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Post-Programme Surveillance Report

Ireland, Autumn 2016

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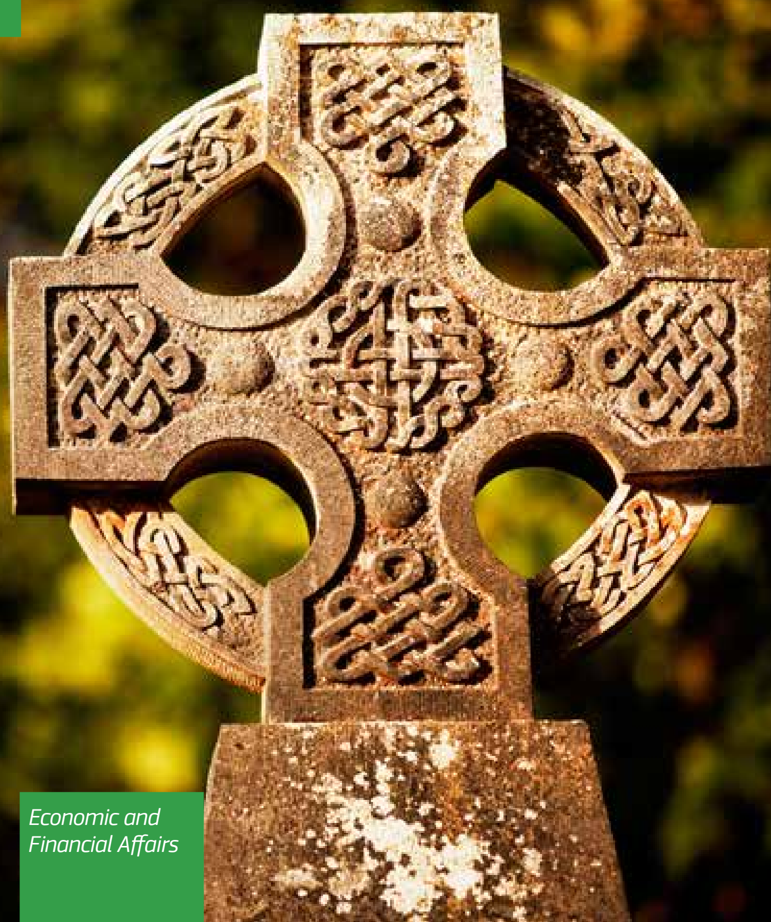
EUROPEAN ECONOMY



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Post-Programme Surveillance Report

Ireland, Autumn 2016

EUROPEAN ECONOMY

Institutional Paper 050

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The report reflects information available up until 1 March 2017.

ABBREVIATIONS

AIB	Allied Irish Bank
APP	Extended Asset Purchase Programme
BEPS	Base Erosion and Profit Shifting
BOI	Bank of Ireland
CET1	Common equity tier 1
CBI	Central Bank of Ireland
CSO	Central Statistics Office Ireland
CSR	Country specific recommendation
CCR	Central Credit Register
CIT	Corporate income tax
CRE	Commercial real estate
DTA	Deferred tax asset
ECB	European Central Bank
EBA	European Banking Authority
EFSF	European Financial Stability Facility
EFSM	European Financial Stabilisation Mechanism
ESM	European Stability Mechanism
GOS	Gross Operating Surplus
GVA	Gross Value Added
HICP	Harmonised Index of Consumer Prices
IBRC	Irish Bank Resolution Corporation
IMF	International Monetary Fund
IPO	Initial public offering
ISIF	Ireland Strategic Investment Fund
LCR	Liquidity coverage ratio
LTI	Loan-to-income ratio
LTV	Loan-to-value ratio
MIP	Macroeconomic imbalance procedure
MNE	Multinational enterprise
m-o-m	Month-on-month
MTO	Medium-term Objective
NAMA	National Asset Management Agency
NPLs	Non-performing loans
NTMA	National Treasury Management Agency
PMI	Production managers index
PPS	Post-programme surveillance
PPM	Post-programme monitoring
PTSB	Permanent TSB
REIT	Real Estate Investment Trust
q-o-q	Quarter-on-quarter
TRIM	Targeted review of internal models
SBCI	Strategic Banking Corporation of Ireland
SGP	Stability and Growth Pact
SME	Small and medium enterprises
SPV	Special purpose vehicle
SSM	Single Supervisory Mechanism
USC	Universal Social Charge
VAT	Value added tax
y-o-y	Year-on-year

EXECUTIVE SUMMARY

Ireland's economic prospects remain bright, but some clouds are on the horizon. In recent years, rapid economic growth has provided tailwinds for policy efforts aimed at financial sector repair and the restoration of sustainable public finances. Most recently, on top of robust underlying growth, the level of GDP surged in 2015 driven primarily by changes in the global operations of some multinationals. This added further to the fall in the headline deficit and debt-to-GDP ratios but had only limited benefits for the domestic economy in terms of household income and employment. While GDP is expected to continue to grow at robust rates, the future evolution of the activities of multinational enterprises remains unpredictable and the external environment has become increasingly uncertain especially after the UK 'leave' vote.

Ireland's fiscal adjustment has been remarkable but slowed in 2016 as the Government seeks to balance demands for spending increases in critical areas with deficit reduction. The government has used a large part of the over-performing, but partly volatile, tax proceeds to fund additional current spending in 2016. Although the increase in corporation tax receipts is recognised as a level shift, its source and durability remain uncertain. Therefore, the government's fiscal policy is not fully in line with the June 2016 EU Council recommendations, which encourage Ireland to use windfall gains to accelerate debt reduction. Looking forward, a continued decline in the still high level of public debt remains sensitive to fluctuations in economic growth and is dependent on the size of fiscal adjustment. In this context the government announcement of a debt-to GDP target of 45 % of GDP by the mid to late 2020s is to be welcomed. Compliance with the EU fiscal framework provided under the Stability and Growth Pact remains of the essence.

Increased external uncertainty puts an even greater premium on prudent fiscal policy and a reorientation of public spending toward investment. Efforts to enhance the budgetary process are commendable. Yet, the reliability of multi-annual expenditure planning remains weak, leading to repeated changes to expenditure ceilings. If correctly designed, changes to the fiscal framework would reduce the risk of pro-cyclical fiscal policy in the future. Ongoing spending pressures call for a strengthening of public spending reviews, including in the healthcare sector. The 2017 budget aims to exhaust the available fiscal space and little has been done to broaden the tax base, to shelter the public finances from future shocks. Further current spending increases and tax cuts could narrow the scope for public investment in infrastructure, making it difficult to address bottlenecks and boost the long-term productive capacity of the economy.

Despite significant progress in recent years, there is ample scope for further progress for the banking sector. A number of factors will continue to drag on bank profitability in the near to medium term. These include the elevated stock of non-performing loans (NPLs) and low-yielding tracker mortgages, weak credit demand, difficulties in accessing collateral, and pressure on net interest margins. Domestic banks' capital levels have improved, even though the results of the recent European Banking Authority stress test signalled remaining vulnerabilities in two domestic banks, mostly stemming from the legacy of their weak asset quality. The resolution of NPLs needs to regain momentum and efforts to ensure that impaired accounts are sustainably restructured should continue. In particular; the focus should remain on mortgage loans that have been non-performing for a long time. Despite the recent pickup in new lending volumes, both households and firms continue to repay more than they borrow, resulting in a still largely credit-less economic recovery. Market uncertainty persists, including in relation to the longer-term impact of the UK 'leave' vote on the banks, especially those with significant UK exposures.

The recovery in the banking sector could be hampered by legislative actions, which could undermine banks' efforts to enhance profitability while maintaining prudent lending standards. The opposition Bill enabling the Central Bank of Ireland (CBI) to cap interest rates on variable rate mortgages, if enacted, could interfere with the smooth transmission of monetary policy. By impinging on banks' ability to generate sustainable profits, it could also have implications for banking supervision and financial stability. Moreover, it could have a deterrent effect on potential new entrants to the market, thereby inhibiting credit extension at sustainable market rates.

Developments in real estate markets need to be closely monitored. While there is little evidence of house price overvaluation so far, recent price and rent increases have drawn attention to persistent housing supply bottlenecks. The government has repeatedly intervened in the housing market to support the recovery in the residential construction industry, but it will take time to restore an adequate supply of new homes. In the meantime, demand-side policies or rent controls could be counterproductive. Although commercial property purchases are largely funded by foreign equity, close supervision of commercial real estate financing should be maintained. After the CBI macro-prudential measures were announced in late 2014, house price expectations moderated. Their review, published in November 2016, resulted in several refinements, while at the same time leaving the macro-prudential framework – and in particular the loan-to-income ratio – intact. Looking forward, the framework should be maintained to prevent the potential re-emergence of a vicious circle between house prices and bank lending.

Overall, the results of the sixth PPS review point to a very limited risk to the capacity to repay. Assuming that Ireland continues to implement prudent economic policies and sovereign market conditions are not impaired, repayment risks for European Financial Stability Mechanism (EFSM) and European Financial Stability Facility (EFSF) loans remain low. Market access conditions for the Irish sovereign remain favourable, following policy actions at national and European levels and due to the strong Irish economy. Moreover, cash buffers of the sovereign remain at comfortable levels and the average maturity of Irish public debt is one of the longest in Europe, with 40 % of long term debt maturing from 2026 on. The next repayment of loans from EU lenders is scheduled in 2018, although the maturity extensions granted in 2013 mean that 2018 European Financial Stabilisation Mechanism (EFSM) maturities will actually be refinanced. Finally, most outstanding loans from the International Monetary Fund (IMF) have been repaid.

Ireland has made some progress in addressing imbalances in the context of the Macroeconomic Imbalances Procedure (MIP). Ireland has macroeconomic imbalances requiring specific monitoring and decisive policy action. The execution of the MIP-relevant Council recommendations is monitored through Post Programme Surveillance (PPS). The sixth PPS review concludes that there have been advances in addressing the relevant Country Specific Recommendations (CSRs) adopted by the Council in 2016. This follows the latest Country Report on Ireland, which found that, overall, Ireland has made some progress in addressing the 2016 CSRs.

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1. INTRODUCTION

Staff from the European Commission, in liaison with the European Central Bank (ECB), undertook the sixth PPS review mission for Ireland from 29 November to 2 December 2016. The mission was coordinated with the International Monetary Fund's (IMF) post-programme monitoring (PPM) mission. The European Stability Mechanism (ESM) participated in the meetings on aspects related to its own Early Warning System. The Single Supervisory Mechanism (SSM) was also represented with staff from the national competent authority, the Central Bank of Ireland (CBI). PPS aims to assess economic, fiscal and financial conditions with the ultimate goal to monitor the repayment capacity of a country that has received financial assistance ([1]). There is no policy conditionality under PPS, but the Council of the European Union can issue recommendations for corrective actions if necessary.

The PPS mission includes specific monitoring under the MIP. In February 2016, the Commission issued a Country Report ([2]) in which it presented the in-depth review on the prevention and correction of macroeconomic imbalances, and concluded that Ireland continues to experience macroeconomic imbalances ([3]). This PPS report covers the specific monitoring of the policies recommended to Ireland by the Council in July 2016 ([4]). Overall, there have been further advances with addressing CSR 1 on fiscal consolidation and with tackling CSR 3 concerning the restructuring of loans in arrears. A more detailed overview of the progress made with the 2016 MIP-tagged CSRs is provided in Section 5 and Annex 1.

([1]) PPS is foreseen by Article 14 of the two-pack Regulation (EU) N°472/2013. It starts after the expiry of the EU/IMF financial assistance programme and lasts until a minimum 75 % of the financial assistance has been repaid. The Council, on a proposal from the Commission, may extend the duration of PPS if there is a persistent risk to the financial stability or fiscal sustainability of the Member State concerned.

([2]) http://ec.europa.eu/europe2020/pdf/csr2016/cr2016_ireland_en.pdf

([3]) See Communication from the Commission to the European Parliament, the Council, the European Central Bank and the Eurogroup: '2016 European Semester: Assessment of progress on structural reforms, prevention and correction of macroeconomic imbalances, and results of in-depth reviews under Regulation (EU) No 1176/2011' COM/2016/0095 final.

([4]) See Council recommendation from 12 July 2016: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016H0818(16)&from=EN.

2. RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

2.1. RECENT DEVELOPMENTS

2.1.1. Macroeconomic trends

The 2015 surge in GDP was primarily due to multinational enterprises (MNEs). Gross value added (GVA) doubled in the sectors dominated by foreign-owned MNEs ([5]). As outlined in the 5th PPS report ([6]), a small number of these MNEs restructured their operations, with the result that substantial GVA from global value chains is now attributed to Ireland. Net exports contributed 18 pps. to GDP growth, driven by the contract manufacturing ([7]) activities of MNEs, leading to a level shift in the volume of GDP ([8]). There is at present no evidence suggesting a reversal of this level shift, albeit its sustainability remains uncertain. In an increasingly uncertain environment, multinationals are expected to react quickly to changes including by shifting their intangible assets.

At the same time, the domestic economy also grew at robust rates. GVA in the sectors not dominated by multinationals grew by 4.4 % in 2015, while core domestic demand (a measure that excludes investment in intangible assets and transport equipment/aircraft) expanded by 5.4 %.

After a mixed picture in the first half of 2016, the performance of GDP was better in the third quarter. 'Core domestic demand' ([9]) grew by 3.0 % on an annual basis driven by strong investment in construction and private consumption. Outside core demand, investment in intangible assets dropped substantially by 50 % in Q3-2016, on an annual basis, mostly mirroring a fall in imports of intellectual property assets of around 52 %. Transport equipment, primarily driven by aircraft leasing, fell for a third consecutive quarter. Investment in both asset types is largely offset by corresponding imports and such that the net effect on GDP was small ([10]).

Export growth continued in 2016 despite the fall in sterling. Exports increased by 2.2 % y-o-y in volume terms in the first three quarters of 2016. In 2016, the value of goods exports, excluding contract manufacturing, was 4.0 % higher than the same period last year, while the trade surplus was 11.9 % higher. Thus, exports held up well as increased trade with the EU and other international markets compensated for the adverse effect of the depreciation of sterling on exports to the UK ([11]).

Employment growth has surprised on the upside. Employment grew by close to 3.3 % in the fourth quarter of 2016 ([12]), compared to the same period in 2015. In 2016, unemployment rate stood at 7.9 %, down from 9.3 % in 2015, despite the growing labour force and rising participation rate. The youth unemployment rate (as defined by Eurostat) also declined significantly in 2016 to 17.2 % from 20.9 % in 2015. In Q4-2016, average hourly earnings are estimated to have increased by 1.1 % y-o-y.

Inflation has remained subdued. The harmonised index of consumer prices (HICP) declined by 0.2 % in 2016, even lower than the 0.0 % observed in 2015. Energy prices continued to drag down the headline inflation rate. Services inflation was 2.5 % and remains the main source of upward price pressures. Nationally, private rents increased 9.7 % y-o-y in December and market

([5]) For instance, communications, electronics, media, pharmaceuticals or medical devices. The precise contribution of each sector is not public due to statistical confidentiality.

([6]) http://ec.europa.eu/economy_finance/publications/eeip/ip035_en.htm

([7]) Contract manufacturing refers to the production of goods abroad on behalf of Irish-domiciled entities for exporting. Following the corporate restructurings in 2015, it started to have a large positive contribution to GVA in Ireland.

([8]) The Economic Statistics Review Group, established by the Central Statistics Office (CSO) to investigate alternative economic indicators, delivered its final report in February 2017. The report proposed that the CSO should compile a new indicator GNI*. In contrast to GDP, this indicator would exclude not just net factor income (as is already the case for GNP), but also the depreciation attributable to relocated capital assets and the impact of re-domiciled firms. In parallel, the CSO will continue to compile international standard indicators GDP and GNP.

([9]) Core domestic demand is domestic demand adjusted for investment in intangible assets and transport equipment.

([10]) About 70 % of investment in intangible assets relates to assets transferred from abroad and was therefore offset by imports. The remaining 30 % is indigenous investment. Aircraft investment is almost entirely compensated by imports of planes. Leasing companies also export some (used) planes but no aircraft are built in Ireland.

