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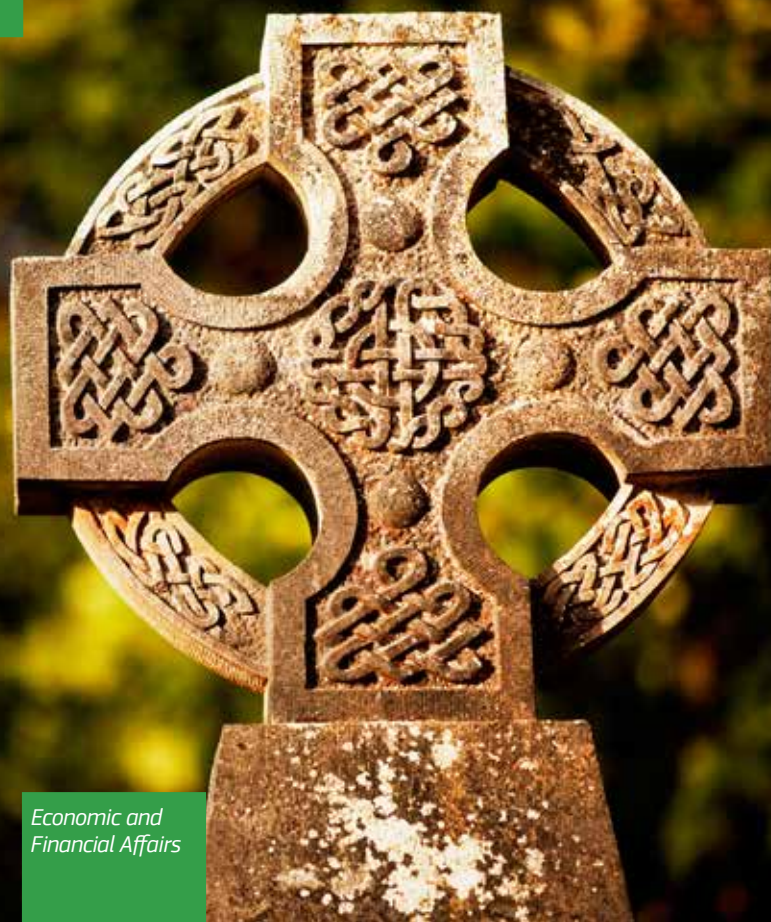
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Post-Programme Surveillance Report

Ireland, Autumn 2015

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European Commission

Directorate-General for Economic and Financial Affairs

Post-Programme Surveillance Report

Ireland, Autumn 2015

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ABBREVIATIONS

ACS: Asset Covered Securities
AIB: Allied Irish Banks
APP: asset purchase programme
AT1: Additional Tier 1
BEPS: Base Erosion and Profit Shifting
BOI: Bank of Ireland
BTL: buy-to-let
CBI: Central Bank of Ireland
CCB: countercyclical capital buffer
CCR: central credit registry
CER: Comprehensive Expenditure Report
CET1: Core Equity Tier 1
CRD: Capital Requirements Directive
CRE: commercial real estate
CRO: Credit Review Office
CRR: Capital Requirements Regulation
CSO: Central Statistics Office
CSRs: country specific recommendations
DBP: draft budgetary plan
DBP: Draft Budgetary Plan
DSA: debt sustainability analysis
EC: European Commission
ECB: European Central Bank
EDP: excessive deficit procedure
EFSF: European Financial Stability Fund
EFSM: European Financial Stability Mechanism
ESM: European Stability Mechanism
ESRI: Economic and Social Research Institute
ETBs: education and training boards
FET: further education and training
GDP: gross domestic product
GNP: gross national product
IBRC: Irish Banking Resolution Corporation
IDR: in-depth review
IFAC: Irish Fiscal Advisory Council
IMF: International Monetary Fund
IPHA: Irish Pharmaceutical Healthcare Association
ISI: Insolvency Service of Ireland
ISIF: Ireland Strategic Investment Fund
KDB: Knowledge Development Box
LPT: local property tax
LT2: Lower Tier 2
MABS: Money Advice and Budgeting Service
MART: Mortgage Arrears Restructuring Targets
MIP: Macroeconomic Imbalances Procedure

