

COUNCIL OPINION
of 4 March 2008
on the updated stability programme of Ireland, 2007-2010

(2008/C 74/03)

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 ⁽¹⁾, 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 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 ⁽²⁾, 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.

⁽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 can be found at the following website:
http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm

⁽²⁾ The assessment takes into account notably the Commission services' autumn forecast and the Commission assessment of the October 2007 implementation report on the national reform programme.

- (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. While the out-turn for central government expenditure in cash terms was broadly in line with budget plans higher-than-planned spending growth occurred in general government, especially in 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 ⁽¹⁾ 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. The Council notes that, although the structural balance remained better than the MTO, expenditure overruns in 2007 imply that budgetary implementation may not be fully consistent 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 0,5 % of GDP in 2007 is expected to turn into a deficit of around 0,5 % of GDP in 2008 and to gradually worsen in subsequent years to a deficit of 0,75 % 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 0,75 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 1,75 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 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 the Council notes that this would also not be consistent with the April 2007 Eurogroup orientations for budgetary policies — unless the margins foreseen in

⁽¹⁾ OJ C 70, 27.3.2007, p. 1.

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 ⁽¹⁾.

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 the above assessment 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.

⁽¹⁾ 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.

The Council also notes that such actions would be consistent with the April 2007 Eurogroup orientations for fiscal policies.

Comparison of key macroeconomic 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.

		2006	2007	2008	2009	2010
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.

Sources:

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).