([11]) Goods exports to Great Britain were approximately EUR 500 million lower in 2016 than in 2015.

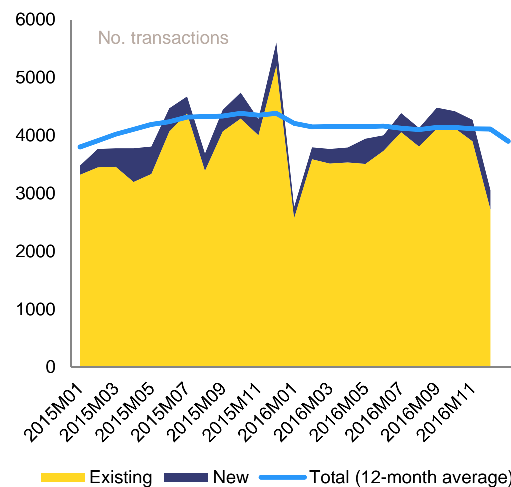
([12]) According to the CSO.

participants report that private rents in Dublin have now exceeded their pre-crisis peaks.

Residential property prices are accelerating but with substantial regional variation. Nationally, residential property prices continued to rise, increasing 8.1 % y-o-y in 2016 compared 4.6 % in 2015. However, this masked substantial regional variation with prices in Dublin increasing by 5.7 % y-o-y, compared to almost 12 % elsewhere. This occurred despite underlying demand being strongest in urban areas, particularly Dublin ([13]). Unlike the pre-crisis period, price increases are not being driven by excessive credit extension and Commission analysis does not yet point to significant overvaluation ([14]). Cash transactions still account for approximately 45 % of the total. Still, accelerating price increases remain a concern.

The recovering housing supply is still not sufficient to meet estimated demand. The number of house completions increased by almost 18 % in 2016 to 14 932. Although the rate of increase is rapid, the projected level of completions remains well below the estimated household formation rate of 25 000 per year ([15]). The number of property transactions per month remained relatively constant during 2016 with existing properties consistently accounting for around 90 % of total transactions (see Graph 2.1). At present, market participants only expect completions to reach the required levels toward the final years of the decade.

Graph 2.1: Residential property transactions



Source: CSO

Commercial property prices are also rising rapidly, but are not being driven by domestic bank funding. Much of the funding is from international sources and comes from large property companies, Real Estate Investment Trusts (REITs) or private equity groups. Market participants report that non-Irish banks and non-bank alternative funders, such as debt funds are also entering the Irish market ([16]). Office prices are reported to have increased by 7.2 % y-o-y in the fourth quarter of 2016, while prime office rents increased 14 % y-o-y in the fourth quarter of 2016 ([17]).

2.1.2. Public Finances

The surge in GDP reduced the 2015 deficit ratio to its lowest level since the crisis. The general government deficit fell to 1.9 % of GDP in 2015, down from 3.7 % a year earlier. Excluding a deficit-increasing one-off transaction of 0.8 % of

([13]) Some of the regional variation in prices and rents may relate to the introduction of CBI macroprudential measures. Loan-to-value (LTV) and loan-to-income (LTI) limits were introduced in 2015 after residential property prices in Dublin had increased by approximately 19 % in 2014. Property prices in the capital are the highest in Ireland both in absolute terms and as a ratio to income. Therefore, in addition to dampening expectations of further house-price increases, the loan-to-value limit is likely to have been more binding in the capital. This may have diverted demand both to commuter areas close to Dublin and to the rental market, contributing to rapid rent increases in 2016.

([14]) 2017 European Semester: Alert Mechanism Report https://ec.europa.eu/info/sites/info/files/2017-european-semester-alert-mechanism-report_en_0.pdf

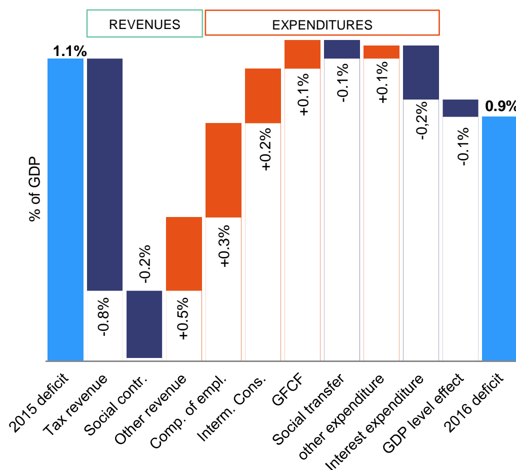
([15]) Duffy, D., Byrne, D. and Fitzgerald, J., 'Alternative scenarios for new household formation in Ireland', Special Article in Quarterly Economic Commentary, Spring 2014, The Economic and Social Research Institute https://www.esri.ie/UserFiles/publications/QEC2014SPR_SA_Duffy.pdf

([16]) CBRE Ireland: real estate market outlook 2017 https://researchgateway.cbre.com/Layouts/GKCSearch/DownLoadPublicUrl.ashx

([17]) See Jones, Lang Lasalle Property Index, Q4 2016 http://www.jll.ie/ireland/en-ie/Research/JLL%20Irish%20Property%20Index%20-%20Q4%202016.pdf?2b463eb6-dd5b-4544-acef-7edda80aceb7
and CBRE Dublin Office Market Review, Q3 2016 https://researchgateway.cbre.com/Layouts/GKCSearch/DownLoadPublicUrl.ashx

GDP ([18]), the underlying deficit was 1.1 % of GDP. The mechanical effect of the surge in GDP on the annual improvement in the deficit-to-GDP ratio amounted to about 0.9 % of GDP, substantially easing the correction of the excessive deficit.

Graph 2.2: **2016 public deficit improvement**

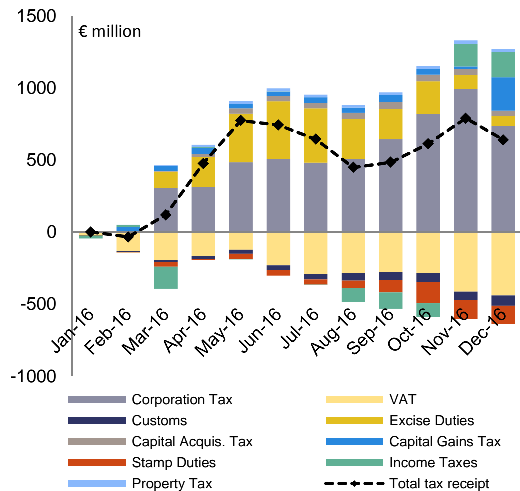


Source: European Commission

Public finances in 2016 are estimated to have slighty improved in terms of headline deficit. The general government deficit is estimated to have fallen to 0.9 % of GDP in 2016, a small improvement from last year's underlying deficit of 1.1 %. Strong tax receipts were utilised to finance current spending across a range of high priority areas, including larger-than-planned expenditure in the health sector. Additional capital spending was allocated towards infrastructure repair from flood damage and bottlenecks, such as school building and housing (Graph 2.2).

End-2016 cash returns showed positive dynamics but with substantial variation across tax heads. Tax revenues increased by 5 % (EUR 2 263 million) over the year, mainly due to the strong performance of corporate tax (7 %, y-o-y) and excise duty (7.9 %, y-o-y). Conversely, value added tax (VAT) receipts ended the year EUR 439 million (3.4 %) below expectations. Income tax receipts were broadly in line with projections, increasing by 4.4 % (EUR 810 million) over the year (Graph 2.3). They were driven by a combination of strong receipts from the self-employed and by the non-indexation of income tax credits and bands, a consistent policy since 2008.

Graph 2.3: **End-2016 cash returns: tax collected vs. government expectations**



Source: Department of Finance

The government remained within the increased spending envelopes. In the last month of 2016 spending rose in line with the revised budgetary targets. Total expenditure of central government departments for the year was broadly in line with the authorities' forecast, with current expenditure 0.2 % (EUR 85 million) below government's plan and capital expenditure 5.7 % (EUR 227 million) above expectation, offset by lower-than-expected debt interest payments (EUR 249 million). Compared to the previous year, current spending increased by nearly 2 %, while capital expenditure was up by 9.6 %. Continued incremental revisions to the health sector's allocations will remain a key area of concern as demographic changes continue to put upward pressure on health expenditure ([19]).

Overall, Ireland appears to have achieved its 2016 budgetary targets. Tax revenue fell EUR 271 million (0.6 %) short of the revised end-year target of EUR 48.1 billion ([20]), but other

([18]) This related to the restructuring of a state-owned bank's capital base.

([19]) Note that the extra-spending by the Department of Social Protection (EUR 187 million more than its original budget) is due to the Christmas Bonus welfare payments.

([20]) As set out in the 2017 Budget, the revised revenue target was needed to fund EUR 850 million of extra expenditure, beyond that originally estimated by the government. This

government revenue helped to offset the shortfall in the December tax take. At the same time, Ireland's contribution to the EU Budget was around EUR 120 million lower than projected on budget day (Table 1). VAT receipts due in January this year, which reflect Christmas sales, may still marginally improve 2016 deficit in accrual terms.

Table 2.1: End-2016 Exchequer cash returns vs budget 2017 projections.

returns vs budget 2017 project Exchequer returns		Budget 2017	Difference
tax revenue	47864	48135	-271
non-tax revenue	2239	1932	307
other receipts (i.e. PRSI)	11995	11836	159
Revenue	**62099**	**61903**	**196**
gross voted current exp.	51787	51982	-195
gross voted capital exp.	4194	4167	27
non-voted currentexp.	9097	9282	-185
Expenditure	**656078**	**65431**	**-353**
Gov.Bal. (cash)	**-2979**	**-3528**	**549**

Source: Department of Finance

The level shift in corporation tax receipts in 2015 was maintained in 2016 and is projected to remain over the forecast horizon. However, difficulties in tracking down the precise source of the surge in corporate tax revenue raise doubts about their durability. For the second year in a row, corporate tax receipts exceeded the government's own projections by a wide margin (EUR 737 million, or 11.1 %). Given their now sizeable share in tax revenue (15.2 %) and their inherently volatile nature, being subject to abrupt decisions by a small number of large MNEs, it is crucial to clarify the underlying drivers and to assess the durability of the strong revenue performance (see Box 1).

2.1.3. Financial Sector

Irish domestic banks are profitable but the prospects of further improvements are uncertain. As their asset quality recovers, banks have been writing back provisions to support their profits. Moreover, lower interest rates have eased funding costs. On the other hand, the prevalence of low-yielding tracker mortgages and continuing deleveraging is limiting the scope for a significant amelioration in interest income. Lastly, operating expenses have increased, in part due to one-off compliance costs and infrastructure investments. Although bearing costs, these actions should be assessed in view of the enhanced financial stability benefits that they bring.

Volatility in global financial markets could spill over to the Irish financial sector. While bank shares across Europe have been weak, Irish domestic banks traded below euro-area market averages in 2016, although they have recovered somewhat from the lows recorded following the UK 'leave' vote (Graph 2.4). Some risks have already materialised through larger pension deficits. This is due to the decrease in AA corporate bond yields which are used to discount the liabilities in the banks' pension schemes ([21]). Further adverse effects came in the form of some losses in trading income and a decrease in the share of new UK loans extended ([22]). The uncertainty affects banks with large UK exposures in particular ([23]). Even though this is mostly mitigated by hedging, substantial sterling denominated assets heightens the banks' exposure to currency volatility. Irish firms that are heavily dependent on exports to the UK may also demand less credit. Additional downside risks for the financial sector stem from the diminished investor confidence in the European banking sector and possible policy developments in the U.S.

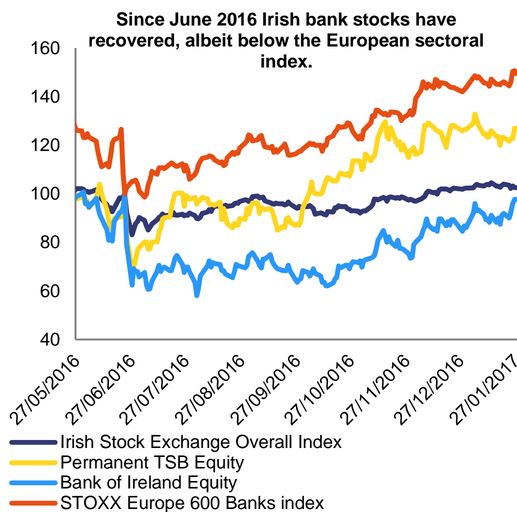
included the additional EUR 500 million for Health and EUR 40 million for Justice. The estimates were voted on by the Irish Parliament on the 11 July this year and a further EUR 310 million reflected in the Expenditure Report 2017, was used to fund a Christmas Bonus for long-term Social Welfare recipients, increased capital expenditure on the school building programme, and flood repairs to transport infrastructure.

([21]) Falling AA bond yields accentuated the divergence between the assets and liabilities of pension funds as they reduce investment income and increase projected future costs, thus creating a deficit.

([22]) The share of new credit extended to the UK fell to 30 % in the third quarter of 2016, from 37 % in the same period of 2015.

([23]) The five main retail banks in Ireland have about 21 % of their total assets in the UK and significant property exposure there. On the back of heightened uncertainty, Bank of Ireland decided to re-commence dividend payments only in the first half of 2018, which is later than it had initially hoped.

Graph 2.4: Performance of Irish Bank shares vs. STXE banks 600 index



Source: Bloomberg

Irish banks meet the capital requirements. They compare favourably with their euro-area peers, with an average fully-loaded common equity tier 1 (CET1) ratio of 15 % at end-September 2016 ([24]). However, the two Irish banks that were included in the 2016 European Banking Agency (EBA) stress test, Allied Irish Banks (AIB) and Bank of Ireland (BOI), underperformed in the adverse stress scenario, mostly due to the high NPL and elevated funding costs. Although these results are highly dependent on the underlying assumptions ([25]), they nevertheless highlight the sensitivity of the Irish banking sector to any reversal in the macroeconomic environment. All Irish banks meet the liquidity coverage ratio (LCR) requirements.

Tracker mortgages make up a significant part of the banks' credit portfolios, despite reductions. At end-September 2016, tracker mortgages accounted for over 44 % of the total mortgage balance. This is also due to the fact that most of them were originated at the height of the boom when loans were larger on average. Banks are trying to price new lending in a way that compensates for their low-yielding (albeit not loss-making) back books.

The substantial stock of deferred tax assets (DTAs) remains a concern. As a result of severe losses in the aftermath of the crisis, Irish banks accumulated a large amount of DTAs ([26]), the value of which depends on the banks' future profitability. Although the inclusion of these assets in the calculation of regulatory capital is allowed, DTAs will need to be gradually deducted from their capital base under current rules. While PTSB does not have substantial DTAs, BOI and AIB had accumulated a stock of over EUR 4.4 billion by the end of June 2016, representing over 20 % of their own funds.

Despite improvements, the stock of non-performing loans (NPLs) remains high and shows signs of stickiness. According to the CBI, the average NPL ratio of the Irish domestic banks was 14.2 % as of September 2016 ([27]). This is much lower than its peak level of 27.1 % recorded at the end of December 2013 but remains substantially above the EU-average of 5.4 %. Moreover, the pace of NPL reduction has slowed somewhat (Panel Graph 2.7).

Banks have been active in restructuring loan accounts but the cases that remain are also the most difficult to resolve. This is especially the case for mortgage arrears. At end-September 2016, 13.9 % of the total balance of mortgages was in arrears ([28]), down from 14.7 % at end-2015. Close to 70 % of this balance are long-term arrears, with reduced chances of recovery. CBI reports show that over 86 % of restructured mortgage loans, meet their revised terms. While restructurings show a significant effort, around 23 % of loans that

([24]) The euro-area weighted average fully loaded CET1 ratio in September 2016 was 13.6 %. Source: EBA.

([25]) Under the adverse scenario, AIB and BOI's CET1 ratio fell respectively from 15.9 % and 13.3 % at end-2015 to 7.4 % and 7.7 % by end-2018. These results are partly due to the relatively high stock of deferred tax assets (DTAs). For the two banks, the counting of DTAs towards CET1 capital is being phased out at a pace of 10% annually from 2015 until end 2023. More importantly, however, the adverse stress scenario penalises banks with high existing NPL stocks and funding costs. These methodological assumptions worked against the two Irish banks, despite their recent restructuring efforts.

