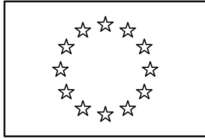

COMMISSION OF THE EUROPEAN COMMUNITIES

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REPORT FROM THE COMMISSION

Ireland

Report prepared in accordance with Article 104(3) of the Treaty

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1. The application of the Stability and Growth Pact in the current crisis situation

Many EU countries are presently facing general government deficits above the 3% of GDP reference value set in the Treaty. The often strong deterioration in the deficit as well as the debt positions must be seen in the context of the unprecedented global financial crisis and economic downturn. Several factors are at play. First, the economic downturn brings about declining tax revenue and rising social benefit expenditure (e.g. unemployment benefits). Second, recognising that budgetary policies have an important role to play in the current extraordinary economic situation, the Commission called for a fiscal stimulus in its November 2008 European Economic Recovery Plan (EERP), endorsed by the European Council in December. The Plan explicated that the stimulus should be differentiated across Member States to reflect their different positions in terms of public finance sustainability and competitiveness and should be reversed when economic conditions improve. Finally, several countries have taken measures to stabilise the financial sector, some of which impact on the debt position or constitute a risk of higher deficits and debt in the future, although some of the costs of the government support could be recouped in the future.

The Stability and Growth Pact requires the Commission to prepare a report such as the present one whenever the deficit of a Member State exceeds the 3% of GDP reference value. This report analyses the reasons for the breach of the reference value with due regard to the economic background and all other relevant factors. The amendments to the Stability and Growth Pact in 2005 aimed specifically at ensuring that in particular the economic and budgetary background was taken into account fully in all steps in the EDP. This means for instance that, if an “excessive deficit” is deemed to exist, adequate attention needs to be paid to the economic background when making recommendations on the pace of the correction. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation.

2. Legal background

This report, which assesses recent and current budgetary developments in Ireland and reviews the short- and medium-term prospects in the light of overall economic conditions

and policy action taken by the government, is prepared according to Article 104(3) of the Treaty.

Article 104 of the Treaty lays down an excessive deficit procedure (EDP). This procedure is further specified in Council Regulation (EC) No 1467/97 "on speeding up and clarifying the implementation of the excessive deficit procedure"[1], which is part of the Stability and Growth Pact. According to Article 104(2) of the Treaty, the Commission has to monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the ratio of the planned or actual government deficit to gross domestic product (GDP) exceeds the reference value of 3% (unless either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value); and (b) whether the ratio of government debt to GDP exceeds the reference value of 60% (unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace).

Article 104(3) stipulates that this report has to "take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State".

Table 1: General government deficit and debt [a]

	2002	2003	2004	2005	2006	2007	2008		2009		2010	
							COM	MS [b]	COM	MS [b]	COM	MS [b]
General government balance	-0.4	0.4	1.4	1.7	3.0	0.2	-6.3	-6.3	-11.0	-9.5	-13.0	-9.0
General government gross debt	32.2	31.1	29.4	27.3	24.7	24.8	40.8	40.6	54.8	52.7	68.2	62.3

Notes:
[a] In percent of GDP.
[b] January 2009 addendum to the update of the stability programme
Source: *Eurostat, Commission services' Interim Forecast January 2009 and January 2009 addendum to the update of the stability programme*

According to the addendum to the October 2008 stability programme update submitted by the Irish authorities on 9 January 2009, the general government deficit in Ireland reached 6.3% of GDP in 2008, thus exceeding the 3% of GDP reference value, while general government gross debt stood at 40.6% of GDP, below the 60% of GDP reference value but nearly 16 percentage points above the level in 2006-07, of which around 9 percentage points was due to increased cash deposits.

The figure for the 2008 deficit provides *prima facie* evidence on the existence of an excessive deficit in Ireland in the sense of the Treaty and the Stability and Growth Pact. The Commission has therefore decided to initiate the excessive deficit procedure for Ireland with the adoption of this report. Section 3 of the report examines the deficit

[1] OJ L 209, 2.8.1997, p. 6. Regulation as amended by Regulation (EC) No 1056/2005 (OJ L 174, 7.7.2005, p. 5). The report also takes into account the "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, available at http://ec.europa.eu/economy_finance/sg_pact_fiscal_policy/index_en.htm?cs_mid=570.

criterion. Section 4 treats debt developments. Section 5 deals with public investment and other relevant factors. The report takes into account the Commission services' January 2009 interim forecast, released on 19 January.

3. DEFICIT CRITERION

In 2008, the general government deficit is estimated to have reached 6.3% of GDP.

Well in excess of 3% of GDP, the deficit is not close to the Treaty reference value.