MNEs: multinational enterprises
MTEF: medium-term expenditure framework
MTO: medium-term budgetary objective
NAMA: National Asset Management Agency
NIMs: net interest margins
NPLs: non-performing loans
NPRF: National Pension Reserve Fund
NTMA: National Treasury Management Agency
OECD: Organisation Economic Cooperation and Development
O-SII: other systemically-important institution
PDH: primary dwelling home
PMI: Purchasing Managers' Index
PPM: post-programme monitoring
PPS: post-programme surveillance
PRSI: pay-related social insurance
PTSB: Permanent TSB
QNA: quarterly national accounts
qoq: quarter-on-quarter
R&D: research and development
REITs: real estate investment trusts
RoA: return on assets
RoE: return on equity
SBCI: Strategic Banking Corporation of Ireland
SF: Supporting Factor
SGP: Stability and Growth Pact
SME: small and medium-size enterprise
SREP: Supervisory Review and Evaluation Process
SSM: Single Supervisory Mechanism
TLTRO: Targeted Longer-Term Refinancing Operations
UHI: universal health insurance
USC: Universal Social Charge
VAT: value-added tax
yoy: year-on-year

EXECUTIVE SUMMARY

Ireland's economic rebound is remarkably strong, underpinned by an ongoing successful macroeconomic adjustment and a supportive external environment. In terms of real gross domestic product (GDP), Ireland was the fastest growing economy in the euro area in 2014 and is set to top the euro-area growth league also in 2015 and 2016. The economic rebound is much stronger than expected. It comes after policy efforts to repair the financial sector and to restore sustainable public finances; the external environment has also been supportive. The focus of economic policy making is gradually shifting away from crisis legacy to long-term matters such as how to safeguard strong and balanced economic growth in the future. The main economic policy challenge for the coming years is twofold: (i) strengthen instruments and frameworks that mitigate the risk of boom-bust cycles, and (ii) underpin medium-term growth, by addressing housing and possible infrastructure bottlenecks. The current economic and financial conditions provide a unique opportunity to accelerate debt reduction.

In 2015, the economy is expected to grow by at least 6%. While volatile quarterly national accounts make the measurement of Ireland's growth dynamic more difficult, real GDP grew by close to 7% year-on-year (yoy) in the first nine months of 2015. The recovery is largely driven by strong investment and private consumption, where private consumption is supported by pent up demand for durable goods, and helped by strong employment growth and low inflation. Exports are growing swiftly thanks to the weaker euro and trade links to the US and the UK, but their contribution to overall growth is more than offset by imports. Construction activity is gradually picking up from a low base. Housing shortages persist, especially in urban areas. Unemployment fell to 8.9% in October, below the euro-area average of 10.7%. Employment gains are reaching more economic sectors and are being generated in largely full-time jobs, while long-term unemployment remains high but continues to decline.

Economic growth is projected to moderate towards more sustainable rates in the medium term. Supply constraints in housing and infrastructure could become more accentuated as the country is likely to return to positive net inward migration and government investment expenditure is set to recover only very gradually. After significant cuts during the crisis, government investment in percent of GDP is projected to slowly rise from 2016, in line with the government's Infrastructure and Capital Investment Plan. Still, the plan will stabilise the government investment ratio to well below the euro-area average. Domestic demand is forecast to moderate with more subdued employment growth. Risks to the economic outlook are broadly balanced. Domestic growth could surprise on the upside while external risks are increasingly tilted to the downside as the slowdown in emerging markets affects global trade.

Ireland is on track to correct its excessive deficit, but recent decisions affect the adjustment path towards a sustainable budgetary position. Recent fiscal policy decisions are influenced by the current political context. In October 2015, the government approved extra permanent spending of 0.7% of GDP, adding to the already strong growth momentum. The extra spending is financed by very strong but generally volatile corporate taxes. Still, Ireland remains on track to correct its excessive deficit in 2015 thanks to the very strong economic rebound. The 2016 budget contains further tax cuts and spending increases of 0.7% of GDP in 2016. Spending increases focus on public wages and social benefits rather than on more growth-friendly expenditure items. The 2016 draft budgetary plan (DBP) is broadly compliant with the EU fiscal rules but there are risks of some deviation from the appropriate adjustment path towards the medium-term objective. Strengthening the medium-term expenditure framework would reduce the risk of pro-cyclical fiscal policy. Government debt is projected to decline to below 100% of GDP in 2015. To lower Ireland's vulnerability to future economic and financial shocks, higher-than-expected revenues should be fully used to reduce the still high debt level.