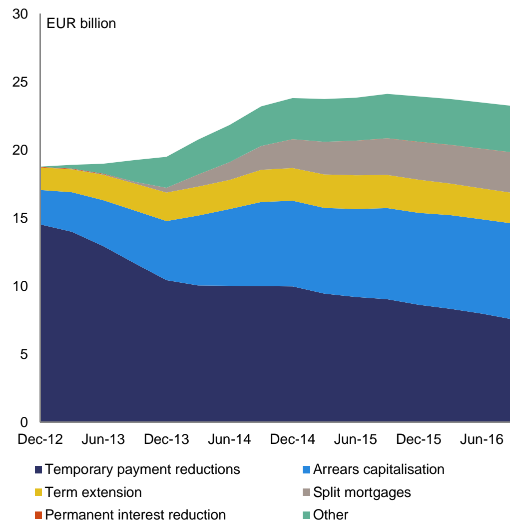
([26]) Accounting and tax rules allow institutions that make losses, and thus pay no income taxes, to generate DTAs that allow them reduce their future tax liabilities in the event that they return to profitability.

([27]) The EBA reports an NPL ratio of 14.4 % at the end of September 2016. However for Ireland we rely on statistics supplied by the CBI as it provides a longer time-series. The euro area average is sourced from the EBA.

([28]) A loan is considered in arrears when 90 days past due, and in long-term arrears after 720 days past due.

defaulted at some point between 2010 and 2015 have never been restructured at all ([29]).

Graph 2.5: Trends in mortgage restructuring solutions



(1) The category of temporary payment reductions includes the conversion of loans to interest-only loans for a pre-specified period, the temporary granting of payment moratoria, loans for which interest payments are deferred to a future date, and temporary interest rate reduction schemes.

Source: Central Bank of Ireland

The ultimate durability of restructurings depends crucially on the quality of proposed solutions ([30]). In terms specific restructuring solutions, the use of temporary payment reductions (incl. interest-only, payment moratorium, deferred interest, and temporary interest reduction schemes) has declined while the use of 'arrears capitalisation' that carries forward the past-due payments, and split mortgages has increased (Graph 2.5). According to latest figures as of end-September 2016, nearly 23 % of all restructured loans subject to an arrears capitalisation solution re-defaulted, while the comparable figure for split mortgages is only 5 % ([31]).

Apart from sales and restructuring, the use of alternative NPL strategies has been rather limited. The number of repossessions is low (about 300 properties per quarter, either through court orders or voluntary surrender/ abandonment) and procedures lengthy. This not only postpones a more definite NPL resolution for the banks, but also blocks a significant portion of the real estate market in an environment of chronic under-supply. Out-of-court arrangements between lenders and borrowers, as well as personal insolvency arrangements, remain relatively uncommon.

High forbearance ([32]) levels in Ireland are partly due to the arrears restructuring process. Forbearance levels in Ireland are comparatively high but are, to a certain extent, a reflection of the loan restructuring activities mandated by the CBI. The large volume of restructured mortgage accounts (over 147 000) confirms this. It is crucial that restructured accounts are given sufficient time to prove their sustainability before being reclassified as performing again ([33]).

Substantial commercial real estate (CRE) and small and medium sized enterprise (SME) NPLs have yet to be resolved. These loan portfolios make up about a third of the domestic banks' loan book ([34]). The banks' CRE NPL strategy has so far focused mostly on portfolio sales, although they still hold EUR 23 billion of CRE loans, of which 32.6 % are non-performing. The NPL ratio for SME loans was 11.8 % at end-September 2016, often with household mortgage linkages.

([29]) Macrofinancial review 2016 II, CBI.
([30]) For example, temporary payment reductions, such as conversion to interest-only loans, may improve banks' NPL ratios on a temporary basis until the terms are revised at a later date. According to regulatory guidance, restructured NPLs can only be transitioned back into performing status if the borrower meets the restructured loan terms for the entire duration of a 'probation period' of 12 months. Banks can also engage in partial write-backs, or provisioning reversals, once these conditions are satisfied. For more, see CBI (2013), Impairment Provisioning and Disclosure Guidelines.
([31]) Permanent payment reductions (eg. lowering of interest rate, or term extensions) or solutions that involve partial debt relief or write-offs (eg. split mortgages) may assume losses at an earlier stage and improve the incentives of borrowers.
([32]) The terms forbearance and loan restructuring are used interchangeably since both refer to actions that amend the original terms of the mortgage contract in order to provide a temporary payment relief to borrowers. Forbearance can raise concerns that the real economic situation of insolvent debtors is being disguised as it may enable banks to hide effectively non-performing exposures.
([33]) As per European Banking Authority (EBA) standards, non-performing forborne exposures require a one year probation period in addition to other requirements before being re-classified to performing.
([34]) The NPL data in this paragraph is based on statistics supplied by the CBI within the PPS framework.

Table 2.2: **Financial soundness indicators**

	2010	2011	2012	2013	2014	2015	2016
(All year-end data or last available data)							
Total assets (in % of GDP)	981.9	812.0	705.6	593.5	558.0	423.8	396.7
Share of assets of five largest banks (in % of total assets)	49.9	46.7	46.4	47.8	47.6	46.0	n/a
Non-performing loans ratio (in % of total loans)	13.1	16.1	25.0	25.7	20.7	14.9	14.7
Regulatory capital to risk-weighted assets (in %) (1)	14.5	18.9	19.2	20.5	22.7	24.4	23.7
Return on equity ratio (in %)	-41.0	-10.8	-7.8	-6.8	5.29	5.69	8.84
Private credit growth (% yoy change)	-12.3	-4.7	-2.6	-6.8	-10.0	-6.5	-3.6
Lending for house purchase (% yoy change) (2)	-2.5	-0.9	6.6	-1.7	-3.9	-1.2	-4.3
Loan to deposit ratio (in %)	170.7	161.9	151.6	142.2	124.5	115.9	112.6
Central bank liquidity (in % of total liab.) (3)	18.5	18.7	17.0	7.4	4.1	2.4	1.7

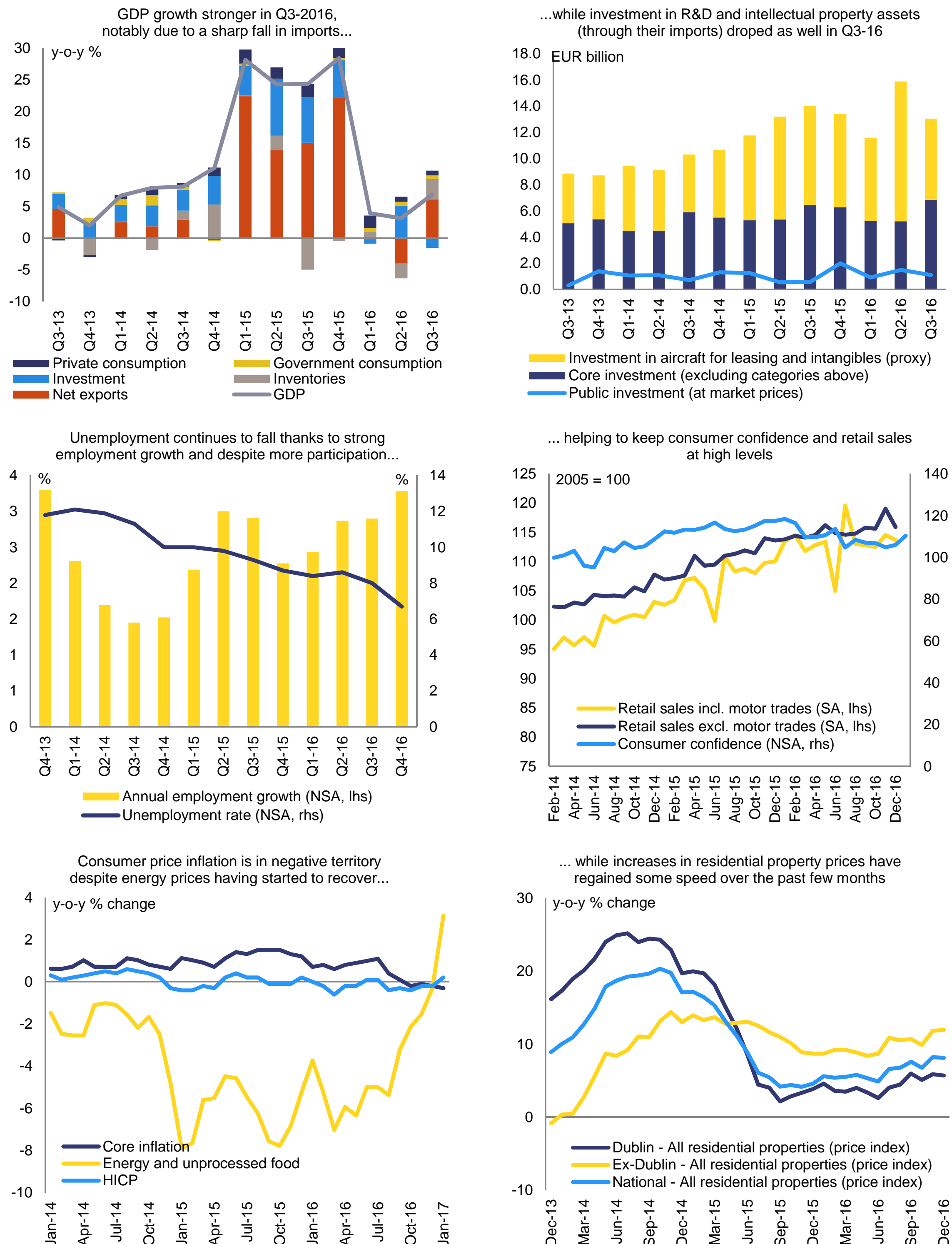
(1) Regulatory capital refers to total regulatory capital (Tier 1, Tier 2 and Tier 3) after supervisory deductions.
(2) Data for end-2012 reflects the expiration of a mortgage interest relief for first time buyers.
(3) ECB derived data, and refers to the share of central bank funding in credit institutions liabilities (total liabilities exclude capital and reserves as well as remaining liabilities).

Source: ECB, IMF, European Commission

The private sector continues to deleverage but new lending has picked up. The trend of negative net lending and growing deposits persists both for households and firms. However, the pace of deleveraging seems to be slowing. While net mortgage lending is still negative, mortgage approvals and drawdowns are increasing. The share of fixed rate mortgages is growing as banks expand their product offers ([35]). The pick-up in new SME lending has been sustained, with a yearly increase of 4.7 % y-o-y in September.

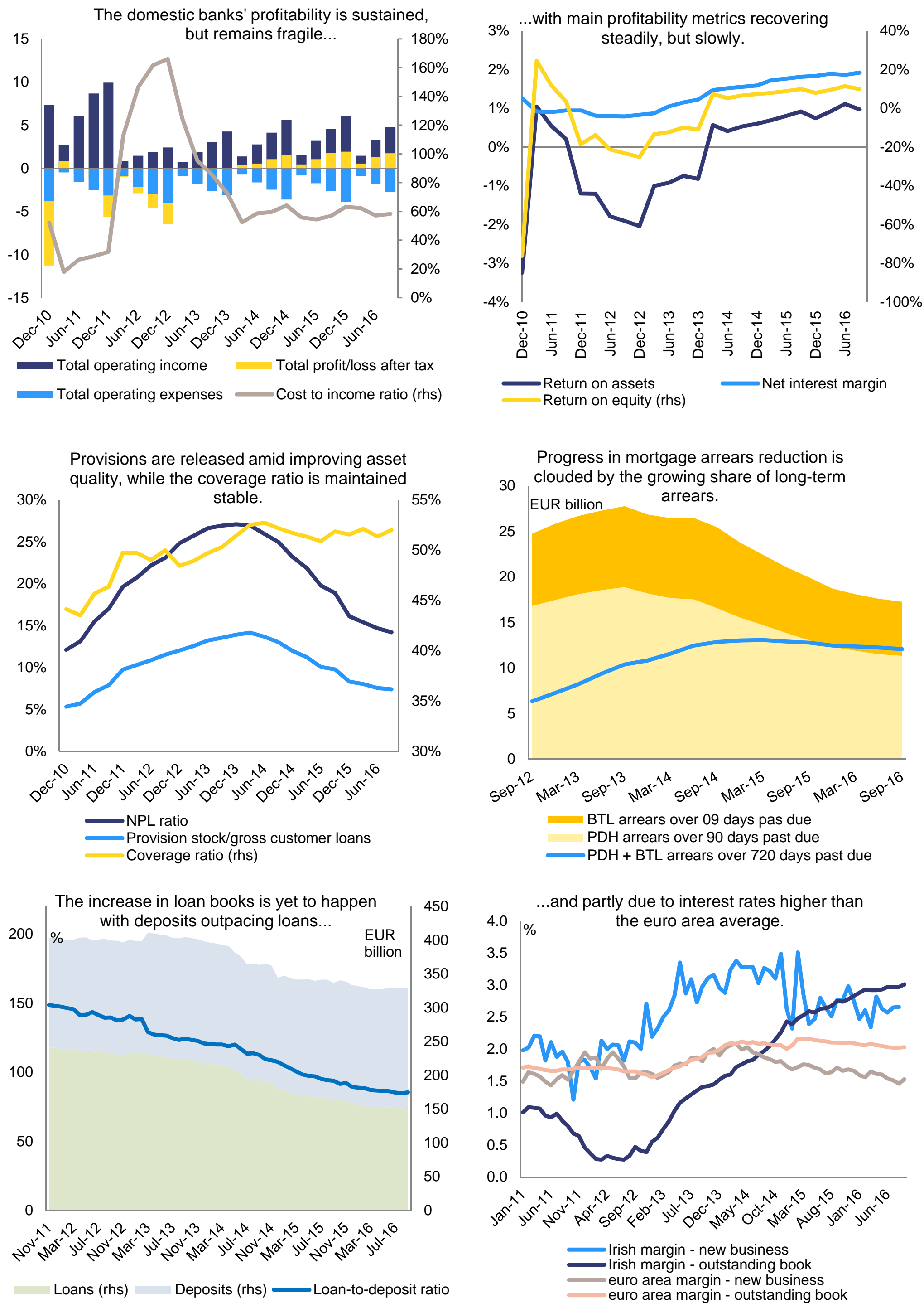
([35]) Fixed rate mortgages still make up just over 10 % of the total mortgage stock.

Graph 2.6: **Recent economic developments**



Sources: Sources: European Commission, Central Statistics Office. Investment in aircraft for leasing and intangibles (proxy) based on staff calculations.

Graph 2.7: **Recent financial developments**



(1) Panel Graph B: Net interest margin = net interest income/average assets; Return on assets = net profit / average assets; Return on equity = net profit /average equity
Panel Graph C: NPL ratio = impaired, overdue and doubtful loans to total gross loans

Source: Source: CBI, ECB

2.2. OUTLOOK

Economic growth is expected to continue this year and next, but some leading indicators now point to a mild slowdown. Consumer confidence softened last year, reflecting heightened external uncertainty though early indications show signs of strengthening in 2017. Although retail sales have continued to increase in 2016, the decline in consumer sentiment could weigh on spending in the months ahead ([36]). Business prospects remain positive, with industry and services purchasing managers' indices (PMIs) signalling continued expansion. The outlook for both sectors moderated over the past year, but early figures in 2017 show more positive signs. A reduction in new export orders for industry, and new business for services, led to a decline in both PMIs over 2016 ([37]).

Despite growing uncertainty, domestic demand is expected to remain strong. Private consumption is forecast to grow by about 2.5 % in 2017 and 2018 buoyed by robust employment trends, increasing wages and recovering household balance-sheets, combined with low inflation (see Table 3). The recovery in the construction sector is also expected to support domestic demand, including by providing increased employment and facilitating inward migration / household formation. The on-going release of pent-up demand for durable goods is expected to contribute significantly to private consumption over the short to medium-term.