The excess over the 3% of GDP reference value can be regarded as exceptional. In particular, it results from a severe economic downturn in the sense of the Treaty and the Stability and Growth Pact. According to the Commission services' January 2009 interim forecast, real GDP growth in Ireland is projected to be strongly negative in the year 2008 (-2.0%, somewhat worse than the Irish authorities' forecast (at -1.4%) in the January 2009 addendum to the update of the stability programme). The recession reflects the sharp adjustment in the housing market which has spread to the wider economy and has been amplified by the global financial crisis and global slowdown, in particular the much lower growth prospects in the main trading partners (euro area, US and UK). The scale of the downturn was unexpected, with the end-2007 update of the stability programme forecasting real GDP growth of 3% in 2008 and the Commission services' spring 2008 forecast expecting growth at 2¼% in 2008, after 5¼% in 2007.

The excess over the 3% of GDP reference value cannot be regarded as temporary in the sense of the Treaty and the Stability and Growth Pact. The Commission services' January 2009 interim forecast projects that, taking into account the measures for the current year in the budget for 2009, the deficit would widen to 11% of GDP in 2009 and worsen further to 13% of GDP in 2010 on a no-policy change basis. Given the non-indexed nature of the tax and social benefit systems, the no-policy change assumption for 2010 is made operational, in the absence of announced measures, by freezing average tax rates and adjusting social transfer payments to reflect the projected increase in cost of living, while capital spending reflects programmed increases. According to the January 2009 addendum to the stability programme, the deficit is targeted to increase to 9.5% of GDP in 2009 (subject to an additional consolidation package of 1% of GDP that is being specified)[2] before falling gradually to a value below 3% of GDP in 2013, based however on yet to be specified consolidation measures.

In sum, the deficit is not close to the 3% of GDP reference value and, while the excess over the reference value can be regarded as exceptional, it is not temporary in the sense

[2] The package would consist 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.

of the Treaty and the Stability and Growth Pact. This analysis suggests that the deficit criterion in the Treaty is not fulfilled.

Table 2: Macroeconomic and budgetary developments [a]

	2002	2003	2004	2005	2006	2007	2008		2009		2010	
							COM	MS [b]	COM	MS [b]	COM	MS [b]
Real GDP (% change)	6.4	4.5	4.7	6.4	5.7	6.0	-2.0	-1.4	-5.0	-4.0	0.0	-0.9
Output gap (% of potential GDP)	2.3	1.2	0.6	1.7	2.5	4.4	0.1	0.5	-4.5	-3.5	-4.2	-4.1
General government balance	-0.4	0.4	1.4	1.7	3.0	0.2	-6.3	-6.3	-11.0	-9.5	-13.0	-9.0
Primary balance	1.0	1.7	2.5	2.7	3.9	1.2	-5.2	-5.2	-8.7	-7.3	-10.3	-6.4
One-off and other temporary measures	-	0.0	0.7	-0.3	0.0	0.0	0.0	-0.3	0.3	0.0	0.0	0.0
Government gross fixed capital formation	4.3	3.7	3.5	3.5	3.6	4.1	4.8	4.8	4.5	4.4	4.6	4.6
Cyclically-adjusted balance	-1.3	0.0	1.2	1.0	2.0	-1.5	-6.3	-6.5	-9.1	-8.1	-11.3	-7.4
Cyclically-adjusted primary balance	0.1	1.2	2.3	2.1	2.9	-0.6	-5.2	-5.4	-6.9	-5.9	-8.6	-4.8
Structural balance [c]	-	0.0	0.5	1.3	2.0	-1.5	-6.3	-6.2	-9.4	-8.1	-11.3	-7.4
Structural primary balance	-	1.2	1.6	2.4	2.9	-0.6	-5.2	-5.1	-7.2	-5.9	-8.6	-4.8

Notes:

[a] In percent of GDP unless specified otherwise.

[b] January 2009 addendum to the update of the stability programme. Output gap, cyclically-adjusted and structural balances recalculated by Commission services on the basis of the information in the programme using the commonly agreed methodology.

[c] Cyclically-adjusted balance excluding one-off and other temporary measures.

Source: Eurostat, Commission services' Interim Forecast January 2009 and January 2009 addendum to the update of the stability programme

4. DEBT DEVELOPMENTS

According to the January 2009 addendum to the stability programme, general government gross debt reached 40.6% of GDP in 2008, below the 60% of GDP Treaty reference value. However, the ratio increased by nearly 16 percentage points of GDP between 2007 and 2008. A further significant increase is projected thereafter, resulting in a breach of the 60% of GDP reference value by 2010. According to the Commission services' January 2009 interim forecast, the rise in the debt ratio would be even faster mainly because of higher deficits. It should be borne in mind that, owing to the accumulation of assets in the National Pension Reserve Fund (NRPF) in order to pre-fund part of future pension expenditure, with a 1% of GNP annual contribution to the NPRF, Irish *net* debt is well below gross debt, standing at around 30% of GDP in 2008 according to the addendum.

