COMMISSION OF THE EUROPEAN COMMUNITIES

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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 2001 update of Ireland's Stability Programme, 2002-2004

(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 of the Treaty, 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].

According to the Regulation, the updated stability programmes, to be presented annually, may also be examined by the Council in accordance with these same procedures. The first annual update, covering the period 2000-2002, was submitted on 1 December 1999 and examined by the Council on 31 January 2000[3]. The second update, covering the period 2001-2003, was submitted on 6 December 2000 and examined by the Council on 12 February 2001[4].

Ireland submitted the third and most recent update, covering the period 2002-2004, on 5 December 2001. The Commission services have carried out a technical evaluation of this update, which warrants the following assessment:

> The new update of the Irish stability programme was presented together with the budget for 2002 and broadly complies with the new *Code of conduct on the content and format of stability and convergence programmes*[5], although some data are not in line with EU standards.
>
> The macroeconomic scenario in the updated stability programme envisages a deceleration from record real GDP growth of 11.5% in 2000 to just under 7% in 2001 followed by below 4% in 2002. In 2003 and 2004, the economy is expected to recover to its medium-term sustainable growth rate of about 5 to 6 percent. The projections are broadly in line with the Commission's *pre-budget* Autumn 2001 forecast, if a touch more optimistic. Given the impact of the indirect tax hike decided in the budget for 2002, there is unlikely to be a significant improvement in HICP inflation before 2003.
>
> Reflecting partly much lower than anticipated growth but also a significant overestimation of tax revenues, the general government surplus for 2001 is expected to be 1.4% of GDP, almost three percentage points lower than initially budgeted. Following the 2001 shortfall, the new update shows a downward shift in the

1 OJ L209, 02.08.1997
2 OJ C42, 17.02.1999
3 OJ C60, 02.03.2000
4 OJ C77, 09.03.2001
5 *Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes*, document EFC/ECFIN/404/01 - REV 1 of 27.06.2001 endorsed by the ECOFIN Council of 10.07.2001.

projected path for the general government balance when compared with the previous update. The previous budgetary strategy of maintaining high surpluses and further reducing the debt ratio, endorsed by the Council in its opinions on previous programmes, is therefore not being followed. Over the programme period 2002-2004, the government balance is expected to record a small deficit on average, while the debt ratio is targeted to broadly stabilise (at the very low level of 34%). In the final year of the programme, the deficit stands at 0.6% of GDP.

However, the targets for 2003-2004 in the new update have to be qualified in two important respects. Firstly, they are based on "technical provisions" for unspecified future budget measures, which are "subject to review in light of emerging future economic conditions". Secondly, they incorporate sizeable contingency provisions (against unforeseen developments), which are larger than usual (which goes unexplained in the update). It is difficult to judge whether these provisions stem from caution regarding the economic and budgetary outlook or represent envelopes for future budgetary developments which are reasonably certain, but at present difficult to quantify.

After years of comfortable surpluses, the update projects that the general government balance records a deficit from 2003, broadly coinciding with the recovery to the medium-term sustainable growth rate. In addition, the cyclically-adjusted balances, while subject to a large degree of uncertainty in Ireland, move into negative territory from 2001. The targets in the update therefore imply that Ireland could cease to comply with the close to balance requirement of the Stability and Growth Pact as early as 2003, although they would still provide a sufficient margin to avoid breaching the 3% of GDP deficit threshold in normal cyclical fluctuations throughout the programme period. However, in the event that the contingency provisions incorporated in the targets for 2003-2004 are not used, the close-to-balance objective can be said to be broadly respected throughout the programme period.

The general government target for 2002 in the update is a surplus of about 0.7% of GDP. Excluding a one-off transfer from the Central Bank, which seems unlikely to qualify as contributing to an improvement of the general government balance under ESA95 rules, this becomes 0.2% of GDP. Another adverse risk to the budgetary outturn is the impact of the public sector wage benchmarking process, the provision for which in the 2002 budget may prove to be on the low side. Upside surprises to the 2002 outcome could come from the proceeds from the allocation of UMTS licences (unbudgeted but possibly yielding 0.2% of GDP) and tax revenues, especially indirect taxes. Based on the targets in the update, the change in the cyclically-adjusted balance for 2002, even after adjusting for the transfer from the Central Bank, points to a broadly neutral fiscal stance, in line with the broad economic policy guidelines agreed for 2001.

Irish general government revenue and expenditure ratios are currently the lowest in the EU. The projections in the stability programme outline a steady increase in the expenditure ratio (including contingency provisions), which is partly due to increased capital outlays to implement the National Development Plan 2000-2006, in line with the BEPGs agreed for 2001. In spite of a broadly stable tax burden, the overall revenue ratio falls over the period. It is clear that the recent rates of increase in current and capital spending, motivated by a desire to tackle infrastructural needs and public service deficiencies, cannot be sustained without action on the revenue side.

The structural reform section in the new update does not present any plans to introduce a medium-term framework to guide public spending or to improve expenditure control, as requested in the BEPGs agreed for 2001. The update covers further progress in the important areas of tax reform and infrastructural investment to relieve supply constraints and describes advances in tax collection and recovery and privatisation of state-owned banks.