Construction continues to recover but with substantial scope for additional output to satisfy demand. The housing PMI remained high at 58.9 in December and has indicated an increase in activity since early 2013. Similarly, other leading indicators also point to continued and accelerating growth ([38]). However, the increase in output is not concentrated in the areas of highest demand ([39]). Government policies to support housing supply and related infrastructure, as well as improved planning are also expected to contribute to increases in output over the medium term. The introduction of the government help-to-buy scheme and the recent recalibration of CBI macroprudential policies will contribute to demand and may provide further support to buoyant residential property prices. However, the effect of these measures will be secondary compared to the impact on prices of persistent supply constraints. Overall, investment in dwellings is expected to grow by 17 % on average in 2016-2018.

Investment activity is projected to remain firm, though at lower rates of growth than registered in 2015. However, the figures could be affected again by intangible assets. Equipment investment decelerated in 2016, after the completion of a large industrial project in 2015. However, it is expected to recover again in the next two years as base effects will start to wear off and firms further replenish their capital stock to meet demand, and construction picks up. Investment in intangible assets decreased in Q3-2016 after a strong increase in the previous quarter, highlighting the volatility in the series.

Public investment is forecast to grow gradually. It will reach 2 % of GDP in 2018, in line with the government's revised Infrastructure Capital and Spending Plan, and helped by the Investment Plan for Europe, following the sharp contraction after the crisis.

The outlook for exports is less positive for indigenous firms than for MNEs. The contribution of net exports to GDP growth is forecast to be positive in 2016 and to decrease thereafter, reflecting increased uncertainty in the global trade outlook. The fall in sterling has already translated in declining exports as the UK accounts for approximately 17 % of total Irish exports. The agri-food sector is the most exposed to currency fluctuations with around 40 % of their exports going to the UK ([40]). MNEs are less exposed partly due to the fact that they price most of their exports in other currencies.

Unemployment is expected to continue to fall and the labour force to expand. The unemployment rate fell to 8.0 % in 2016, thanks to continued employment creation offsetting sizeable

([36]) Average consumer sentiment stood at 109.7 in 2016 compared with 114.3 in 2015. In 2016, retail sales volumes were up 5.9 % on the year.

([37]) On average for 2016, the industry PMI was 53 compared with 55 in 2015 and the services PMI was also slightly down from 62 on average in 2015 to 60 in 2016.

([38]) For instance, in construction employment was 6.8 % higher y-o-y in Q3-2016.

([39]) Up to November 2016, 35 % of commencements and 29 % of completions were located Dublin.

([40]) According to Bord Bia.

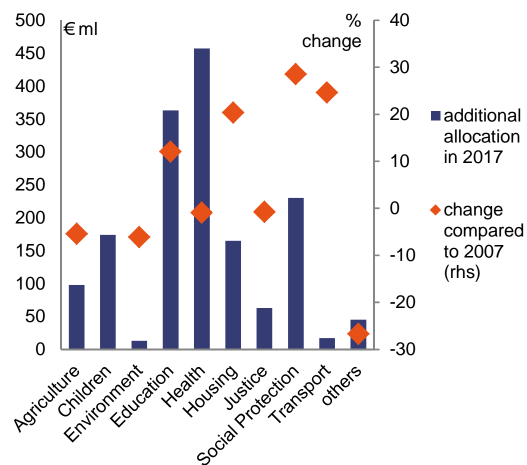
natural population growth and net inward migration. Short-run job losses in the sectors exposed to the sterling depreciation are expected to be compensated for by employment growth in services and construction. Employment trends are also positive, but growth is projected to moderate as the employment gap is gradually closing. The evolution of unit labour costs is expected to normalise after the step change in 2015 caused by the surge in GVA. Yet, the evolution of productivity indicators in Ireland has become difficult to gauge.

Inflation is expected to gradually recover. Improvements in the labour market and expected growth in energy prices in 2017 are forecast to drive inflation up in the medium term. Still, the services sector is expected to remain the main source of upward pressure. Residential rents are also projected to increase due to the still limited supply of residential property and despite the government's rent control initiative.

Risks to the outlook have heightened considerably. The uncertainty following the UK 'leave' vote remains an important risk, as considered in the 5th PPS report ([41]). Further falls in sterling or hits to consumer or business confidence could weigh on economic activity. Ireland is also particularly exposed to any deceleration in demand from the EU. The future of US trade and tax policies, in particular possible lower corporate tax rates and trade tariffs, heighten the risks further. On the upside, investment in construction and infrastructure could be stronger than anticipated and entice more employment and private consumption. Also, the recent appreciation of the US dollar against the euro supports Irish exports to the US market. Yet, overall, risks remain tilted to the downside.

Public finances are expected to gradually improve in 2017. The general government deficit is expected to fall to 0.6 % of GDP in 2017. This represents a 0.1 pp. downward revision relative to the autumn 2016 Commission forecast, due to a worsening economic outlook and increases in the public wage bill. Based on a no-policy change assumption, the deficit is expected to remain unchanged in 2018. The government projects that spending in 2017 will rise by EUR 1.9 billion, or 3.3 %, compared to the previous year. Healthcare will absorb a large share of the additional resources in 2017 (EUR 497 million compared to 2016), thereby returning to its pre-crisis peak. The social protection budget is also projected to expand, further exceeding the 2007 level. Other spending initiatives are directed to education, housing and children (Graph 2.8). The structural deficit is estimated to have worsened in 2016, rising to nearly 2 % of GDP. The Commission estimates that the structural deficit will narrow to 1½ % of GDP in 2017 and to about 1 % in 2018.

Graph 2.8: Current expenditure allocations



Source: Expenditure Report 2017, Department of Public Expenditure and Reform

The gross general government debt-to-GDP ratio is projected to continue to decline. The surge in 2015 GDP mechanically reduced the debt-to-GDP ratio by around 15 pps. to 78.6 %. It is expected to have declined by 3.5 pp. to 75.1 % of GDP in 2016 and to further fall to 72.6 % of GDP in 2018, contingent on moderate yet robust GDP growth and the realisation of primary budget surpluses of around 1.5 % of GDP in both 2017 and 2018. However, the evident distortion of indicators expressed as a ratio to GDP will necessitate the examination of complementary debt indicators ([42]).

([41]) http://ec.europa.eu/economy_finance/publications/eeip/ip035_en.htm

([42]) See Section 4.1.1 of the Ireland Country Report 2017.

Table 2.3: Main features of country forecast - IRELAND

	2015			Annual percentage change						
bn EUR	Curr. prices	% GDP	97-12	2013	2014	2015	2016	2017	2018
GDP	255.8	100.0	4.2	1.1	8.5	26.3	**4.3**	**3.4**	**3.3**
Private Consumption	87.3	34.1	3.8	-0.3	1.8	5.0	**2.7**	**2.5**	**2.5**
Public Consumption	32.1	12.5	3.5	-1.3	4.5	0.3	**5.4**	**2.4**	**2.0**
Gross fixed capital formation	54.2	21.2	2.7	-5.7	18.3	32.9	**5.0**	**6.4**	**5.0**
of which: equipment	16.4	6.4	7.4	-6.3	24.2	3.0	**1.3**	**6.0**	**5.0**
Exports (goods and services)	317.2	124.0	8.2	3.1	14.4	34.4	**2.3**	**3.8**	**4.2**
Imports (goods and services)	236.0	92.2	7.9	1.1	15.3	21.7	**1.5**	**4.0**	**4.5**
GNI (GDP deflator)	203.9	79.7	3.4	5.1	8.7	18.2	**3.8**	**3.2**	**2.9**
Contribution to GDP growth: Domestic demand			3.3	-1.5	4.9	8.9	**2.7**	**2.5**	**2.2**
Inventories			0.0	-0.1	1.3	-0.8	**0.2**	**-0.2**	**0.0**
Net exports			1.2	2.3	1.9	18.3	**1.4**	**1.1**	**1.1**
Employment			2.1	2.5	1.7	2.5	**2.5**	**2.1**	**1.8**
Unemployment rate (a)			7.5	13.1	11.3	9.4	**8.0**	**7.0**	**6.7**
Compensation of employees / head			3.9	1.4	1.8	2.8	**2.9**	**2.5**	**2.1**
Unit labour costs whole economy			1.8	2.8	-4.5	-16.5	**1.1**	**1.3**	**0.6**
Real unit labour cost			-	1.4	-3.4	-20.4	**1.4**	**0.0**	**-0.6**
Saving rate of households (b)			-	10.3	10.9	10.7	**9.8**	**9.7**	**9.6**
GDP deflator			2.6	1.4	-1.2	4.9	**-0.3**	**1.2**	**1.2**
Harmonised index of consumer prices			2.3	0.5	0.3	0.0	**-0.2**	**0.9**	**1.0**
Terms of trade goods			0.5	0.9	-5.6	8.3	**-0.2**	**0.7**	**0.6**
Trade balance (goods) (c)			21.7	19.1	21.1	43.2	**40.9**	**40.5**	**40.6**
Current-account balance (c)			-1.7	2.1	1.7	10.2	**9.6**	**9.5**	**9.3**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-1.3	1.6	-1.8	9.7	**10.0**	**9.9**	**9.7**
General government balance (c)			-3.5	-5.7	-3.7	-1.9	**-0.9**	**-0.6**	**-0.6**
Cyclically-adjusted budget balance (d)			-3.7	-3.1	-3.6	-2.5	**-1.9**	**-1.4**	**-1.0**
Structural budget balance (d)			-	-3.5	-3.5	-1.6	**-1.8**	**-1.4**	**-1.0**
General government gross debt (c)			50.7	119.5	105.2	78.6	**75.1**	**73.6**	**72.6**

(a) Eurostat definition. (b) gross saving divided by adjusted gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.

(a) Eurostat definition.
(b) gross saving divided by adjusted gross disposable income.
(c) as a % of GDP.
(d) as a % of potential GDP.

Source: European Commission

3. POLICY ISSUES

3.1. PUBLIC FINANCES

3.1.1. Fiscal stance and compliance with the Stability and Growth Pact

Public finances have improved but the government's fiscal effort has declined. Ireland has achieved considerable success in stabilising its public finances since the crisis. However, despite broad-based economic growth and strong revenue performance, the overall fiscal effort declined in the most recent years. This loosening follows two consecutive years of expansionary policy measures and expenditure slippages. Notwithstanding the volatility of the estimates in the case of Ireland, the structural balance deteriorated by around 0.2 % of GDP in 2016, in contrast with the 0.6 % of GDP annual improvement required under the Stability and Growth Pact. The structural balance is estimated to improve by 0.5 % of GDP in 2017.

Ireland's 2017 budget provides extra stimulus to a fast growing economy. The budget includes EUR 1.3 billion of additional measures split at a ratio of 3:1 between additional spending and tax cuts ([43]). Taking intra-budget spending revisions for 2016 and 2017 into account, the total fiscal expansion rises to EUR 3.0 billion, or almost 1.2 % of GDP ([44]). This expansion is taking place amid a recovery that is increasingly led by domestic demand. With most economic indicators back to pre-crisis levels, the current fiscal stance is likely to be pro-cyclical as the Irish economy already appears to be operating close to its capacity, and various institutions, including the Commission, estimate a positive output gap for Ireland.

Adherence to EU fiscal rules is at risk. Ireland consistently seeks to exhaust all of the fiscal space available within the EU fiscal rules. There is a risk of some deviation from the required adjustment path towards the medium-term objective (MTO) in both 2016 and 2017. In particular, the analysis points to a deviation below – but close to – 0.5 % of GDP in 2016, the threshold for launching a significant deviation procedure ([45]).

Increased, and partly volatile, tax revenues have been used to fund permanent increases in expenditure. At this point in time, there are no signs of a quick reversal of the 2015 level shift in corporate taxes at present. Nevertheless, the decision to use a large part of volatile, easy to reverse, tax receipts to allocate additional expenditure in 2016 is not in line with Council recommendations in the context of the European Semester. This asks Ireland to use windfall gains from better-than-expected economic and financial conditions to accelerate debt reduction. The additional uncertainty following the UK referendum adds further emphasis to the need of a prudent fiscal stance.

Policymakers are facing the challenge of balancing demand for a 'recovery dividend' with prudent fiscal management, amid heightened external risks. Since the onset of the recovery in 2013, successive governments have tried to safeguard the achievements of the economic adjustment programme while reaping the benefits of the economic recovery, including by directing resources to those who suffered most during the crisis. The current fiscal fatigue may be indicative of the difficulties in reconciling these objectives. Moreover, new challenges have emerged for fiscal policy makers, including the need for investment in critical infrastructure to tackle bottlenecks, as well as heightened uncertainty posed by the UK 'leave' vote.

Growing pressure to raise public sector wages may further reduce the government's rooms of manoeuvre. Following a recent Labour Court ruling, some of the terms of the current public pay arrangement (the *Lansdowne Road Agreement*), which entails a gradual wage increases over 2016-2018, had to be revised. The government agreed to bring forward to April a EUR 1 000 pay rise for employees earning under EUR 65 000. The cost of these increases is estimated to amount to

([43]) Reductions in the Universal Social Charge (USC) account for the majority of the tax package in the 2017 budget. Spending measures, of which more than three quarters are current, focus on public pay rises and recruitment of additional staff (around 0.1 % of GDP), and social protection initiatives (nearly 0.2 % of GDP).

([44]) See the Irish Fiscal Advisory Council's Fiscal Assessment Report (November 2016), Table 1.2. The value rises to EUR 3.7 billion when the full-year cost of the policy measures is taking into account.

([45]) https://ec.europa.eu/info/files/commission-opinion-16112016-draft-budgetary-plan-ireland_en

approximately EUR 120 million in 2017. Work on the new public pay agreement has also been accelerated. The Public Service Pay Commission report is now expected in the second quarter of 2017.

3.1.2. Spending reviews and resource allocation

The quality of the medium-term budgetary plan has improved. In particular, the reforms introduced in the budgetary process, such as the Summer Economic Statement and the Mid-Year Expenditure Report, have the potential to enhance the budgetary process and increase transparency ([46]). The government's fiscal forecasts now provide scenarios that include the planned use of the estimated fiscal space, which improves the overall reliability of the budgetary plans.

However, expenditure control remains a concern for budgetary execution. Short-term, year-to-year budgeting at department level has not yet given way to multi-annual expenditure plans. This has led to repeated changes to expenditure ceilings. Moving to a more strategic and effective system of resource allocation would require sound cost estimates of providing the current level of public services and forecasts of their benefits in the future, taking into account price and demographic pressures. However, the revised departmental expenditure ceilings for the years 2017-2019 ([47]) do not appear to take fully into account the available analysis on the costs of demographic change ([48]). By the same token, the additional carry-over into 2018 of the spending measures planned in Budget 2017, even though estimated by the government in the same document, was not allocated in the departmental ceilings. The document noted that this carryover cost would need to be met from unallocated resources or reprioritisation of expenditure.

Effective spending reviews are essential to improve the quality of expenditure. Developing a culture of spending evaluation and responsibility at all levels of public administration is a long and complex process. A well-designed review of government spending could support fiscal responsibility and contribute to a better allocation of resources, e.g., towards more growth-enhancing public investment. In this context, the government's decision to undertake a fully-fledged review of departmental day-to-day spending before Budget 2018 is welcome ([49]).

Infrastructure bottlenecks could hinder economic growth. As a result of low government capital expenditure during the recession, bottlenecks have emerged in the areas of education, social housing, water and transport infrastructure, amongst others. According to the 2017 Budget, public investment will increase by 10.7 % compared to 2016. The additional investment will be directed toward social housing and education. As illustrated in Graph 3.1, Ireland is also planning to increase public investment by rebalancing priorities between current and capital spending.