Whereas the increase in the debt level in 2008 would be primarily driven by a sizeable stock-flow adjustment linked to a deliberate build-up of liquidity, thereafter the main contribution would come from the projected primary deficits. Snow-ball effects historically had a debt-reducing impact. Their impact has now turned positive, on the back of increasing interest expenditure and falling nominal GDP, which together should contribute significantly to the rise in the debt ratio especially in 2009.

Table 3: Debt dynamics [a]

	2002	2003	2004	2005	2006	2007	2008		2009		2010	
							COM	MS [b]	COM	MS [b]	COM	MS [b]
Gross debt ratio	32.2	31.1	29.4	27.3	24.7	24.8	40.8	40.6	54.8	52.7	68.2	62.3
Change in the ratio	-3.3	-1.1	-1.6	-2.2	-2.6	0.1	16.0	15.8	14.0	12.1	13.5	9.6
Contributions: [c]												
Primary balance	-1.0	-1.7	-2.5	-2.7	-3.9	-1.2	5.2	5.2	8.7	7.3	10.3	6.4
Snowball effect	-2.2	-0.9	-0.8	-1.4	-1.4	-0.8	1.7	1.5	4.5	3.9	2.0	2.6
Of which:												
Interest expenditure	*1.4*	*1.3*	*1.1*	*1.0*	*0.9*	*1.0*	*1.1*	*1.1*	*2.3*	*2.2*	*2.7*	*2.6*
Growth effect	*-2.0*	*-1.4*	*-1.4*	*-1.7*	*-1.4*	*-1.4*	*0.5*	*0.4*	*2.1*	*1.7*	*0.0*	*0.5*
Inflation effect	*-1.5*	*-0.7*	*-0.6*	*-0.6*	*-0.9*	*-0.3*	*0.1*	*0.1*	*0.0*	*0.0*	*-0.7*	*-0.5*
Stock-flow adjustment	-0.1	1.5	1.8	1.9	2.8	2.0	9.1	9.1	0.8	0.9	1.1	0.6

Notes:
[a] In percent of GDP.
[b] January 2009 addendum to the update of the stability programme.
[c] The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} \right) + \frac{SF_t}{Y_t}$$

where t is a time subscript; D, PD, Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth. The term in parentheses represents the “snow-ball” effect, measuring the combined effect of interest expenditure and economic growth on the debt ratio.
Source: Eurostat, Commission services' Interim Forecast January 2009 and January 2009 addendum to the update of the stability programme.

5. RELEVANT FACTORS

Article 104(3) of the Treaty provides that the Commission report “shall also take into account whether the government deficit exceeds government investment expenditure and take into account other relevant factors including the medium-term economic and budgetary position of the Member State”. These factors are further clarified in Article 2(3) of Council Regulation (EC) No 1467/97, which also specifies that “any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess in qualitative terms the excess over the reference value and which the Member State has put forward to the Commission and to the Council” need to be given due consideration.

In view of the above provisions, the following four subsections consider in turn (1) the medium-term economic position; (2) the medium-term budgetary position (including public investment); (3) other factors put forward by the Member State; and (4) other factors considered relevant by the Commission.

5.1. Medium-term economic position

Cyclical conditions and potential growth. Following the boom period of exceptionally high growth at the end of the 1990s, Ireland experienced several years of still strong growth (on average 5.5% in the period 2003-2007), which became increasingly driven by domestic demand, with a particularly buoyant construction sector. Annual housing completions increased steadily from the mid-1990s onwards, accelerated after 2002 and peaked in 2006. The ratio of nominal construction investment to current price GDP had

reached 21½% by 2006, the highest value in the euro area, while the housing subcomponent accounted for 14% of GDP. While in 2007 real GDP still increased by 6%, it is expected to have declined by 2% in 2008. The correction in the housing market that started in 2007 has spread to other sectors through negative effects on confidence and employment, amplified by the financial crisis and global downturn. The Commission services' January 2009 interim forecast envisages a contraction of Irish GDP by 5% in 2009. Net exports are expected to make a positive contribution to GDP growth but this reflects falling imports (on the back of declining domestic demand) rather than a strong performance of exports, which remain subdued given the global slowdown and the competitiveness losses sustained in recent years. In the course of 2010 a very mild recovery is foreseen, with slightly declining domestic demand offset by a corresponding positive contribution from the external sector. Commission services' calculations according to the commonly agreed methodology show a marked deceleration in the rate of potential growth, from an average 5% in the period 2003-2007 to 2.2% in 2008, weakening further thereafter. Estimates of the output gap confirm the scale of the adjustment, with the gap moving from strongly positive in 2007 (+ 4½ percentage points of GDP) to 0.1 percentage point in 2008 and turning strongly negative in 2009 (-4½ percentage points).