Recent developments bode well for the disposal of the government's stakes in the domestic banks. Under the planned reorganisation of Allied Irish Banks' (AIB) capital base, the government has received EUR 1.7 billion (0.8% of GDP) for the partial redemption of the preference shares, followed by EUR 1.6 billion in July 2016 when the contingent capital (cocos) instruments mature. The government's total stakes in the domestic banks are valued at 8.8% of GDP and proceeds from their disposal will be used to lower general government debt but there are no firm dates yet for these sales.

Financial sector performance continues to improve though the high level of non-performing loans (NPLs) requires more efforts and is one reason for high lending rates. The profitability of the domestic banks continues to improve with increased net interest-rate margins and on the back of provision write-backs, which banks should undertake cautiously. New lending has picked up although debt loan repayments remain higher. Long-term arrears, although showing a first decline in absolute terms in September, continue to rise as a proportion of total mortgage arrears and legal solutions involving a loss of ownership are very lengthy. New court procedures introduced over the summer may help reduce the length of the proceedings but will not apply to the existing cases already in the pipeline. Despite recent measures to boost the use of the new insolvency and bankruptcy procedures, their usage remains low. Research links high interest rates charged by domestic banks on new lending to the limited degree of competition in the banking sector, the high share of NPLs, legacy low-yielding assets and difficulties accessing collateral. Unlike the previous post-programme surveillance (PPS) report, the analysis of the domestic banks in this report is based on aggregate data only, not individual bank data, due to a recent decision of the Irish authorities.

Macro-prudential measures aim at enhancing resilience of banks to shocks while the government has announced measures to address housing supply constraints. The Central Bank of Ireland (CBI) is stepping up its macro-prudential activities and analysis in line with its mandate. Survey data indicate that the new mortgage lending rules from February have dampened expectations of property inflation. Constraints continue to affect the supply-side response in the housing market but the authorities have announced an extensive package of new measures. These include less onerous national building regulations and a targeted rebate of contributions paid by developers to lower building costs. The package also includes a reduction in the frequency of rent reviews as well as a longer notification period for rent rises. Both measures should be carefully monitored to ensure they do not undermine investment in rental properties. Rapid increases in commercial real estate prices are to a large extent driven by nonbank financing; the authorities should remain vigilant for any spillovers to banks and the rest of the economy.

Structural reforms continue to progress, though some areas still need more work. Significant additional capacity to provide activation services to long-term job seekers through private contractors will become effective in 2016 as planned. The modernisation of education and training programmes is progressing well. The minimum wage will rise by 6% in early 2016 but, judging from empirical evidence, it is not expected to have a significant impact on labour demand as coverage is low. More policy actions are needed to reduce public expenditure on pharmaceuticals and to improve cost effectiveness in the delivery of healthcare. Following concessions, it remains to be seen whether the Legal Services Regulation Act will be effective reducing high legal services costs. It is important to ensure funding for Irish Water's capital plan beyond 2016 in order to address critical weaknesses in water infrastructure.

The repayment risks for the European Financial Stability Mechanism (EFSM) and European Financial Stability Fund (EFSF) loans remain low over the medium term. This assumes that the authorities continue to implement agreed fiscal consolidation, financial sector policies and structural reforms. General government debt is expected to decline markedly, as reflected in the debt sustainability analysis. The average maturity of public debt in Ireland is one of the longest in Europe. In November 2015, the average weighted maturity of government bonds and the EU-IMF programme loans was estimated at 12.4 years. The implied interest rate on total government debt was only 3.5% in 2014 and is estimated to fall to 3.3% in 2015. Total interest payments on EFSF/EFSM loans in 2016 will be 0.5% of GDP. The next principal repayment of EFSM/EFSF loans is due in 2018 although maturity extensions granted in 2013 mean 2018 EFSM maturities will be refinanced.

Ireland has made good progress with the implementation of certain 2015 European Council recommendations. Under 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 PPS. Overall, the fourth PPS review concludes there have been advances with addressing the relevant country-specific recommendations (CSRs).

1. INTRODUCTION

Staff from the European Commission (EC), in liaison with the European Central Bank (ECB), undertook the fourth PPS review mission for Ireland from 9 to 13 November 2015. 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 both the ECB and the national competent authority, the CBI. PPS aims to assess the 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. Overall, the results of the fourth PPS review point to very limited risk to the capacity to repay. The next repayment of loans from EU lenders is scheduled in 2018, although the maturity extensions granted in 2013 mean that in reality 2018 EFSM maturities will be refinanced ⁽²⁾.