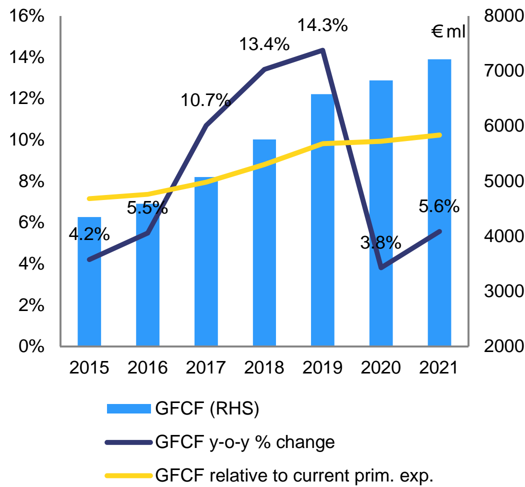
([46]) For a summary of the evolution of the budgetary process see the Irish Fiscal Advisory Council's Fiscal Assessment Report (November 2016), Box A.

([47]) Expenditure Report 2017: http://www.budget.gov.ie/Budgets/2017/Documents/Expenditure%20Report%202017.pdf

([48]) Connors, J., Duffy, R., Newman, F. (2016): Budgetary Impact of Changing Demographics 2017-2027. Irish Government Economic & Evaluation Service. Staff Paper 2016.

([49]) The new spending review announced by the Minister for Public Expenditure and Reform on 8 February reflects the changed economic and fiscal circumstances and the lessons of previous reviews. According to the available information the review will be designed to systematically examine day-to-day public spending with the aim of ensuring that policy objectives are being delivered in an efficient manner and that the best use is made of funding in each area.

Graph 3.1: **Government investment**



Source: Budget 2017, Department of Finance

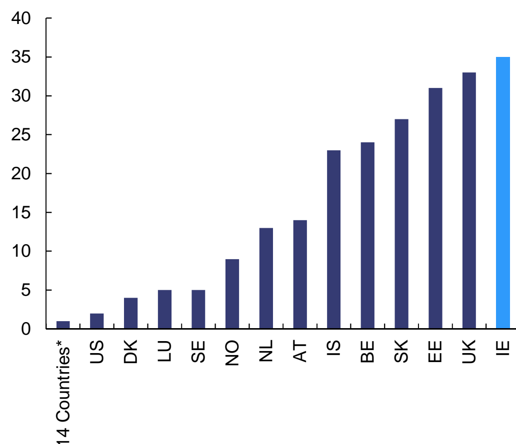
3.1.3. Reduce vulnerability and broadening the tax base

Efforts to increase Ireland's resilience to shocks feature high on the government's agenda. The government has put forward a number of proposals to improve the fiscal framework. These include the creation of a 'rainy day fund', into which surpluses could be transferred after 2019, when the country is projected to reach its MTO. At present, no operative rules for the fund have been proposed by the government ([50]). The fund could facilitate counter-cyclical fiscal policy and help to absorb future shocks. The government also announced a new target for the debt-to-GDP ratio of 45 %, to be achieved by the end of the next decade, in order to provide an additional safety buffer ([51]).

A broader tax base would increase the resilience of public finances to adverse events. Graph 3.2 presents one indicator, the tax entry threshold, which suggests that the tax base in Ireland is relatively narrow. However, recently adopted measures are likely to have narrowed the tax base further. In Budget 2017 the government increased the earned income tax credit, the home-carer tax credit and introduced a help-to-buy scheme for first-time buyers of residential property. Each of these measures will serve to further narrow the tax base and will exacerbate risks to long-term revenue stability.

No substantial base broadening measures were included in the budget. VAT is still not included in the general review of tax expenditures. Exceptionally, a review of the reduced VAT rate for hotels and restaurants was conducted. The report concluded that returning to the standard rate would generate EUR 600 million. Nevertheless, the government decided to maintain the reduced rate as a buffer for the sector against the weakness in sterling, which increases the cost of holidaying in Ireland for British tourists.

Graph 3.2: **Tax entry threshold**



(1) * 14 countries are Switzerland, the Czech Republic, Germany, Greece, Spain, Finland, France, Hungary, Italy, Japan, Poland, Portugal, Slovenia, Turkey.
(2) The tax entry threshold refers to the percentage of average wage at which the effective average tax rate for a exceeds 25%.

Source: OECD, Eurostat

The increasing share of corporate income tax (CIT) in total revenue poses a risk to the public finances. MNEs transactions in intellectual property may have driven the recent spike in investment and could be linked to the upsurge in

([50]) The design of the fund would require domestic fiscal rules to specify a target value for the fund in normal times. It would also be important for a set of rules to define which revenue windfalls would be paid into the fund, and under which circumstances withdrawals from the fund could take place, and with which allocation rules across expenditures. This would help the fund to play a balancing role in the event of unanticipated revenue fluctuations.

([51]) The recent budgetary reform incorporates novel procedures that can help to improve communication on expenditure limits, increase stakeholder engagement and harness public support to improve the quality of expenditure. Those changes are welcome. However, these novel procedures also carry risks, including additional opportunities to revise spending limits upward during budget execution.

corporate tax receipts since 2015 ([52]). This may be a response to the OECD Base Erosion and Profit Shifting (BEPS) initiative, changes in residency rules aimed at preventing the use of the 'double Irish' tax avoidance scheme, or domestic implementation of measures such as *country-by-country reporting* ([53]) ([54]).

([52]) The annual corporate tax revenue increased by approximately 49 % in 2015 compared to 2014, with the top 10 payers accounting for over 40 % of net receipts. Corporate tax revenue can therefore be characterised as highly concentrated and volatile.

([53]) Country-by-country reporting requires an Irish resident parent company of large multinational groups to provide annually, and for each tax jurisdiction in which they do business, a report to the revenue commissioners. The requirement begins for fiscal years commencing on or after 1 January 2016. The report is required to contain details of the MNE group's revenue, profit before income tax and income tax paid and accrued. It also requires MNEs to report their number of employees, stated capital, retained earnings and tangible assets in each tax jurisdiction. Finally, it requires MNEs to identify each entity within the group doing business in a particular tax jurisdiction and to provide an indication of the business activities each entity engages in. The country-by-country report is based on guidance published by the OECD Action Plan on BEPS from 5 October 2015.

([54]) This coincided with the abolition of the so called 'Double Irish' scheme, that allowed companies registered in Ireland to be tax residents elsewhere, including in tax havens. In October 2014 it was announced that, starting from January 1, 2015, new companies registered in Ireland would also need to be Irish tax residents. However, a transition period of 5 years was given to existing Irish-registered companies.

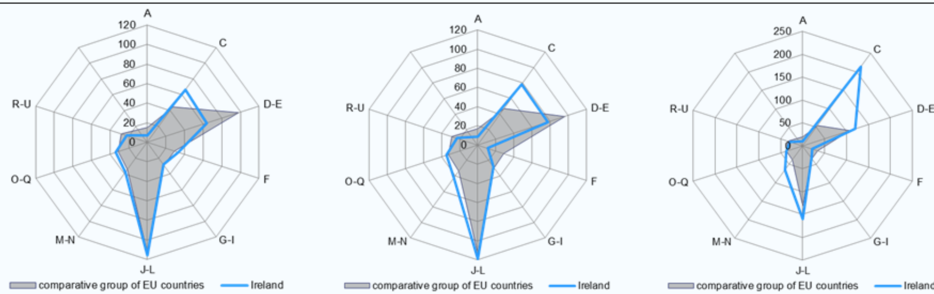
Box 3.1: How much of the corporate tax surges should be prudently set aside?

In 2016, corporation tax receipts were exceptionally strong for the second year in a row. In 2015, corporation tax receipts increased by 49 % y-o-y, exceeding government's own projections by EUR 2.3 billion. At the end of 2016, receipts stood at EUR 7 351 million, up by 7 % compared to the previous year and about 11 % (EUR 737 million) above government's expectations.

The precise drivers of the increase in corporation tax receipts remain uncertain. Given their now sizeable share in tax revenue (15.2 %) and their inherently volatile nature, being subject to relocation decisions by a small number of large MNEs, it is critical to clarify the underlying drivers or at least to identify which portion of the strong revenue performance should be deemed more resilient. Prudent fiscal policy would use the most volatile and unexpected sources of revenues, sometimes referred to as *windfall* revenues, to accelerate deficit and debt reduction.

Tax liabilities originating from substantive activities taking place in the country are likely to be more resilient to companies' abrupt decision to relocate their operations. A sectoral decomposition of companies' gross value added (GVA), and similarly, the gross operating surplus (GOS), provides a coarse indication of profits that originate from underlying economic activities taking place in Ireland (i.e. hours effectively worked) and which are, therefore, potentially more stable in nature. Both GVA and the GOS per hour worked in Ireland significantly increased in 2015, well above that of a comparable group of EU Member States. The chart below shows that the difference mostly stems from Ireland's manufacturing sector where MNE operations and contract manufacturing have widened the productivity gap.

Graph B.1: **Gross Value Added per hour worked by sectors (2006, 2010, 2015)**



Note: A=Agriculture, forestry and fishing; C=Manufacturing; D-E=Utilities; F=Construction; G-I=Wholesale and retail trade, transport, accommodation and food service activities; J-L=Information and communication, finance and insurance and real estate activities; M-N=Professional, scientific and technical activities; administrative and support service activities; O-Q=Public administration, defence, education, human health and social work activities; R-U=Arts, entertainment and recreation; other service activities; activities of household and extra-territorial organizations and bodies.

Source: European Commission

A 'underlying' gross value added can be approximated by using the average manufacturing productivity in a set of comparable EU economies. It follows that output-per-hour of the comparative group of EU countries can be applied to the hours worked in the manufacturing sub-sectors in Ireland ([1]). Using these estimates, tax liabilities still grow at robust rates but at a more moderate pace than implied by Irish National Accounts data (Graph B.2).

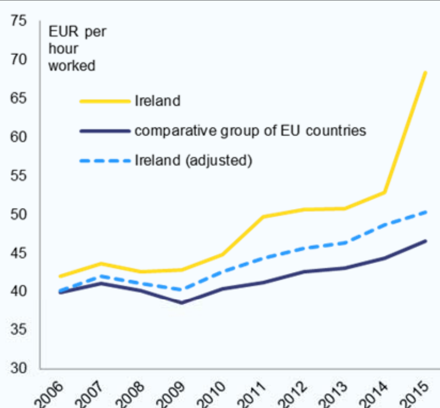
([1]) In a similar way, sector profitability could be approximated by taking the operating surplus and mixed income per hour worked. While this would lead to the same conclusion, we work with gross value added per sector due the availability of more accurate data.

(Continued on the next page)

Box (continued)

The influence of MNE activities that do not substantively take place in Ireland can be discounted to estimate the more stable components of corporate tax receipts. Assuming a one-to-one relation between companies' output and the corporate tax receipts, the ***adjusted***, 'real-based', gross value added can be used to hypothetically distinguish the more resilient part of government revenues (which, nevertheless, hinge on the business cycle and structural decisions of the companies) from the more volatile part of corporate tax receipts, subject to the more uncertain developments in global value chains.

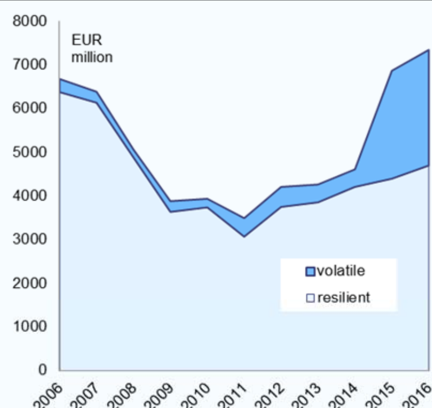
Graph B.2: **Gross Value Added per hour worked**



Note: The comparative group of EU countries includes Denmark, Germany, France, Finland, Sweden and United Kingdom. The contribution of the manufacturing sector in the "adjusted" line is proxied by the hours effectively worked in all sub-sectors times the hourly productivity of the comparative group of countries in the same sub-sectors.

Source: European Commission

Graph B.3: **Ireland's corporation tax revenue**



Note: The more volatile part of corporate tax receipts is calculated by applying the percentage difference between the gross valued added as estimated in the national accounts and the one adjusted by the hours effectively worked in the manufacturing sector, to the corporate tax receipts.

Source: European Commission

The above estimates suggest that the recent upsurge in corporate tax in Ireland was due to the activities of MNEs. To what extent this constitutes a ***revenue windfall*** ultimately depends on the volatility of corporate location decisions. Globally operating enterprises base those decisions on a set of criteria, some of which are not under the control of Irish authorities. Graph B.3 implies that a large part of the corporate tax intake of the last two year (around 35 %) could have been set aside in order to accelerate deficit and debt reduction. Continuing to use this volatile source of revenue to finance current and hard to reverse government expenditure, risks exposing the public finances to strains in case of a deterioration in the economic outlook or changes in the global tax environment.

3.2. FINANCIAL SECTOR POLICIES

New measures aimed at resolving arrears are welcome but it is too early to assess their effectiveness. After a pilot phase, the Mortgage Arrears Resolution Service ('Abhaile') was launched nationally in October 2016. The scheme provides free financial and legal advice to distressed borrowers. The initial take-up has been encouraging, with close to 3 000 vouchers for free legal and financial advice being distributed by end-November 2016.

There is scope to further incentivise more durable NPL resolution strategies. Options such as formulating a set of derecognition (or write-off) rules to facilitate the timely removal of NPLs from banks' balance sheets could be explored ([55]).

The CBI's Examination of Tracker Mortgages is ongoing. As of December 2016, the review has identified 8 200 cases where the option of a tracker interest rate was either not provided or was incorrectly applied. The lenders will offer redress packages to affected customers by mid-2017. The CBI may, where necessary, impose enforcement actions. So far, only a single fine has been imposed.

High indebtedness remains a source of vulnerability for segments of the private sector. Bearing in mind the overall high corporate debt levels ([56]), the capacity of domestic firms to service their debt is particularly vulnerable to changes in interest rates. Moreover, SME credit demand could be partly muted by expectations of weaker foreign demand for exporters. Overleveraged households are sensitive to economic conditions or an increase in policy rates, especially mortgage holders benefitting from tracker mortgage rates (about half of total loans).

New credit developments remain an important indicator of the underlying economic recovery. Although more than offset by larger loan repayments, there have been significant increases in the volume of some types of lending. In the household sector, new mortgage and consumer credit grew. Importantly, the pattern of mortgage lending is different than that observed in the past, with a higher share of fixed rate products, more sustainable interest rates, as well as being bound by more stringent prudential limits.

Access to finance for SMEs is still an issue. Despite a moderate pick-up in SME credit demand, the bulk of SMEs still rely on retained earnings for financing. However, borrowing costs remain higher for Irish firms than for most of their euro-area peers. The availability of funding for viable firms should remain a priority. Government initiatives such as the Strategic Banking Corporation of Ireland (SBCI) aim to diversify sources of SME credit ([57]).

New specialized non-bank lenders have entered the Irish market ([58]). Their planned lending volumes represent a modest part of total lending as they are focussed on niches within sectors such as mortgage lending or agricultural sector loans. However, their presence is welcome in the context of the diversification of credit supply and because of their tailored sectoral knowledge. Encouragingly, after a strategic review of its Irish activities, KBC bank reaffirmed its intention to remain active in the Irish market in the long-run.

The proposed legislation to empower the CBI to cap variable interest rates on mortgages would have a negative impact on the financial sector. In November 2016, the ECB published their opinion on this draft proposal, in which they emphasised its potential interference with the CBI's task of implementing monetary policy. It also pointed out the risks for financial stability arising from curbing the banks' ability to generate sustainable profits and its deterrent effect for new entrants to the market.

([55]) The lack of guidance on write-offs or specific rules on moving assets off the balance sheets has been recognised as one of the common and most pressing missing elements within the SSM in its recent stocktake consultation document. For more, see ECB (2016), Stocktake of national supervisory practices and legal frameworks related to NPLs, October.

([56]) Irish firms remain overleveraged in comparison to their euro-area peers, even after adjusting for the effect of MNEs in aggregate debt indicators.

([57]) For a more detailed overview of SME access to finance conditions, see the Ireland Country Report 2017, Section 4.2.4.

([58]) Some examples are Finance Ireland (SMEs and farmers, refinancing for commercial property owners), CapitalFlow (SMEs), Future Finance (student loans), Bluestone Asset Finance (construction and agriculture SMEs), Pepper (mortgage lending).