Recent structural reforms. Structural policy measures have focused on strengthening R&D, increasing access to high-speed internet, unlocking business potential and moving towards an efficient and integrated energy policy. Gross expenditure on R&D increased from 1.1% of GDP in 2002 to 1.3% in 2007, of which two-thirds comes from the business sector. The Science, Technology and Innovation Strategy provides a framework to build a world-class research base by concentrating on higher education, the link between research institutions and business and increasing R&D efforts by indigenous companies. The strategy constitutes one of the principal pillars of the National Development Plan (NDP) for the period 2007-2013 with around 0.5% of GDP annually earmarked to it.

5.2. Medium-term budgetary position

Structural deficit and fiscal consolidation in good times. Ireland experienced economic good times in recent years, as assessed by strong growth and a positive output gap, and until 2006, the nominal and structural balance improved markedly. In 2008, however, the economy entered economic bad times and is projected to remain in bad times throughout the period covered by the Commission services' interim forecast. The deterioration in the fiscal position in 2007 in both nominal and structural terms (the latter by more than 3 percentage points of GDP) reflected an expansionary fiscal stance accompanied by some expenditure overruns. The further strong deterioration in the structural balance in 2008, by close to 5 percentage points of GDP, is mostly due to massive revenue shortfalls, while expenditure grew more strongly than budgeted[3];

[3] 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.

however, without the savings measures announced in July 2008, the expenditure overruns would have been larger. According to the Commission services' January 2009 interim forecast, the structural balance is projected to worsen by around 3 percentage points of GDP in 2009, mainly caused by further revenue shortfalls amid the ongoing recession, as well as higher social transfers linked to the expected increase in unemployment and rising interest expenditure. Notwithstanding uncertainties surrounding estimates of the output gap, the budgetary position departed from the medium-term objective for the budgetary position (a broadly balanced position in structural terms in the Irish case) in 2007 and is moving much further away from it in 2008 and 2009.

Public investment. The estimated general government deficit ratio in 2008 (6.3% of GDP) exceeded the estimated government investment-to-GDP ratio (4¾% of GDP). Government investment as a share of GDP is high in Ireland compared to the euro area average and has been on an upward trend in recent years. The rise in the public investment ratio, from around 3½% of GDP in 2006 to 4% in 2007 and 4¾% in 2008[4], is much less pronounced than the deterioration in the general government balance (from a 3% of GDP surplus in 2006 to a 6.3% deficit in 2008) or in the structural balance (from a 2% of GDP surplus to a 6¼% deficit). According to the Commission services' forecast, the general government deficit ratio would continue to exceed the public investment ratio until 2010.

Quality of public finances. General government expenditure has risen from 31½% of GDP in 2000 to 35½% in 2007, still the lowest in the euro area. Besides public investment, social transfer payments have been growing faster than other public expenditure. The further significant increase in the expenditure ratio in 2008, to 40% of GDP, owes to higher investment, social transfer payments and public sector wages. The government's policy outlined in the January 2009 addendum to the stability programme update confirms the need to reduce especially current public expenditure growth to a sustainable level, more in line with revenue generated within the economy. Taking into account the expenditure cuts in the context of the 1% of GDP package announced in the addendum, a sharp deceleration of primary current government expenditure growth in 2009 (+3½%) is foreseen, after an increase by 10% in nominal terms in 2008. Compared to earlier plans, the budget for 2009 rescheduled capital expenditure in an amount of 0.7% of GDP in 2009 to a later date securing investment in the core economic infrastructure; in early February additional across-the-board cuts in capital expenditure amounting to 0.2% of GDP were announced.

Long-term sustainability of public finances. In its recommendation for a Council opinion on the October 2008 update of the stability programme and its addendum, adopted today, the Commission assesses the long-term sustainability of Ireland's public finances as follows. " 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. (…) While assets have been accumulated in the

[4] Includes the above-mentioned unbudgeted buyout by the government of the M50 Westlink toll bridge.

National Pension Reserve Fund 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 (…) risks from financial sector stabilisation schemes [see Section 5.4 below] 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."