The PPS mission includes specific monitoring under the MIP. The results of the in-depth review (IDR) for Ireland carried out under 2015 European Semester confirmed that remaining macroeconomic imbalances require decisive policy action and the specific monitoring of the implementation of MIP-tagged CSRs ⁽³⁾. Overall, there have been further advances with addressing CSR 1 on fiscal consolidation and with tackling CSR 4 concerning the restructuring of loans in arrears. A more detailed overview of the progress made with the 2015 MIP-tagged CSRs is provided in 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. It may be extended if there are financial difficulties or fiscal instability issues.

⁽²⁾ On 21 June 2013 the Council of the European Union adopted Implementing Decision 2013/313/EU to increase the average maturity of EFSM loans to Ireland to by seven years to 19.5 years. Thus, Ireland has the option to request that any maturing tranche under its EFSM loans be extended. This needs to be formally notified four months prior to the relevant expiry date.

⁽³⁾ See Communication from the Commission to the European Parliament, the Council and the Eurogroup, 2015 European Semester: Assessment of growth challenges, prevention and correction of macroeconomic imbalances, and results of in-depth reviews under Regulation (EU) No 1176/2011, http://ec.europa.eu/europe2020/pdf/csr2015/cr2015_comm_en.pdf.

2. RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

2.1. RECENT DEVELOPMENTS

While the volatility of Irish national accounts data makes it difficult to precisely measure the strength of economic growth, the economic rebound is much stronger than expected. In the first nine months of 2015, real GDP grew by 7% yoy and 1.4% quarter-on-quarter (qoq) in the third quarter. Initially driven by net exports, the much stronger than expected economic rebound is now firmly based on domestic demand components. Investment is playing a central role in the recovery despite its high volatility, driven by aircraft leasing and cross-border transfers of intellectual property by a few multinationals. Investment in intangible assets⁽⁴⁾ grew by 121% yoy in the first nine months of 2015, particularly in the third quarter. This surge is mostly explained by some multinationals re-domiciling patents to Ireland. Nevertheless, core investment, which excludes intangibles and aircraft, has been strong, growing at an estimated 11.7% over this time. Real private consumption grew by 3.5% yoy in the first nine months of 2015, despite the still high deleveraging needs of households. Exports are experiencing another upward level shift, mostly due to pharma and information technology (IT) goods produced by multinationals, whose share in global trade continues to expand. Indigenous companies are also exporting more, helped by the weaker euro. Real gross national product (GNP) increased by 6% yoy in the first nine months of 2015 but declined by 0.8% qoq in the third quarter of 2015 due to greater income outflows, largely explained by the repatriation of profits by multinationals.

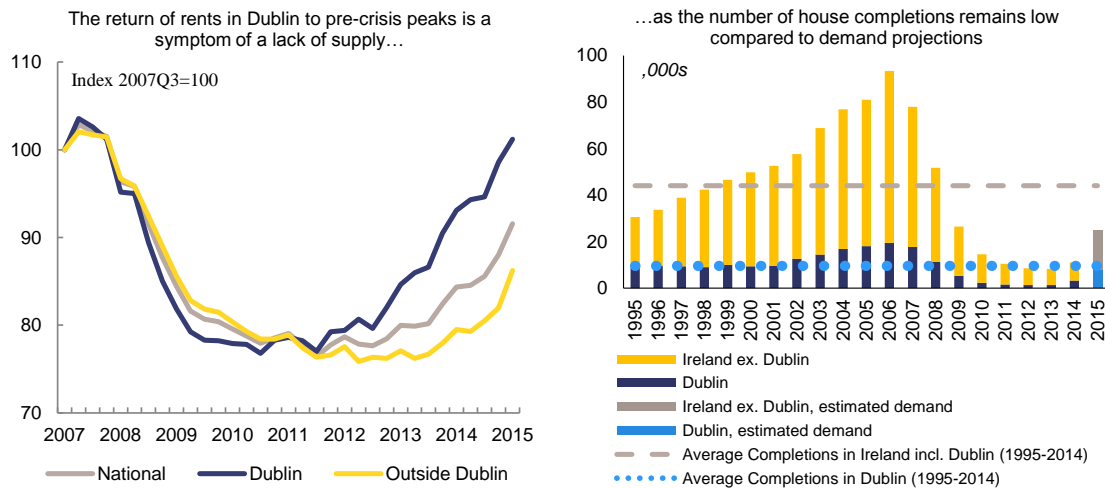
Employment growth is strong while inflation remains low. The overall unemployment rate decreased to 8.9% in November 2015, from 10.4% a year earlier. This was driven by strong employment growth of about 56,000 or 2.9% over the same period. Labour market participation increased slightly to 60.5% in the third quarter of 2015. Relative to GDP growth, the recovery continues to be rich in job creation, more moderately than in 2013 but reaching more economic sectors and regions, and mainly in full-time jobs. Long-term joblessness remains high but fell to 54% of total unemployment in the third quarter of 2015, compared to 57% a year earlier. Average hourly earnings increased by 2.1% yoy in the third quarter of 2015 though they were down by 1.7% qoq — with large differences across sectors, as salary pressures remain moderate. The fall in nominal unit labour costs moderated in the first half of 2015 to 3% yoy, while real labour productivity increased by 3.6%. Consumer price inflation remained close to zero in the last months of 2015 with falls in energy prices in contrast with increases for services.