The National Asset Management Agency (NAMA) continues its successful asset sales. This process has recently been clouded by investigations regarding the sale of one of its portfolios ([59]). By February 2017, NAMA had redeemed EUR 28.7 billion or 95 % of its senior debt. Most of its UK CRE assets, the sale price of which could be impacted by the UK 'leave' vote, have already been sold.

The government still owns 75 % of Permanent TSB (PTSB), which turned profitable in 2015. In September and October 2016 the bank reportedly sold its remaining non-core Irish portfolio and their UK CRE portfolio ([60]). Non-core divestments are mandated by PTSB's restructuring plan. The divestments are a favourable development as they counter-balance adverse factors affecting PTSB such as the low-interest rate environment, legacy issues and weak new lending.

Preparations are underway for AIB's initial public offering (IPO). The government has indicated that it could sell up to 25 % of AIB shares in 2017 and has appointed Bank of America Merrill Lynch, Davy and Deutsche Bank as 'Global Coordinators' to assist with the IPO ([61]).

The implementation of the Central Credit Register (CCR) has been further delayed. According to the new timeline, queries by lenders will only start in September 2018. Stakeholders have expressed concerns over the capacity of non-bank lenders and loan acquirers/services to deliver high quality data within the timelines.

3.3. PROPERTY MARKET AND CONSTRUCTION

Although much demand is from abroad, close supervision of CRE financing remains a priority. New financing for CRE projects is seldom provided by domestic banks, which account for only 12 % of the new lending. This is indicative of risk aversion to CRE lending on the side of the Irish banks. Nevertheless, it is important to monitor possible price distortions in the CRE market, both because of real economic effects, and because domestic banks remain exposed to the sector via legacy assets. In this context, the joint CBI, CSO and NAMA initiative to develop official CRE statistics is welcome. In the absence of this data, comparisons of market-based indicators continue to suggest that CRE prices and rents are sustainable relative to those of international competitor cities. As such, CRE does not appear to be an impediment to firms seeking to relocate to Ireland ([62]), particularly as, in contrast to the residential market, substantial additional office supply is in the pipeline for 2017 and 2018.

The taxation of non-resident property investors is being reformed. Budget 2017 introduced a withholding tax of 20 % on Irish property funds' distributions to overseas investors ([63]). This measure targets the tax treatment of funds regularly used to acquire loans in the Irish market. As a consequence, it may somewhat dampen international investor demand for Irish CRE assets although it is too early to draw strong conclusions.

The existing macro-prudential framework has been maintained. Following the publication of the first review in November, the key loan-to-income ratio has been kept at 3.5. The loan-to-value ratio has been recalibrated under certain scenarios, but these changes will be rather narrow in scope ([64]). Moreover, only 10 % of new lending was over the LTV cap in the first half of 2016 (see Graph 3.3) ([65]). As such, the implications for housing demand should be relatively mild ([66]).

([59]) http://www.irishtimes.com/business/commercial-property/public-accounts-committee-set-to-report-on-nama-inquiry-at-end-of-the-month-1.2939399

([60]) The current agreement with DG COMP is that PTSB does not have to sell at any more than a 10 per cent discount to the UK loan book's value. It could therefore be assumed that the adequate price has been achieved.

([61]) http://www.irishtimes.com/business/financial-services/minister-sees-two-windows-for-2017-aib-share-sale-1.2940722

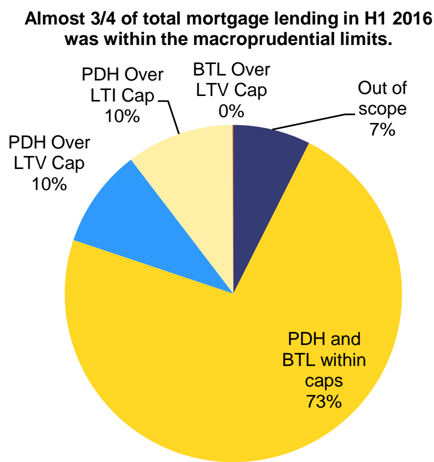
([62]) Hunt, M., 'Dublin will have enough stock to meet Brexit demand', CBRE 2016. https://researchgateway.cbre.com/Layouts/GKCSearch/DownLoadPublicUrl.ashx

([63]) From January 2017, entities classified as Irish Real Estate Funds (IREF's) will deduct a 20 % withholding tax on profits distributed to non-resident investors in their funds.

([64]) Following the review, the LTV for first time buyers has now been set at 90 percent and 80 percent of second and subsequent buyers. For first time buyers, 5 percent of all new lending is permitted to be above the limits, while 20 percent may exceed the limits for second and subsequent buyers.

([65]) See also: Kinghan, C., Lyons, P., McCarthy, Y., and O'Toole, C., (2016) Macroprudential Measures and Irish

Graph 3.3: Mortgage lending



(1) PDH: Primary dwelling housing; BTL: Buy-to-lets; LTV: Loan-to-value; LTI: Loan-to-income

Source: CBI

Government interventions in the residential property market may take time to deliver a supply response. Like the housing package announced along with the Budget 2016, Budget 2017 included an array of additional measures aimed at restoring equilibrium to the housing market amid on-going supply shortages. Earlier, well targeted, measures include the easing of apartment construction standards and the EUR 200 million *Local Infrastructure Housing Activation Fund.* The number of apartments granted planning permissions increased to [4.073 in the year to September 2016, compared to just 1,683 in the previous year]. This could indicate a response to the relaxation of planning standards, but it will still be several months before the resultant housing units enter the market. The latter infrastructure scheme is reported to have received applications from local councils far in excess of the available funding.

Further examination of planning and infrastructure policies may be necessary. This specifically relates to the availability of adequate infrastructure supporting housing or planning regulations such as urban height limits and underground parking requirements. The new *National Planning Framework*, which is intended to replace the 2002 National Spatial Strategy, is currently open for public consultation, and will be an important milestone in ensuring a coherent policy, such that new supply is delivered in appropriate locations with the necessary supporting infrastructure. It is unfortunate the vacant site levy will not come into effect until 2018 as it would provide a disincentive to speculative land holding.

The introduction of a separate housing ministry should facilitate a coherent policy response. Despite this, Budget 2017 saw the introduction of measures that further stimulate demand or were inconsistent with efforts to increase supply. The most prominent new housing measure announced in the budget was a *help-to-buy* tax rebate for first time buyers of newly built properties. The estimated first year fiscal cost is EUR 50 million which implies that the scope of the scheme may be relatively limited. Nevertheless, the measure is likely to increase demand for new properties in the face of inelastic supply, thereby supporting further price increases while only indirectly contributing to increasing supply.

The government has introduced rent controls. This measure imposes an upper limit on rent increases of 4 % per annum for a maximum of 3 years in areas designated as *rent pressure zone*. This follows a number of years of rapid rents increases in urban areas. However, Commission research indicates that rent controls have had a destabilising impact on the aggregate housing market in other EU countries ([67]). If government measures were to limit upward rent increases too much, this could discouraging new construction and maintenance, while also discouraging investors from putting properties in the rental market. It is also notable that the limitations on the frequency of rent-reviews introduced by the

Mortgage Lending: Insights from H1 2016, Central Bank of Ireland Economic Letter Series Vol. 2016, No. 6.

http://www.centralbank.ie/publications/Documents/Economic%20Letter%20-%20Vol%202016,%20No.%206.pdf

([66]) As households and non-financial corporations are still deleveraging, the Counter-Cyclical Buffer rate (CCyB) remains at 0 %, and subject to reviews.

([67]) Cuerpo, C., Pontuch, P., and Kalantaryan, S., (2014) Rental Market Regulation in the European Union, European Commission, Economic Papers 515. http://ec.europa.eu/economy_finance/publications/economic_paper/2014/pdf/ecp515_en.pdf

previous government, did not prevent rapid rent increases in 2016. Budget 2017 also modified the *rent-a-room* tax relief whereby the tax ceiling from rental income was increased and provided for a phased restoration of a full mortgage interest tax deduction for residential landlords.

The undersupply of housing is having severe social consequences. In June 2016 the government agreed to increase rent limits under the rent supplement scheme and the Housing Assistance Payment. Increases averaged around 15 % in order to maintain recipients' access to the private rental market amid rising rental costs and the increasing number of cases where homelessness was imminent. While short term measures to ameliorate homelessness are necessary, the ultimate resolution will depend on the provision of adequate supply.

The Action Plan for Housing included a substantial expansion of the direct provision of social housing units. The *Rebuilding Ireland: Action Plan for Housing and Homelessness*, launched on 19 July, committed the government to directly providing 47 000 social housing units by 2021. The estimated cost is EUR 5.35 billion. Additional social housing units will contribute to increasing overall supply. Complementary reforms to the social housing system, such as cost rental, could help to reduce the cost of the direct provision of social housing. Otherwise, direct provision is likely to be more expensive in the long run than schemes operating via the private rental market.

3.4. STRUCTURAL REFORMS

Labour market

Labour market developments largely remain positive. Job creation has been sustained since early 2012 and the unemployment rate is now well below the euro-area average, having reached 8.0 % in 2016. Long-term and youth unemployment have also fallen substantially. However, very-long-term unemployment (over 2 years) accounted for more than 40 % of all unemployment in 2015. Despite the strong recovery, labour market participation has increased only marginally. Active labour market policies (such as Intreo and JobPath programmes) appear to be a step in the right direction but their impact has not yet been fully assessed. Low female participation remains an issue, as well as the high prevalence of low-work intensity households.

Healthcare system

Public healthcare expenditure continues to creep upward. The public healthcare system has deviated from ex-ante budget plans repeatedly over the past few years. In July 2016, the government allocated supplementary funding of EUR 500 million for 2016 and 2017, respectively. For 2016, the additional funding was primarily used to cover overspending within the year rather than expanding services. Including the extra allocation for 2017, the total health budget is set to increase to a record level of EUR 14.6 billion. However, the extra allocation does not provide for any new infrastructure investment projects beyond those already in the pipe-line.

Better planning could improve control of the healthcare budget. Improved monitoring of budget execution is essential given the history of poor expenditure control. Supplementary resource allocations should be conditional on an enhanced governance and accountability framework. The multi-year budgeting proposal in the Programme for Partnership Government, based on a five year service plan built on verifiable metrics, would address technical challenges in the planning and budgeting of healthcare.

Health reforms are in progress but concerns about cost-effectiveness remain. The Health Service Executive (HSE) reached an agreement with the pharmaceutical industry on the pricing of medicines. The deal should deliver an estimated EUR 750 million in savings over the next four years. The agreement will not reduce the total spending on pharmaceutical products, but rather expand the provision of medicine, including innovative (and potentially more expensive) products. Therefore, the cost developments, and their pressure on the health budget, should still be monitored. Additional savings in public healthcare are largely dependent upon multi-year reforms, such as activity-based funding and financial management reform, which will not yield results immediately.

Water sector

Uncertainty about the future of Irish Water persists. Water charges have been suspended for a period of nine months starting from July 2016. The expert commission, assembled to examine the long-term funding model for Irish Water, reported in November ([68]). Its report recommended State funding of domestic water consumption through general taxation up to a 'normal' level of water usage per household, to be determined by the Energy Regulator. Households that consume above this level would be charged extra tariffs for the excess consumption. The suspension period can be extended if an agreement on the long term funding is not reached.

The suspension of charges could affect investment in water infrastructure. Metering plans have been accomplished and works to overcome the leakages have started. The authorities have committed EUR 5.5 billion in the Infrastructure and Capital Investment Plan to address the essential needs, such as lifting all current boil water notices ([69]) and reducing the leakage from 49 % to 38 % (saving 180 million litres every day). However, the suspension of water charges may jeopardise planned investment in water infrastructure. The government allocated EUR 123 million to Irish Water to cover the shortfall from the suspension of water charges in 2016, mostly savings from the suspension of the water conservation grant. While the suspension of water charges is expected to have only marginally affected the government balance for 2016, the functioning of Irish Water is likely to continue to weigh significantly on public finances ([70]). The government allocated EUR 125 million in 2017 to cover the suspension of water charges and additional EUR 114 million will be required if domestic water charges do not return this year.

([68]) The recommendations will be considered by a special Oireachtas committee, expected to report after three months.
([69]) A boil water notice is an alert services provided by the Irish Water to residents in a particular area to boil water before using it.
([70]) In 2015, the impact of Irish Water on the general government balance was around 0.2 % of GDP.

4. SOVEREIGN FINANCING

The sovereign financing situation remains comfortable. The sovereign held EUR 8.6 billion in cash and other liquid assets at the end of 2016. The National Treasury Management Agency (NTMA) issued EUR 8.4 billion in long-term debt in 2016, out of its target of EUR 6-10 billion. This was less than in recent years, reflecting a single bond redemption of just over EUR 6 billion in October 2017 and benefits from the positive trends in the cash deficit. The NTMA plans to issue between EUR 9-13 billion in 2017. The agency continues to pre-fund and run strong cash buffers in advance of large redemptions over the medium-term, 2019 and 2020 especially.

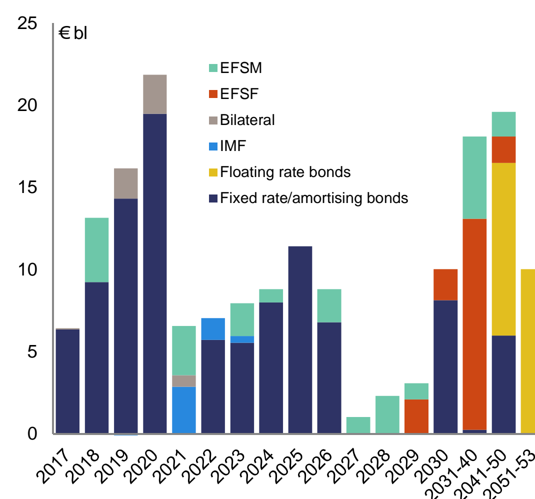
The Commission's state aid ruling has not changed Ireland's funding plans. The NTMA has made no allowance for the EUR 13 billion of funds that the Irish sovereign is called to recover from Apple Inc. following the Commission's decision of 30 August in its funding plans.

Both yields and spreads on 10-year bonds have remained reasonably stable. This signals continued market confidence in the country. Debt issuance and budget execution progressed as planned in 2016 and, with large cash buffers and limited financing needs over the next twelve to fifteen months, the sovereign is in a good position to withstand potential volatility in markets.

ECB actions have underpinned the reduction in yields on government bonds. Under the Eurosystem's expanded asset purchase programme (APP), monthly purchases of Irish government bonds have been approximately EUR 831 million in eligible securities per month. Cumulative net purchases of Irish public securities under the Public Sector Purchase Programme (PSPP) stood at EUR 18.5 billion at end December 2016. The APP is scheduled to continue until at least December 2017.

The repayment risks for EFSM and EFSF loans remain low. This assumes that Ireland continues to implement prudent economic policies and sovereign market conditions are not impaired. The average maturity of Irish public debt is one of the longest in Europe, with 40 % of long-term debt maturing from 2026 on, and the general government debt-to-GDP ratio is forecast to continue to decline. The redemption profile of EFSF and EFSM loans currently extends until 2042, with the next principal repayment due in 2018 (see Graph 4.1). However, the 2018 EFSM maturities are expected to be refinanced, owing to the maturity extensions granted in 2013.

Graph 4.1: Bonds and EU-IMF programme loans repayment schedule (end-December 2016)



(1) The Irish programme was the second euro area assistance programme, and the first financed by two new financial assistance instruments established in 2010, the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM). EFSF loans reflect the maturity extensions agreed in June 2013. EFSM loans are also subject to a seven year extension. It is not expected that Ireland will have to refinance any of its EFSM loans before 2027. However, the revised maturity dates of individual EFSM loans will only be determined as they approach their original maturity dates.
(2) Bilateral loans were provided by the United Kingdom, Sweden and Denmark.