5.3. Other factors put forward by the Member State

In a letter of 27 January 2009, the authorities of Ireland listed some relevant factors in accordance with Article 2(3) of Council Regulation (EC) No 1467/97. The analysis presented above already covers most of the items put forward by the authorities. The letter also draws attention to the following action taken since mid-2008 and planned to be taken in the coming years.

> *"In view of the severity and suddenness of the economic downturn and in order to avoid possible further damage to the economy, the Government has concluded that restoring sustainability to the public finances can only realistically be pursued over a period of up to five years. Even so, very significant and difficult adjustments will be required during this period, including in 2009. The Government aims as a priority to eliminate the current budget deficit by 2013 and in that period to bring the General Government deficit to below 3% of GDP. (…) the Government took decisions in July 2008 and in Budget 2009 which will reduce public expenditure by €1.4 billion and increase tax receipts by €2 billion in 2009. The Government now also plans in the light of the end 2008 data to reduce public expenditure by up to €2 billion in 2009, representing additional corrective action of 1% of GDP over and above that contained in the 2009 Budget.*
>
> *As part of this strategy, the Government considers it important to maintain a relatively high level of public investment to help remedy the infrastructure deficit and to support the growth potential of the economy in line with the Lisbon Agenda. This is also consistent with the call from the European Council to Member States for appropriate fiscal stimuli during these extraordinary times."*

5.4. Other factors considered relevant by the Commission

Recent public finance developments in Ireland are also influenced by the following factors in the area of budgetary institutions and procedures. The medium-term budgetary framework, especially for current expenditure, seems to be underdeveloped. The budget covering the period three years ahead (coincident with the standard stability programme period) puts forward annual spending projections but it is unclear whether these are binding or effective in anchoring the budgetary process. While the practice of "contingency provisions" in the forward budget projections has been abandoned, the addendum includes for the years 2009-2013 a sizeable "cumulative fiscal consolidation objective" which is neither allocated to the revenue or expenditure side (let alone to

subcomponents) nor supported by measures. Furthermore, Ireland has generally recorded slight expenditure overruns compared to plans. While this used to be masked by higher-than-expected revenue and GDP growth, it has contributed to the worsening budgetary position in recent years.

On 30 September 2008, the government announced a guarantee scheme for the financial system, covering liabilities existing from that date onwards up to 29 September 2010, in an estimated amount of €440 billion. The scheme was put in place to protect the financial system in Ireland given the global financial crisis. Furthermore, the statutory limit for the deposit guarantee scheme was increased to €100,000 per depositor. In December, a recapitalisation programme of €10 billion (5% of GDP) for three major banks[5], intended to be financed at least partly from the NPRF, was announced. On 15 January, the Irish government announced a change of strategy with regard to Anglo-Irish Bank and took the bank into full State control instead, citing persistent lack of investor confidence due to concerns about corporate governance. On 11 February, the government decided capital injections of €3.5 bn for each of the two remaining banks (together 3¾% of GDP). The required funds are planned to come from the NPRF's current resources and from a frontloading of the government's contributions to it for 2009 and 2010. In the absence of precise information on the degree and timing of the utilisation of the guarantee scheme and bank recapitalisations, the Commission services' January 2009 interim forecast includes no budgetary impact.

6. CONCLUSIONS

The general government deficit in Ireland reached 6.3% of GDP in 2008. This breach of the deficit reference value mainly reflects a broad-based strong decline in tax revenue in the context of the economic recession led by a sharp adjustment in the housing market. While Ireland has taken some measures supporting the economy in line with the European Economic Recovery Plan, they are part of a broader medium-term budgetary strategy geared at consolidation. Financial rescue operations put in place since autumn 2008 have not affected the deficit to date.

The 2008 deficit is above and not close to the 3% of GDP reference value. The excess over the reference value can be qualified as exceptional within the meaning of the Treaty and the Stability and Growth Pact, but cannot be considered temporary. This suggests that the deficit criterion in the Treaty is not fulfilled.

At 40.6% of GDP in 2008, general government gross debt remains below the 60% of GDP reference value but a significant rise projected in the coming years is expected to lead to a level exceeding the reference value by 2010.

In line with the Treaty, this report has also examined "relevant factors", which, according to the Stability and Growth Pact, can only be taken into account in the steps leading to the

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[5] Bank of Ireland, Allied Irish Bank and Anglo-Irish Bank.

decision on the existence of a excessive deficit if the double condition – that the deficit remains close to the reference value and that its excess over the reference value is temporary – is fully met. Considered on their own merit, the relevant factors in the current case present a mixed picture.

The existence of a severe economic downturn, the implementation of measures to support the economy and the financial sector support package increase the need to undertake enhanced surveillance under the EDP.