Residential property price increases have slowed in Dublin while commercial real estate prices remain buoyant. Residential property price increases in Dublin have decelerated compared to a year ago, with a rise of 4.5% yoy in October 2015, compared to 24.2% yoy in October 2014. The recovery in residential property prices outside Dublin, which was previously less strong than in the capital, continued, recording an increase of 10.7% yoy in October 2015, compared to 8.3% in October 2014. While price increases are significant, there is no evidence of overvaluation when compared with standard indicators or model-based property price estimates. Residential property transactions also decreased in the third quarter of 2015 by 1.4% yoy, following a few years of sustained increases. Rent increases in Dublin persist, at 8.7% yoy in the third quarter of 2015 (compared to 10.0% in the third quarter of 2014), suggesting that excess demand for accommodation may have been diverted to the rental sector (Graph 2.1). The cost of prime office space in Dublin rose by 16.7% yoy in the third quarter of 2015 continuing the recovery observed in recent years. Commercial property value increased by 18.1% yoy in the same period.

The construction sector continues to recover. Construction employment grew by 13.3% yoy in the third quarter while the Ulster Bank Construction Purchasing Managers' Index (PMI) remains elevated at 56.3 in October (where 50 indicates no change in activity), both suggesting an acceleration in construction activity. Nonetheless, the recovery underway in the construction sector is from a very low base and below estimated needs. Notices of housing commencements were issued for 7,016 units in the

⁽⁴⁾ An intangible asset is an asset that is not physical in nature, such as intellectual property assets, patents, and trademarks.

