increasing and expenditure-saving measures amounting to close to 3% of GDP. The latter include a 1% of GDP package announced in the addendum without providing details and therefore not incorporated in the Commission services' interim forecast. In early February, the government specified the package, which consists of a pension levy on public sector wages (tentatively estimated at 0.5% of GDP on a full-year basis, taking into account the levy's tax deductibility), further cuts in public investment (0.2% of GDP) and other smaller expenditure-saving measures (adding up to 0.2% of GDP on a full-year basis). In 2009, the overall net savings would amount to around 0.8% of GDP. The structural deficit (as recalculated by the Commission services on the basis of information in the programme) is nevertheless estimated to widen by 2 percentage points of GDP. The deterioration is largely due to the deepening recession and in particular the ongoing adjustment in the housing market and its impact on tax revenue, but it also reflects difficulties in bringing down spending growth sufficiently quickly in response to changed economic circumstances.

(6) The government's medium-term budgetary strategy is to bring the headline deficit below the 3% of GDP reference value by 2013. The decline in the deficit would start

---

5 The assessment notably takes into account the Commission services' January 2009 forecast, but also other information that has become available since then.

6 The addendum estimates the deficit outcome for 2008 at 6.3% of GDP. In view of the reported breach of the Treaty reference value, the Commission prepared on 18 February 2009 a report under Article 104(3) of the Treaty.

7 The higher-than-expected expenditure is explained by (i) higher-than-planned social transfers, (ii) increased interest expenditure and (iii) unbudgeted capital investment, including the purchase of the Westlink toll bridge at a cost of 0.3% of GDP.

in 2010 and would accelerate from 2011. The programme provides no indications as to when the medium-term objective (MTO) should be met[8]. While an annual consolidation objective amounting to a cumulated effort of around 7% of GDP in nominal terms is announced from 2010 onwards, no specific measures are set out. The indicative projections of the addendum envisage a mainly expenditure-based consolidation strategy. Over the programme period, the revenue ratio is expected to increase slightly (by ¾ percentage point of GDP), while the primary expenditure ratio is projected to decline markedly (by around 5¼ percentage points), especially in social transfers and government consumption. Interest expenditure as a share of GDP is expected to treble over the programme period, to 3½% of GDP. The fast rise in the deficit, falling nominal GDP and sizeable stock-flow adjustment in 2008 linked to a deliberate build-up of liquidity contribute to a doubling of the debt ratio between 2007 and 2009 and a breach of the 60% of GDP reference value from 2010.

(7) The budgetary outcomes are subject to downside risks throughout the programme period. First, significant risks stem from the lack of information on the planned consolidation strategy after 2009, in particular as regards the trajectory for expenditure and revenue, especially in view of the importance given to expenditure restraint[9]. Second, growth projections in the economic scenario might be favourable, especially in the outer years of the programme. In view of the negative risks to the deficit targets, the evolution of the debt ratio is also likely to be less favourable than projected in the programme. In addition, specific risks relate to contingent liabilities arising from the financial crisis, in particular from possible further capital injections or nationalisations of banks (debt) and the government's bank guarantees (deficit and debt, if called).

(8) 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 2008 as estimated in the programme, which is markedly worse than the starting position of the previous programme, compounds the budgetary impact of population ageing on the sustainability gap. If the 2009 budgetary position as projected by the Commission services' interim forecast was taken as the starting point, the sustainability gap would widen substantially. While assets have been accumulated in the National Pension Reserve Fund (NPRF) in order to pre-fund part of future pension expenditure, gross debt is projected to exceed the Treaty reference value within the programme period. Reducing the high primary deficit over the medium term, as foreseen in the programme, and implementing reform measures that curb the substantial increase in age-related expenditure would contribute to reducing the high risks to the sustainability of public finances. The above-mentioned risks from financial sector stabilisation schemes put in place by Ireland could have a potential negative impact on the long-term sustainability of public finances, primarily via their impact on government debt, although some of the cost of the government support could be recouped in the future.