Source: National Treasury Management Agency

Table 4.1: **Government financing plans (January 2017)**

EUR billion	2016 Provisional Outturn	2017 Estimate
Funding Requirement		
Exchequer borrowing requirement(EBR) (1)	1.0	2.2
Medium/long-term debt redemption (2)	8.2	6.3
Other (3)	5.8	3.0
Total requirement	**15.0**	**11.5**
Funding sources		
Government bonds (4)	8.7	11.0
Net short-term paper funding	1.0	1.5
Other (5)	2.9	0.5
Use of cash & other short-term investment balances (-represents an increase)	2.3	-1.5
Total sources	**15.0**	**11.5**
Financial buffer (6)	**8.6**	**10.1**

2016 figures are provisional outturns, and therefore subject to revision. 2017 figures are estimates as of January 2017. Rounding may affect totals.
(1) 2017 EBR estimate as per Department of Finance, Budget 2017 (October 2016).
(2) Bond maturities, including the early purchase of the 4.6 % Treasury Bond 2016 in February 2016, and Amortising Bonds.
(3) 2016 includes bond purchases and switches; 2017 figure includes general contingencies and potential bond purchases.
(4) In its Funding Statement for 2017 issued on 13 December 2016, the NTMA announced that it plans to issue €9 - €13 billion of Government bonds in 2017. €11 billion is used as an indicative amount in this presentation.
(5) Includes net State Savings (Retail), other Medium/Long- Term funding and, in 2016, rebate of pre- paid margin on initial EFSF drawdown in 2011.
(6) End- year cash and other liquid short- term investment balances. Excludes non- liquid financial asset classes such as Housing Finance Agency (HFA) Guaranteed Notes and CSA Collateral Funding.

Source: National Treasury Management Agency

5. PROGRESS ON POLICY MEASURES WITH A VIEW TO ADDRESS MACROECONOMIC IMBALANCES

Ireland has been identified as experiencing imbalances in the context of the MIP. These imbalances are linked to very high levels of external, private and government debt, a high NPL ratio and rapidly growing house prices. The strong economic recovery observed in recent years has allowed for significant deleveraging, both private and public, and for a rapid reduction in the stock of net foreign liabilities. The Country-Specific Recommendations under the European semester provided guidance for follow-up policies. This section overviews the state of play as regards progress with policy implementation to address imbalances. In order to avoid an overlap of surveillance processes, it does not provide an assessment of fiscal targets.

The 2016 CSRs aim to address the macroeconomic imbalances identified under the MIP. CSR 1 recommends continued adjustment of the fiscal position to meet the medium-term objective (MTO). It advises in favour of using windfall gains to accelerate debt reduction. It also recommends reducing vulnerability to economic fluctuations and shocks, including by broadening the tax base. In addition, CSR 1 calls for enhancing the quality of public expenditure. This particularly relates to increasing the cost-effectiveness of healthcare. It also recommends prioritising government capital expenditure in R&D and in public infrastructure in transport, water services and housing. CSR 3 recommends the finalisation of durable restructuring solutions to lower NPLs. It also calls on Ireland to accelerate the phasing-in of a central credit registry.

Government debt is projected to further decline but public finances remain vulnerable to shocks. According to the Commission forecast, government debt is expected to fall to approximately 72 % of GDP by 2018, conditional on robust economic growth and primary budget surpluses. However**,** the burden of gross government debt on public finances has declined more slowly than a superficial reading of the debt-to-GDP ratio would suggest. Complementary indicators, such as the weight of the debt stock or debt servicing costs on total tax revenue, show that the burden of public debt remains significant. Risks to long-term debt sustainability relate mostly to changes to the economic outlook since most of the outstanding stock of debt pays fixed interest rates. Favourable market conditions and the long-term maturity of the debt stock are expected to ease future refinancing operations. Regrettably, surging corporate tax revenues have not been directed toward debt reduction but have been used to fund expenditure increases and cuts to the universal social charge (USC).

Addressing the vulnerabilities of public finances to shocks is key. In this context, the government is studying the feasibility of a rainy-day fund as a tool to mitigate risks. The government also announced its intention to target a 45 % debt-to-GDP ratio in the long-term. However, broadening the tax base does not appear to be a high priority. Budget 2017 introduced a range of tax expenditure measures that are likely to narrow the income tax base, thereby increasing public finances' exposure to shocks. This adds to the decision to further delay to November 2019 the revaluation of self-assessed property values used to calculate local property tax liabilities. In isolation, the planned phasing out of the USC will hinder the commitment to maintain a broad tax base. However, the decision not to increase the income tax bands will somewhat broaden the tax base. Measures to implement internationally agreed efforts to reduce tax avoidance can contribute to broadening the tax base.

Some progress has been made in enhancing the quality of expenditure. The government has put forward a number of proposals to improve the fiscal framework. The gradual implementation of Finance Reform Programme could help to improve communication on expenditure targets, increase stakeholder engagement and harness public support to improve the quality of expenditure. A well designed review of government spending could support fiscal responsibility and drive to a better allocation of resources, i.e. towards more growth-enhancing public expenditure, in particular in view of prioritising investment. However, expenditure plans at departmental level are still characterised by a short-term year-to-year budgeting approach. Regarding healthcare, the roll-out of activity-based funding, the development

of a new eHealth architecture, the streamlining of financial management and information systems, and the new cost-saving deal with the pharmaceutical industry are also steps forward.

The government plans to increase capital expenditure. A mid-term revision of the Capital Investment Plan (2016-2021) is expected by July 2017. Much of the additional resources (around EUR 5.2 billion) will be allocated to social housing projects (around EUR 2.2 billion). According to the government, 74 direct provision social housing schemes were scheduled to start in 2016 delivering 1 424 units. The EUR 200 million Local Infrastructure Housing Activation Fund aims to provide infrastructure to support urban housing development. Water charges have been suspended for a period of nine month starting from April 2016 which could have an impact on planned infrastructure investment.

Strong economic growth is expected to support deleveraging. It is important to distinguish between the trends for domestic firms and multinationals. The latter dominate the external accounts, but the external sustainability of domestic sectors does not appear to have deteriorated.

Measures to strengthen the banking sector have continued and the stock of NPLs is declining. Banks' asset quality is slowly improving, while profitability is recovering but remains fragile. While the progress made in loan restructuring is notable, the pace of the process weakened and there is still some uncertainty about the restructured loans' sustainability in the long run. The legal procedures for mortgage arrears resolution are still slow and cumbersome, while the use of insolvency and bankruptcy schemes remains limited. In July 2016, the government started the pilot phase of a service that provides access to some free financial and legal advice for debtors at risk of losing their homes due to mortgage arrears. The scheme was launched nationally in October 2016 and the initial take-up seems good. After several delays, the full operation of the central credit register is now expected only in mid-2018.

Overall, some policy measures have been taken to address macroeconomic imbalances. This is especially true for measures relating to the financial sector, and the management of public finances. Still, Ireland has not yet adopted a number of key reforms that could contribute to the sustainability of domestic sectors of the economy. Regarding public finances, efforts to broaden the tax base could be prioritised. Concerning healthcare expenditure, specific strands of reforms continue to progress but financial management and information systems could be strengthened further. Water reforms introduced during the programme could be reintroduced. Regarding indebtedness, a number of means of partial debt relief intended to support viable households and businesses remain under-utilised.

ANNEX 1

Overview of MIP reforms

ANNOUNCED MEASURES	ADOPTED MEASURES	IMPLEMENTED MEASURES	SOURCE OF COMMITMENT
Public finance and taxation			
Fiscal policy and fiscal governance			
	• The Draft Budgetary Plan (DBP) for 2017 included new expansionary measures worth around EUR 1.3 billion (around 0.5 % of GDP) at a ratio of three euros in spending increases for every euro in tax cuts. Reductions in the Universal Social Charge (USC) account for the vast bulk of changes to government revenue. On the expenditure side, current expenditure increases focus on public pay rises and social protection initiatives. Capital expenditure, which was significantly reduced	• Ireland corrected its excessive deficit in 2015. The deficit is set to remain below the Treaty reference value of 3 % of GDP over the forecast horizon. • Under the preventive arm of the Pact, following an overall assessment, both the Draft Budgetary Plan for 2017 and the Commission 2016 autumn forecast point to a risk of some deviation in both 2016 and 2017 from the required adjustment towards the MTO. In particular, the assessment points to a deviation below – but close to – 0.5 % of GDP in 2016. • Government's decision to use a large part of volatile, still uncertain, tax intakes to fund additional expenditure in 2016 is not in line with Council recommendations asking Ireland to use windfall gains from strong economic and financial conditions to accelerate debt	**CSR 1 – 2016** • Following the correction of the excessive deficit, achieve an annual fiscal adjustment of 0.6 % of GDP towards the medium-term budgetary objective in 2016 and in 2017. • Use windfall gains from strong economic and financial conditions, as well as from asset sales, to accelerate debt reduction.

	during the post-2007 consolidation process, is projected to increase by 9 % compared to 2016.	reduction.	
Reduce vulnerability and broaden the tax base			
• As previously announced, the Draft Budgetary Plan (DBP) for 2017 confirmed the government intention to establish a rainy day fund once a balanced budget is achieved. The government also announced a new target for the debt-to-GDP ratio, namely that this will be brought to 45 % by the end of the next decade in order to provide an additional safety buffer. • In its SES, the Government also committed to measures including: • Reducing marginal tax rates on labour, including by phasing out the Universal Social Charge (USC). • Increasing the Earned Income Tax Credit for the	• The DBP for 2017 introduced further revenue-decreasing tax measures (beyond the USC cuts). These include a tax rebate to first-time buyers of newly-built homes, increases to tax credits for self-employed and home carers, a higher threshold for capital acquisition tax on inheritances, a cut in capital gains tax on qualifying asset disposals for entrepreneurs. • On the other hand, in addition to an increase in excise duties on cigarettes, the government committed to a range of revenue-increasing tax compliance initiatives, mostly directed to	• In the short-term, the Draft Budgetary Plan for 2017 has introduced a range of tax expenditure measures which are likely to narrow the income tax base, thereby increasing public finances' exposure to shocks. • This adds to the decision to further delay to November 2019 the revaluation of self-assessed property values used to calculate local property tax liabilities. • In isolation, the phasing out of the USC will hinder the commitment to maintain a broad tax base. However, the decision not to increase the income tax bands will somewhat broaden the tax base. • Measures to implement internationally agreed efforts to reduce tax avoidance can contribute to broadening the tax base. While the full impact of the gradual phase-out of the double Irish tax scheme may not be fully apparent in the near term, it has the potential to broaden the tax base.	**CSR 1 – 2016** • Reduce vulnerability to economic fluctuations and shocks, inter alia by broadening the tax base.

self-employed to match the pay as you earn (PAYE) credit by 2018. • Introducing a pay related social insurance (PRSI) scheme for the self-employed. • Reducing the rate of Capital Gains Tax for new start-ups to 10 % from 2017. • Maintaining Ireland's Corporation Tax rate at 12.5 % and monitoring how the Knowledge Development Box is promoting the development of knowledge_based capital in Ireland. • These measures will be funded inter alia by: • Increasing revenue by not indexing tax credits and bands. • Removing the PAYE tax credit for high earners to further enhance the progressivity of the income tax system. • Funding part of the increase in expenditure by increasing taxation to promote healthy	offshore tax evasion and misused special tax regimes.	• No other measures have been taken to broaden the tax base. The Irish authorities completed a rolling programme of tax expenditure reviews and published an updated report in this regard in 2016. However, the review process does not cover VAT related tax expenditures. • In the medium to long term, the announced establishment of a rainy-day-fund, if appropriately designed, could provide a fiscal buffer during a future economic downturn and, together with the announced long-term target for the debt-to-GDP ratio to stand at 45 %, could reduce vulnerability to economic fluctuations.	

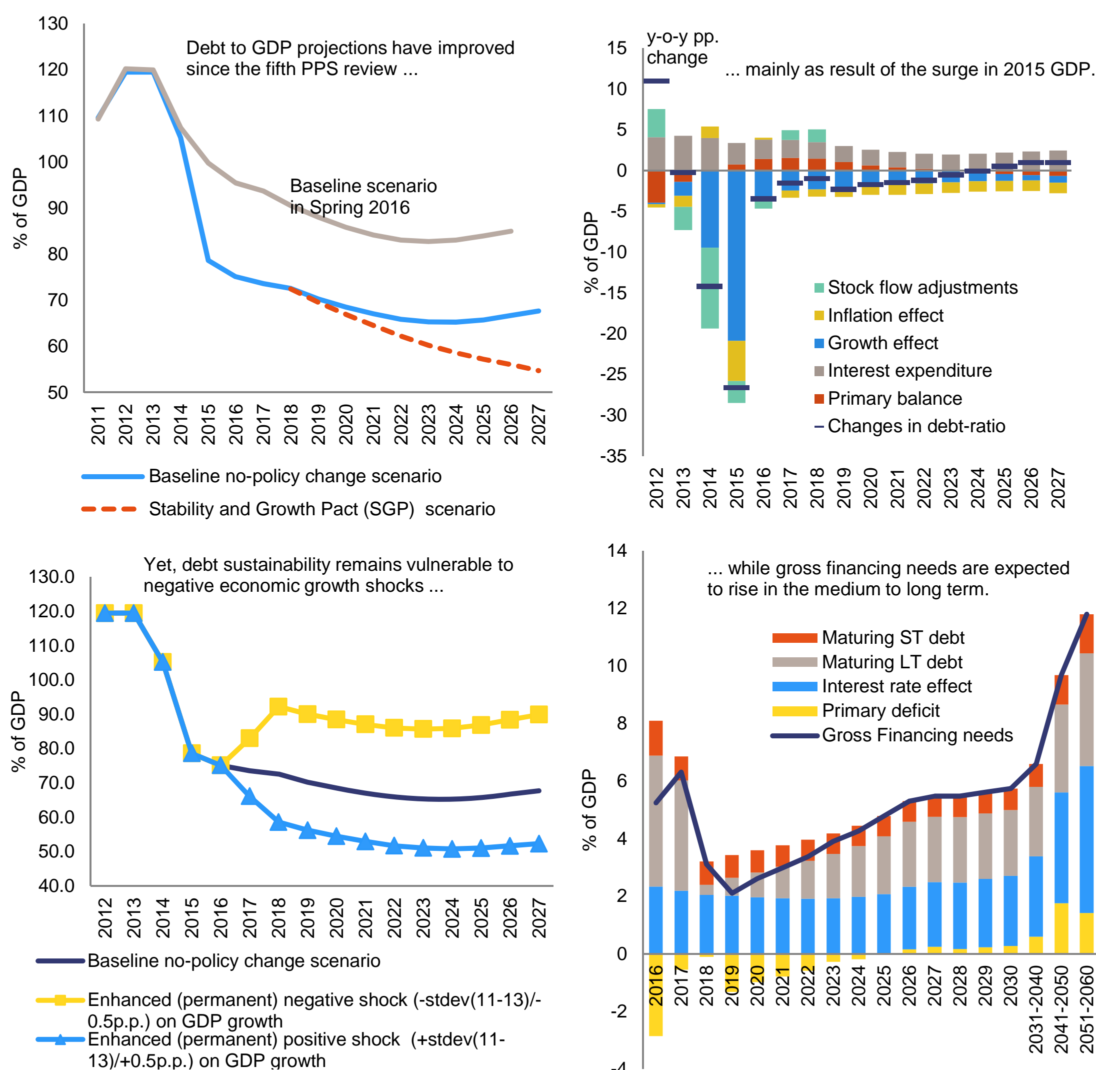
lifestyles, for instance by taxing sugar sweetened drinks.			
Quality of public expenditure			
• A mid-term revision of the Capital Investment Plan (2016-2021) is expected by July 2017. Additional resources (of around EUR 5.2 billion) will largely be allocated to social housing projects. • The government is designing a new cycle for the Programme for Research in Third Level Institutions (PRTLI), the key mechanism to deliver *Innovation 2020*. The proposed budget for the new cycle of PRTLI will be an additional EUR 635 million over five years. • The first study to review the RD&I support for businesses was launched in April 2016. • An expert commission on the funding model for Irish	• Capital expenditure, which was significantly reduced during the post-2007 consolidation process, is projected to increase by 9 % compared to 2016. • Government estimates suggest that the "Framework Agreement on the Supply and Pricing of Medicines" (July 2016) will lead to over EUR 700 million in savings. • An additional EUR 49 million for R&D funding has been allocated to the Department of Jobs, Enterprise and Innovation. R&D funding will reach EUR 761 million in 2016, compared to	• Some progress has been made in enhancing the quality of expenditure through a reform of the budgetary process which can help to improve communication on expenditure targets, increase stakeholder engagement and harness public support to improve the quality of expenditure. A culture of spending evaluation including by increasing the responsibility across the public administration for assessing the efficiency and effectiveness of public expenditure, is gradually emerging. • Gradual implementation of Finance Reform Programme (2014 onwards) • The roll-out of activity-based funding, the development of a new eHealth architecture, the streamlining of financial management and information systems and the new cost-saving deal with the pharmaceutical industry are also steps forward. • Water charges have been suspended for a period of nine month starting from Aprils 2016.	**CSR 1 – 2016** • Enhance the quality of expenditure, particularly by increasing cost-effectiveness of healthcare and by prioritising government capital expenditure in R&D and in public infrastructure, in particular transport, water services and housing.