Graph 2.1: Residential property market developments



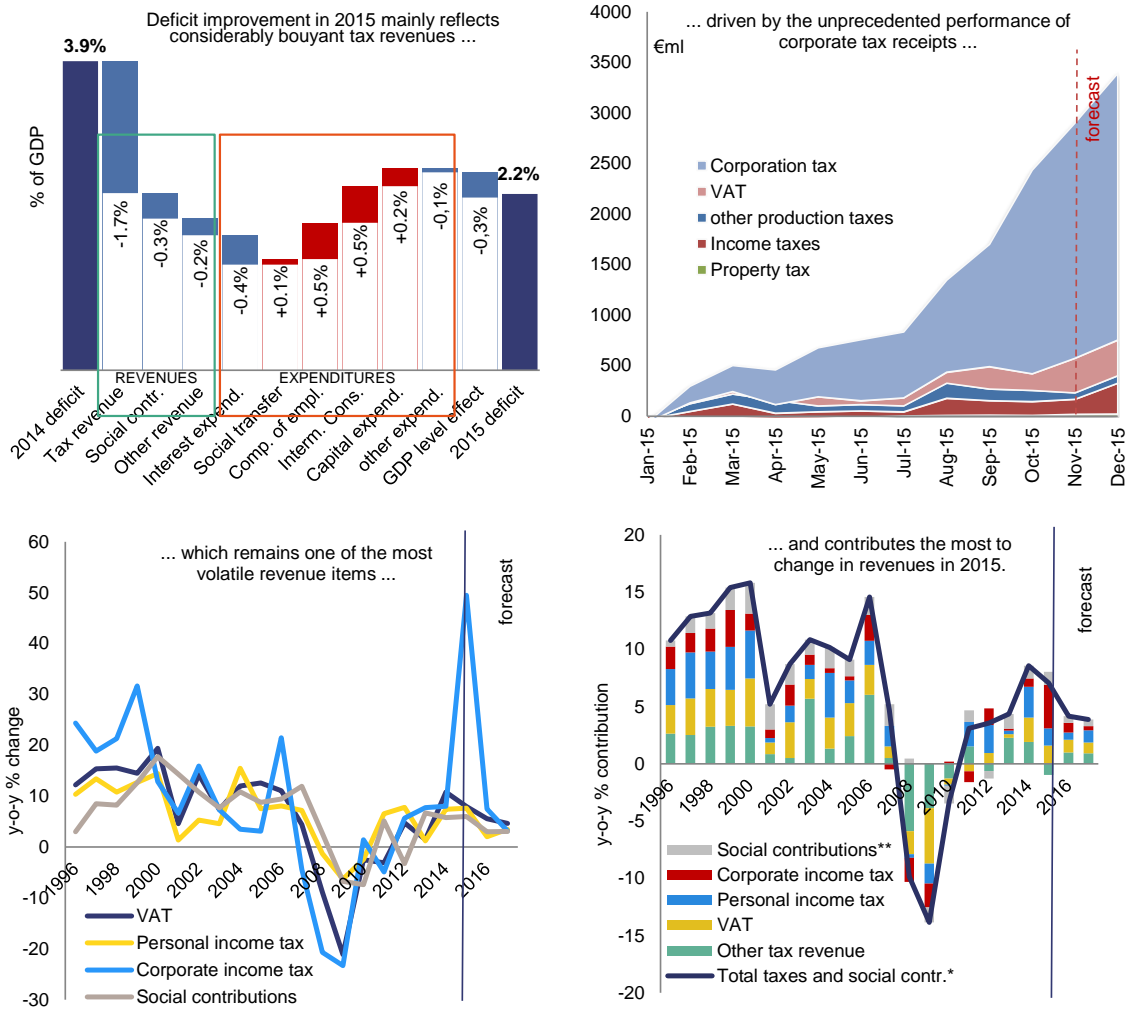
Source: Private Residential Tenancies Board, department of the environment, community and local government. Estimated demand based on Morgenroth (2014) and Duffy et al. (2014).

first ten months of 2015 (compared to just 1,821 in the first ten months of 2014), while 10,052 units were completed over the same period (compared to only 8,796 in the first ten months of 2014). Although the number of commencements suggest some pick-up in private development activity, until recently the National Asset Management Agency (NAMA) was responsible for a large proportion of completions in Dublin (43% in 2014). Overall, even the latest figures remain far below estimates of national housing demand of approximately 25,000 units per year.

On the back of a much stronger than expected economic rebound, the budget deficit is expected to drop to close to 2% of GDP in 2015, down from 3.9% of GDP in 2014. Tax returns through end-November were well ahead of the government's budget plans, reflecting the exceptional strength and the comparatively high-job content of the economic growth: income tax receipts increased by 5.1% yoy and value-added tax (VAT) receipts by 8.6% yoy (Graph 2.2). However, the by far strongest contribution to the better-than-planned exchequer tax returns comes from an exceptionally strong surge of corporate tax receipts, which were up by 52.0% yoy. More than half of the observed increase in total tax revenues in 2015 is attributable to the corporate income tax. Whilst the Irish authorities are of the view that the extra revenues are sustainable, the specific factors underlying the strong corporate tax revenue performance in 2015 still need to be clarified⁽³⁾. Regarding expenditure, yearly recurring overruns on current spending became evident through end-November, mainly in healthcare and social protection (Box 2.1). Overruns were only partially offset by savings in other current expenditure categories. Capital spending continued to remain below the budgetary plan (by 0.1% of GDP). Thanks largely to lower-than-expected market interest rates, as well as the pace of early repayment of all IMF debt subject to the higher rate of charge, debt interest costs were also below budget 2015 plans (by 0.3% of GDP) through end-November.

⁽³⁾ Taxes paid by companies are based on a preliminary assessment of their tax liability for the accounting period. The final tax liability for 2015 is expected in September 2016.