The re-emergence of a deficit from 2003 in the update, if confirmed, would imply a halt to the recent strong gains in the long-term sustainability of the public finances, although 1% of GNP continues to be set aside as the annual contribution to the National Pensions Reserve Fund. On current policies, including the medium-term budgetary projections, increasing budgetary imbalances would be recorded over the long run. This does not imply that public finances are unsustainable, but rather that budget deficits cannot be planned indefinitely. Higher levels on spending on pensions and health care will need to be accompanied with measures to finance them on a sound basis, but these policy measures should be of manageable proportions.

Based on this assessment, the Commission has adopted the attached recommendation for a Council opinion on the 2001 update of Ireland's Stability Programme and is forwarding it to the Council.

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 2001 update of Ireland's Stability Programme, 2002-2004

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 co-ordination of economic policies[6], 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 [12 February 2002] the Council examined the 2001 update of Ireland's stability programme, which covers the period 2002-2004. The update broadly complies with the revised "code of conduct on the content and format of stability and convergence programmes"[7], although some data are not in line with EU standards. The Council notes that the macroeconomic scenario in the update envisages a deceleration from record real GDP growth of 11.5% in 2000 to just under 7% in 2001 followed by below 4% in 2002 and a recovery to Ireland's medium-term sustainable growth rate of about 5 to 6 percent thereafter.

The general government surplus for 2001 is expected to be 1.4% of GDP, almost three percentage points lower than budgeted, and that this is largely blamed on the economic downturn. The Council regrets that this underperformance has apparently resulted in a downward shift in the projected path for the general government balance in the new update from 2002 onwards. The Council expresses its concern over the budgetary strategy in the new update, in which the previous approach of projecting high surpluses and a further reduction of the debt ratio is not being followed. The update targets a surplus of 0.7% of GDP in 2002 (0.2% of GDP excluding the transfer from the Central Bank, which seems unlikely to qualify as a credit item) and small deficits in 2003 and 2004 of 0.5% and 0.6% of GDP respectively. The debt ratio is expected to broadly stabilise at the very low level of 34%. The Council notes with concern that the move to a small deficit in 2003-2004 coincides with the recovery to the medium-term sustainable growth rate. However, the Council notes that these deficits

6 OJ L209, 02.08.1997

7 *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.

incorporate important conditional "technical provisions" for unspecified future budget measures and increasingly large contingency provisions "against unforeseen developments".

The Council observes that, according to the projections in the stability programme, the overall revenue ratio falls over the period (in spite of a broadly stable tax burden), while the expenditure ratio shows a steady increase (including contingency provisions). The Council notes that the recent rates of increase in current and capital spending, motivated by a desire to tackle infrastructural needs and public service deficiencies, cannot be sustained without appropriate action on the revenue side.

While the Council found that the budgetary projections in previous stability programmes fully respected the requirements of the Stability and Growth Pact, it notes with concern that the projections in the new update, including their evaluation in cyclically-adjusted terms, would not respect the close-to-balance requirement of the Pact from 2003. However, they would still provide a sufficient margin to avoid breaching the 3% of GDP deficit threshold in normal cyclical fluctuations throughout the programme period. At the same time, the Council notes that, in the event that the contingency provisions incorporated in the targets for 2003-2004 are not used, the close-to-balance objective would be broadly respected throughout the programme period. The Council therefore urges the Irish authorities to ensure that compliance with the Pact is continued throughout the programme period.

The Council recalls that, on 6 November 2001, in its conclusions on economic and budgetary developments in Ireland in the wake of the Recommendation of 12 February 2001[8], it had stressed the need for continued vigilance on the fiscal stance, given the experience of overheating[9]. In particular, it had advocated a broadly neutral budget for 2002. Based on the targets in the updated programme, the change in the cyclically-adjusted balance for 2002 points to a broadly neutral fiscal stance, in line with its November conclusions. The Council notes that the targeted outcome for the general government balance in 2002 is subject to a number of risks (such as the outcome of the public sector wage benchmarking process). The Council urges the Irish authorities to ensure that the budgetary stance for 2002 is broadly neutral.

The Council welcomes further progress in the important areas of tax reform and infrastructural investment to relieve supply constraints, as described in the update. However, it regrets that the new update does not present any plans to introduce a medium-term framework to guide public spending or to improve expenditure control. The Council recommends that the Irish authorities address these issues urgently, as requested in the broad economic policy guidelines agreed for 2001.

The Council considers that Ireland is in a good position to meet the budgetary costs of ageing populations. However, the long-term sustainability of public finances should not be taken for granted as public spending on pensions and health care is expected to rise significantly in coming decades. The move towards a structural deficit in the programme, if confirmed, would imply a halt to the recent strong gains in the long-term sustainability of the public finances. The Council nevertheless notes with satisfaction the broad-based strategy to prepare for ageing populations, and in particular that 1% of GNP continues to be set aside as the annual contribution to the National Pensions Reserve Fund.

8 OJ L69, 10.03.2001
9 These conclusions are available at http://ue.eu.int/emu/OtherTopics/4404EN.pdf.