Water recommended that normal water usage for households should be paid through taxation, with a charge being levied for wasteful usage. • The Action Plan for Housing and Homelessness contained proposals for Ireland Strategic Investment Fund (ISIF) funding of large infrastructure projects to support housing investment.	EUR 736 million in 2015. • According to the Government, 74 direct provision social housing schemes were scheduled to start in 2016 delivering 1,424 units. • The EUR 200 million Local Infrastructure Housing Activation Fund aims to provide infrastructure to support urban housing development.		
Financial sector			
Financial services			
• In the 'Programme for a Partnership Government' (PPG) several initiatives were announced: – A review of the thresholds and the processes for Personal Insolvency	• The full implementation of a central credit register has been pushed to late 2018. Data protection concerns, that had halted progress for several months, have been addressed.	• Since July 2016, through the Government Mortgage Arrears Resolution Service, Abhaile, debtors at risk of losing their homes due to mortgage arrears have access to free financial and legal advice. The Scheme is due to last 3 years with reviews every 6 months. It was launched nationally in October, with encouraging initial take-up of over 3,000	**CSR 3 – 2016** • Finalise durable restructuring solutions to lower non-performing loans, to ensure debt sustainability of households and to encourage lenders to reduce the debt of excessively leveraged yet viable businesses.

Arrangements. – The retention of mortgage interest relief beyond the current end date of December 2017. – An amendment of the Code of Conduct on Mortgage Arrears (CCMA). • The PPG also contained a proposal for the creation of specialized courts for mortgage arrears and insolvency proceedings. Although the prospect of specialised courts now seems less likely, from September 2016, Circuit Court repossession procedures take place on specified days at dedicated court venues and with specific judges. • In the Action Plan for Housing and Homelessness, EUR 1.5 million were earmarked for a 2017 information campaign on the support available to debtors in arrears.		vouchers between July and December. • The National Asset Management Agency (NAMA) looks set to achieve its targets. As of January 2017, it had generated EUR 38.1 billion from the sale of commercial real estate and non-disposal income such as rental receipts, and is expected to achieve a surplus of around EUR 2.3 billion by the time it winds-down. It has redeemed EUR 27.6 billion or 91 % of the EUR 30.2 billion of its senior debt. • The review of the macro-prudential measures resulted in relatively minor changes to the loan-to-value ratio, leaving the bulk of the framework intact. • The Strategic Banking Corporation of Ireland (SBCI) involved more on-lenders into its lending scheme, that accounted for 9 % of all SME lending in the period from March to December 2015.	• Accelerate the phasing-in of a fully operational central credit registry covering all categories of lenders and debtors.

ANNEX 2
Debt sustainability analysis

Graph A2.1: **Gross government debt projections (based on 2017 winter forecast)**



(1) The baseline scenario assumes no- policy change from 2018 onward, with a structural primary balance kept constant at last forecast year (cyclical effects until closure of output gap estimated using standard budgetary semi- elasticity). Costs of ageing are included. The large contribution of stock flow adjustment to debt in 2014 is mainly due to the liquidation of the Irish Banking Resolution Corporation (IBRC), which from 2015 should no longer have a significant impact on debt reduction.
(2) The Stability and Growth Pact (SGP) scenario assumes a structural adjustment path in compliance with the fiscal effort recommended by the Council until the excessive deficit is corrected, and thereafter an annual structural consolidation effort of 0.6 percentage points until the medium- term objective (MTO) is reached.
(3) The sensitivity tests on real GDP growth consist of enhanced (permanent) negative and positive shocks (-1 standard deviation/+1 standard deviation for the first 2 projection years, followed by a -0.5 percentage point (p.p.)/+0.5 p.p. over the remaining projection period) on real GDP growth applied from the year following the one of last actual data available until the end of the projection horizon (2027). The shock is symmetrically applied to actual and potential GDP growth, so that the output gap remains unchanged. The cyclical component of the balance is therefore not affected by these shocks to growth.
(4) Details of the gross financing needs projections can be found in Box 2.4 of the Debt Sustainability Monitor 2016.
Source: European Commission

The debt to GDP ratio is projected to fall further but vulnerability remains. Ireland's government debt-to-GDP ratio is projected to continue to decline, after peaking at 119.5 % in 2012. The Commission winter 2017 forecast projects the ratio to further fall to 75.1 % in 2016 and to reach 72.6 % in 2018, contingent on further robust GDP growth and the realisation of primary budget surpluses. However, the

impact of the operations of MNEs on Ireland's GDP means that caution is required when interpreting these trends. The government debt interest payments remain high, both in absolute terms and as a share of revenue, also compared with other highly-indebted countries in the EU. The previously announced disposal of government stakes in domestic banks has been delayed but would reduce the level of gross public debt. The value of government holdings in the banks is estimated at around 5 % of GDP.

Medium to long term projections of the debt to GDP ratio have improved since the fifth PPS review mainly as result of the surge in 2015 GDP. The Commission's latest Debt Sustainability Analysis (DSA) ([71]) based on the winter 2017 forecast shows that, if fiscal policy beyond 2018 were to remain unchanged to the last forecast year (2018), the general government debt-to-GDP ratio would fall steadily until 2024 to around 65.2 % and slightly increase in the following few years, mainly on account of increasing ageing costs (Graph A2.1). This represents a significant improvement compared to the previous DSA where the debt bottomed out at around 73 % of GDP by middle of next decade. This is mostly due to the level shift in 2015 nominal GDP which carries over into later years. The full implementation of the stability programme would nonetheless put debt on a firmly decreasing path, reaching 54.8 % of GDP in 2027 ([72]).

The sustainability of government debt remains vulnerable to negative economic growth shocks. Ireland's still high level of public debt makes government debt projections very sensitive to variations in economic growth and to the expected size of budgetary adjustment. Risks to long-term debt sustainability relate mostly to changes to the economic outlook — since most of the outstanding stock of debt pays fixed interest rates. According to the Commission's debt sustainability analysis, adverse developments on real GDP growth — of a magnitude reflecting the country's historical variability of output ([73]) — would increase the public debt-to-GDP ratio by 22 pps. by 2027 to about 90 %. On the other hand, save for any potential future changes to market conditions, interest rate risk for the Irish sovereign remains low due to the Ireland's debt structure and its long debt maturity profile ([74]). However, gross financing needs are expected to rise in the medium to long term as bonds and loans mature.

([71]) The Commission services' DSA makes use of both deterministic and stochastic projections over a 10-year horizon. Alternative scenarios are designed to capture possible future alternative 'states of the world'. The aim is to have a comprehensive set of debt projection results supporting conclusions in a context of uncertainty about future realizations. Scenarios are conceived to be used in an integrated way to reach assessments on debt sustainability.

([72]) The Stability Programme is built under a no-policy-change assumption according to which tax revenues are assumed to increase in line with nominal GDP growth while government primary expenditures are kept broadly constant in level terms. The assumption of broadly stable expenditure in level terms contrasts with both pre-crisis trends and the government's own estimates presented in the last expenditure review.

([73]) This enhanced sensitivity test is designed based on a one standard deviation reduction/increase in real GDP growth, calculated over the last three years of historical data, for two years following the one of last historical data available. After two years of projections, -0.5/+0.5 pp. permanent shocks on GDP growth would be applied till the end of the projections period.

([74]) In turn, a permanent 1 pp. increase to short- and long-term interest rates on newly issued and rolled-over debt would raise the public debt-to-GDP ratio by 3.1 pps. by 2027 to about 70.8 %.

ANNEX 3

Supplementary tables

Table A3.1: **Fiscal accounts (based on 2017 winter forecast)**

	2011	2012	2013	2014	2015	2016	2017	2018
				% of GDP				
Indirect taxes	10.3	10.4	10.7	11.0	8.8	8.8	8.8	8.9
Direct taxes	12.0	12.7	12.7	12.9	10.9	10.9	10.9	10.9
Social contributions	6.0	5.6	5.8	5.7	4.5	4.5	4.5	4.5
Sales	3.0	2.9	2.7	2.4	2.1	1.8	1.7	1.7
Other current revenue	1.6	1.9	1.9	1.7	1.1	0.8	0.7	0.4
Total current revenue	**32.9**	**33.5**	**33.8**	**33.7**	**27.3**	**26.8**	**26.7**	**26.4**
Capital transfers received	0.5	0.3	0.3	0.4	0.2	0.3	0.3	0.3
Total revenue	**33.3**	**33.9**	**34.1**	**34.1**	**27.6**	**27.0**	**26.9**	**26.7**
Compensation of employees	11.2	10.8	10.3	9.5	7.4	7.4	7.4	7.4
Intermediate consumption	5.1	4.7	4.5	4.6	3.6	3.6	3.6	3.5
Social transfers in kind via market producers	2.9	3.0	2.8	2.7	2.0	1.9	1.9	1.8
Social transfers other than in kind	13.8	13.8	13.1	11.9	9.0	8.6	8.5	8.3
Interest paid	3.3	4.1	4.2	3.9	2.6	2.3	2.2	2.0
Subsidies	1.0	1.1	1.1	1.0	0.7	0.7	0.6	0.6
Other current expenditure	1.5	1.4	1.6	1.4	1.0	1.1	1.1	1.1
Total current expenditure	**38.7**	**38.9**	**37.6**	**35.0**	**26.3**	**25.7**	**25.2**	**24.8**
Gross fixed capital formation	2.4	2.0	2.0	2.2	1.7	1.7	1.8	2.0
Other capital expenditure	4.8	0.9	0.2	0.7	1.4	0.5	0.5	0.5
Total expenditure	**46.0**	**41.8**	**39.8**	**37.8**	**29.4**	**28.0**	**27.6**	**27.3**
	35.4	34.9	33.4	31.1	23.7	23.4	23.1	22.8
General government balance	**-12.6**	**-8.0**	**-5.7**	**-3.7**	**-1.9**	**-0.9**	**-0.6**	**-0.6**
Underlying government balance (EDP)	**-8.5**	**-7.8**	**-5.7**	**-3.7**	**-1.1**	**-0.9**	**-0.6**	**-0.6**
				EUR billion				
Indirect taxes	17.8	18.3	19.3	21.2	22.5	23.3	24.6	25.8
Direct taxes	20.8	22.3	22.9	24.9	27.9	29.0	30.3	31.7
Social contributions	10.4	9.9	10.4	11.0	11.4	12.0	12.6	13.1
Sales	5.2	5.1	4.9	4.7	5.3	4.8	4.9	4.9
Other current revenue	2.7	3.3	3.4	3.3	2.9	2.1	1.9	1.3
Total current revenue	**56.9**	**58.9**	**60.9**	**65.0**	**69.9**	**71.2**	**74.2**	**76.8**
Capital transfers received	0.9	0.6	0.6	0.8	0.6	0.7	0.7	0.8
Total revenue	**57.7**	**59.5**	**61.5**	**65.8**	**70.5**	**71.9**	**75.0**	**77.6**
Compensation of employees	19.4	19.0	18.6	18.3	18.9	19.7	20.7	21.4
Intermediate consumption	8.8	8.3	8.2	8.9	9.2	9.7	10.0	10.3
Social transfers in kind via market producers	5.0	5.2	5.0	5.2	5.1	5.1	5.2	5.2
Social transfers other than in kind	23.9	24.2	23.5	23.0	23.1	23.0	23.6	24.2
Interest paid	5.7	7.2	7.6	7.4	6.7	6.2	6.1	5.9
Subsidies	1.7	1.9	1.9	1.9	1.8	1.7	1.7	1.8
Other current expenditure	2.6	2.5	2.9	2.8	2.6	2.9	3.1	3.3
Total current expenditure	**67.1**	**68.4**	**67.8**	**67.5**	**67.4**	**68.4**	**70.3**	**72.1**
Gross fixed capital formation	4.2	3.5	3.5	4.2	4.3	4.6	5.1	5.8
Other capital expenditure	8.3	1.6	0.4	1.3	3.6	1.5	1.4	1.5
Total expenditure	**79.6**	**73.5**	**71.7**	**73.0**	**75.3**	**74.4**	**76.8**	**79.4**
General government balance	**-21.8**	**-14.0**	**-10.2**	**-7.2**	**-4.8**	**-2.5**	**-1.8**	**-1.8**
Deficit-increasing financial sector measures	7.121	0.3	0.0	0.0	2.1	0.0	0.0	0.0
Underlying government balance (EDP)	**-14.7**	**-13.7**	**-10.2**	**-7.2**	**-2.7**	**-2.5**	**-1.8**	**-1.8**

Source: European Commission

Table A3.2: **General Government debt projections (based on 2017 winter forecast)**

	2011	2012	2013	2014	2015	2016	2017	2018
Government deficit (% of GDP)	**-12.6**	**-8.0**	**-5.7**	**-3.7**	**-1.9**	**-0.9**	**-0.6**	**-0.6**
Government gross debt (% of GDP)	109.6	119.5	119.5	105.2	78.6	75.1	73.6	72.6
levels, EUR billion								
Government deficit	**-21.8**	**-14.0**	**-10.2**	**-7.2**	**-4.8**	**-2.5**	**-1.8**	**-1.8**
Gross debt	189.7	210.0	215.3	203.3	201.1	199.8	204.9	211.2
Change in gross debt	45.5	20.3	5.3	-12.0	-2.2	-1.3	5.0	6.3
Nominal GDP	173.1	175.8	180.2	193.2	255.8	266.0	278.4	291.0
Real GDP	167.1	165.2	167.0	181.2	228.8	238.7	246.8	254.9
Real GDP growth (% change)	**0.0**	**-1.1**	**1.1**	**8.5**	**26.3**	**4.3**	**3.4**	**3.3**
Change in gross debt (% of GDP)	26.3	11.5	2.9	-6.2	-0.8	-0.5	1.8	2.2
Stock-flow adjustments (% of GDP)	13.7	3.6	-2.7	-9.9	-2.7	-1.4	1.2	1.5
% of GDP								
Gross debt ratio	**109.6**	**119.5**	**119.5**	**105.2**	**78.6**	**75.1**	**73.6**	**72.6**
Change in gross debt ratio	23.3	9.9	0.0	-14.2	-26.6	-3.5	-1.5	-1.0
Contribution to change in gross debt								
Primary balance	-9.3	-3.9	-1.4	0.1	0.7	1.4	1.5	1.4
"Snow-ball" effect	0.3	2.4	1.3	-4.3	-22.1	-0.7	-1.1	-1.1
of which								
Interest expenditure	*3.3*	*4.1*	*4.2*	*3.9*	*2.6*	*2.3*	*2.2*	*2.0*
Real growth effect	*0.0*	*1.2*	*-1.3*	*-9.4*	*-20.9*	*-3.3*	*-2.4*	*-2.3*
Inflation effect	*-3.0*	*-2.9*	*-1.7*	*1.3*	*-3.9*	*0.3*	*-0.9*	*-0.9*
Stock-flow adjustments	**13.7**	**3.6**	**-2.7**	**-9.9**	**-2.7**	**-1.4**	**1.2**	**1.5**
Implicit interest rate	*4.0*	*3.8*	*3.6*	*3.5*	*3.3*	*3.1*	*3.0*	*2.9*

Source: European Commission

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