Graph 2.2: Fiscal sector developments



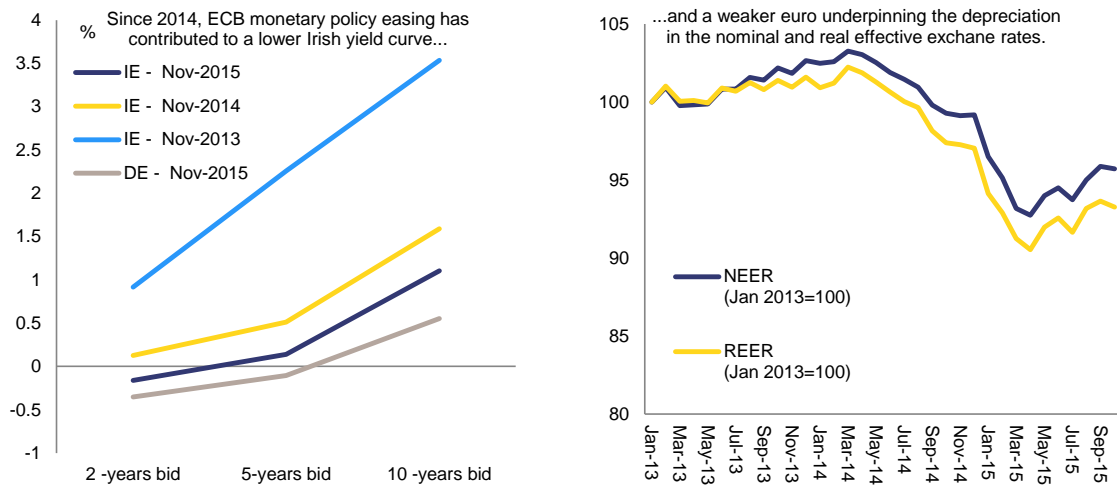
(*) excluding property income and capital receipts

(**) including imputed social contributions

Source: Department of finance and European Commission

Financial market conditions remain supportive for debt issuances, helped by the ECB's asset purchase programme (APP). It has supported a loosening in monetary conditions via lower market interest rates (Graph 2.3). After hitting a low of 0.66% in April, the yield on the ten-year Irish bond was at about 1.10% in mid-December 2015, while the 10-year spread over German bonds remained near post-crisis lows at about 50 basis points. The National Treasury Management Agency (NTMA) raised EUR 2.75 billion in three auctions of its benchmark 15-year bond with yields ranging from 2.2% in June to 1.6% in October. In the second half of the year, AIB and Bank of Ireland (BOI) issued respectively a EUR 0.75 billion Asset Covered Securities (ACS) bond and EUR 0.75 billion Additional Tier 1 (AT1) paper. AIB also issued EUR 750 million in Lower Tier 2 (LT2) bonds and EUR 500 million in AT1 bonds in November 2015, as a part of its capital reorganization plan. All three major rating agencies recognized the improved fundamentals either by sovereign upgrades (Standard & Poor's, from A to A+ in June) or upwards revisions of the outlook (Fitch and Moody's, from stable to positive in August and September respectively). In July 2015, Standard & Poor's raised the ratings of all the domestic banks and revised KBC bank's rating from negative to stable. In December 2015, Moody's changed the outlook on

Graph 2.3: Recent financial developments



Source: Bank for International Settlements (BIS) and iBoxx

the Irish banking system to positive from stable. Moody's upgraded AIB's long-term deposit ratings and senior unsecured debt ratings in November 2015.

Banks' profitability continues to recover on the back of improved asset quality, lower-cost funding and higher margins on new loans. Recent profitability indicators for domestic banks are higher than the EU average with an average return on equity (RoE) of 8.9% and a return on assets (RoA) of 0.8% in the second quarter of this year⁽⁶⁾. Operating income has increased due to a continued widening of net interest margins (NIMs) on new lending (Figure 2.5). The high NIMs reflect several factors including a concentrated lending market, difficulties with access to defaulted-loan collateral, cross-subsidies to outstanding low-yielding loans linked to tracker mortgages and credit risks associated with the still high amount of impaired loans. The tracker mortgages still account for more than half of the banks' mortgage books, but their total stock in all licensed banks has decreased from EUR 72.8 billion at end-2010 to EUR 57.6 billion in mid-2015, reducing their profitability drag. Banks' funding continues to rely more on deposits and less on central bank borrowing⁽⁷⁾. Domestic banks are making progress in meeting the prudential liquidity requirements⁽⁸⁾. In the first half of 2015, their capital positions were stable with an average Core Equity Tier 1 (CET1) ratio of 16.2% on a transitional basis, but substantially lower on a fully-loaded basis with an average CET1 ratio of 10.9% (excluding preference shares). As deleveraging continues and deposits increase, the loan-to-deposit ratio fell for domestic banks, averaging 115% at end-June 2015, compared to 122% at the end of 2013.