(9) Ireland's medium-term budgetary framework has some weaknesses. In particular, budgetary targets for the years beyond that covered by the budget, especially

---

8 The programme contains for the first time a quantification of the MTO, which should be a structural balance (i.e. a cyclically-adjusted balance net of one-off and other temporary measures) in the range of -0.5% to 0% of GDP, compared to the previous indication of a position of “close to balance”.

9 The national authorities have announced that policy decisions in relation to the allocation between expenditure and revenue measures of the planned consolidation will be announced in subsequent budgets.

expenditure envelopes, can be changed in subsequent budgets. As recent experience has shown, this makes it more difficult for policymakers to maintain a prudent fiscal policy course in the presence of (persistent) windfall revenues. At the same time, it might limit their ability to credibly commit to a consolidation strategy in difficult times. While these issues are not directly addressed in the programme, the government has established a Commission on Taxation and a "Special Review Group on Public Service Expenditure and Numbers" to make recommendations for the improvement of the taxation system and of public expenditure programmes respectively. The reports of these groups are expected in the course of 2009 and the national authorities have indicated that the recommendations will feed into the decision making process for the 2010 and subsequent budgets.

(10) Ireland adopted several measures to safeguard the stability of the financial sector. The statutory limit for the deposit guarantee scheme was increased to € 100,000 per depositor. Guarantees to covered banks were put in place in an estimated amount of € 400 billion. A recapitalisation programme of € 10 billion (5% of GDP) for three major banks, intended to be financed at least partly from the NPRF, was announced in December. However, one of the concerned banks was later taken into public ownership instead, while the amounts of the capital injections for the two remaining banks are still under discussion.

(11) In line with the European Economic Recovery Plan agreed in December 2008 by the European Council, Ireland adopted a number of measures to support economic activity and to enhance structural reforms. In view of the high deficit and sharply increasing debt position, the package of measures providing support to the economy adopted by Ireland for 2009, which is part of a broader consolidation effort, is an adequate response to the macro-fiscal situation. The measures taken by the Irish authorities focus on support to households' purchasing power and investment and are timely and targeted. Specific measures were taken to support the adjustment process in the housing market, where the current economic downturn started, while other measures were targeted specifically at the most vulnerable groups likely to be most affected by the crisis, including a social welfare package. The measures are of a permanent rather than temporary nature but this has to be seen in the light of the fact that the overall budgetary strategy is deficit-reducing. Furthermore, support to the recovery would come from structural measures such as continued high public investment in the framework of Ireland's multi-annual National Development Plan (around 4½% of GDP annually over the programme period) and tax advantages for R&D activities and small start-up companies. These measures are related to the medium-term reform agenda and the country-specific recommendations proposed by the Commission on 28 January 2009 under the Lisbon Strategy for Growth and Jobs.

(12) After the further deterioration in 2009, the deficit is projected to narrow progressively. However, a reduction of the headline deficit below 3% of GDP by 2013, as envisaged in the programme, will require addressing the above-mentioned significant risks to the budgetary targets and standing ready to adopt additional measures if necessary. The fiscal consolidation plans should be backed up with measures.

(13) 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, following a very sharp deterioration in 2008, the general government deficit will widen further in 2009, to 9.5% of GDP. The measures adopted by the government in response to the downturn can be regarded as welcome and adequate given the high deficit and sharply increasing debt position and are in line with the European Economic Recovery Plan. After the budgetary deterioration in 2009, the programme envisages a reduction of the deficit below the 3% of GDP reference value by 2013, while debt would breach the 60% of GDP reference value from 2010. This would take place against the background of a rapid recovery of economic activity after 2010. The budgetary outcomes are subject to downside risks throughout the programme period, mainly due to (i) the lack of information on the envisaged consolidation measures after 2009 and (ii) the favourable macroeconomic outlook especially in the outer years of the programme. Further risks stem from the measures in place to support the financial sector, in particular bank guarantees and, concerning the debt ratio, the possibility of further capital injections or nationalisations of banks. In recent cases, the government has announced that some of this will be funded from the National Pensions Reserve Fund. A reduction of the headline deficit below 3% of GDP by 2013, as envisaged in the programme, will require addressing the significant risks to the budgetary targets and standing ready to adopt additional measures if necessary. Also with a view to improving the long-term sustainability of public finances, the fiscal consolidation plans should be backed up with measures.

In view of the above assessment Ireland is invited to:

(i) limit the widening of the deficit in 2009 and specify and rigorously implement a substantial broad-based fiscal consolidation programme for 2010 and beyond;

(ii) in order to limit risks to the adjustment, strengthen the binding nature of the medium-term budgetary framework as well as closely monitor adherence to the budgetary targets throughout the year;

(iii) in view of the significant projected increase in age-related expenditure, and also of the increase in debt albeit from a low level expected over the programme period, improve the long-term sustainability of public finances by implementing further pension reform measures in addition to pursuing fiscal consolidation.

---

10 In particular, where required data are concerned, only nominal effective exchange rate, EU GDP growth and growth of relevant foreign markets were not provided. On the optional data side, gaps include sectoral balances and government expenditure by function.

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.
	SP Nov 2007	*4.8*	*3.0*	*3.5*	*4.1*	*n.a.*	*n.a.*	*n.a.*
HICP inflation (%)	**SP Jan 2009**	**2.8**	**3.1**	**0.5**	**1.5**	**1.8**	**1.8**	**1.8**
	COM Jan 2009	2.9	3.1	0.7	1.8	n.a.	n.a.	n.a.
	SP Nov 2007	*2.8*	*2.4*	*2.0*	*1.8*	*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.
	SP Nov 2007	*-0.5*	*-1.3*	*-1.5*	*-0.7*	*n.a.*	*n.a.*	*n.a.*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**SP Jan 2009**	**-5.4**	**-6.3**	**-4.2**	**-3.5**	**-3.4**	**-3.0**	**-2.8**
	COM Jan 2009	-5.4	-5.7	-3.3	-3.2	n.a.	n.a.	n.a.
	SP Nov 2007	*-4.4*	*-3.9*	*-3.5*	*-3.1*	*n.a.*	*n.a.*	*n.a.*
General government revenue (% of GDP)	**SP Jan 2009**	**35.7**	**33.6**	**33.7**	**34.4**	**34.6**	**33.9**	**34.4**
	COM Jan 2009	35.7	33.7	33.7	33.9	n.a.	n.a.	n.a.
	SP Nov 2007	*36.6*	*36.1*	*35.8*	*35.4*	*n.a.*	*n.a.*	*n.a.*
General government expenditure (% of GDP)	**SP Jan 2009**	**35.4**	**39.9**	**43.3**	**43.4**	**41.0**	**38.7**	**37.0**
	COM Jan 2009	35.4	40.0	44.7	46.9	n.a.	n.a.	n.a.
	SP Nov 2007	*36.1*	*37.0*	*36.9*	*36.5*	*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.
	SP Nov 2007	*0.5*	*-0.9*	*-1.1*	*-1.0*	*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.
	SP Nov 2007	*1.4*	*0.0*	*-0.1*	*0.0*	*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.
	SP Nov 2007	*0.7*	*-0.4*	*-0.5*	*-0.7*	*n.a.*	*n.a.*	*n.a.*
Structural balance[4] (% of GDP)	**SP Jan 2009**	**-1.7**	**-6.2**	**-8.1**	**-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.
	SP Nov 2007	*0.5*	*-0.4*	*-0.5*	*-0.7*	*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.
	SP Nov 2007	*25.1*	*25.9*	*27.6*	*28.7*	*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 interim forecast.

Source:

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