The level of NPLs continues to decrease but remains very elevated, especially for commercial real estate (CRE) loans. At end-June 2015, the domestic banks had NPLs at 19.8% of total loans, down from a high of 27.1% at end-2013. Nevertheless, the NPL ratio remains among the highest in the euro-area. The continued improvements in asset quality led to a reduction in provisions, but the coverage ratio was stable at about 55% in the third quarter of 2015. Although declining through restructurings and disposals,

⁽⁶⁾ This compares with the EU average for RoE of 7.9% and RoA of 0.5% in the second quarter of 2015.

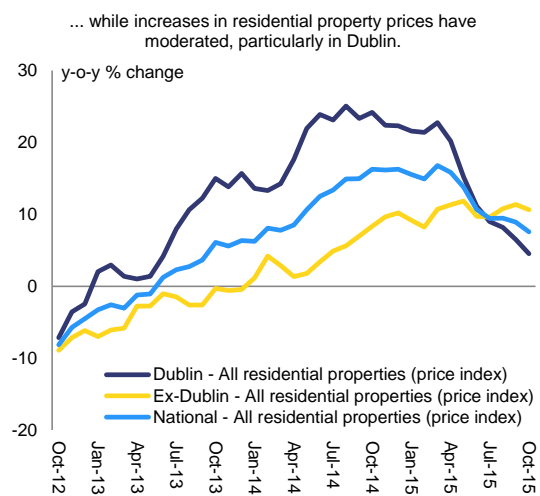
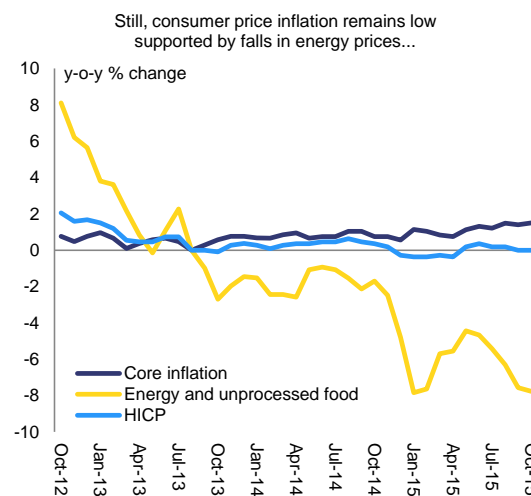
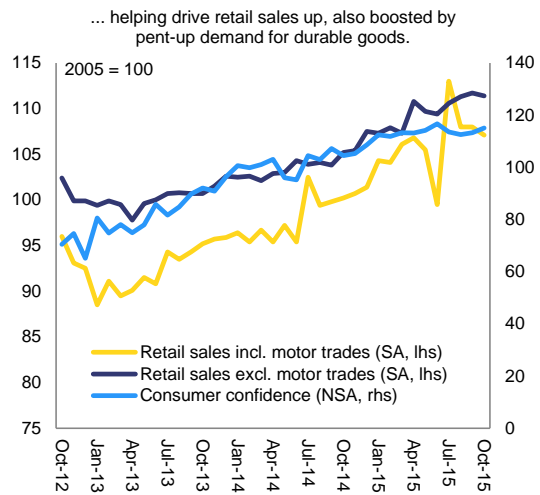
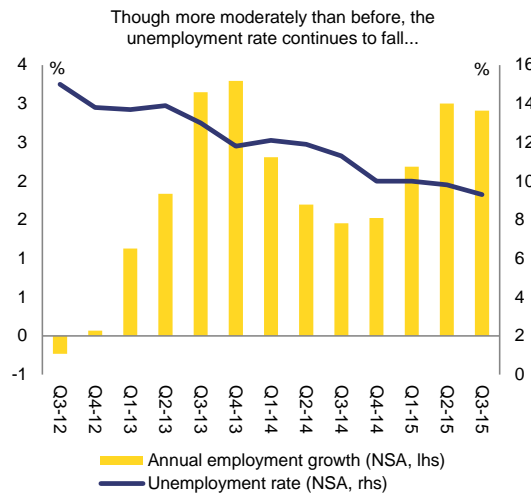
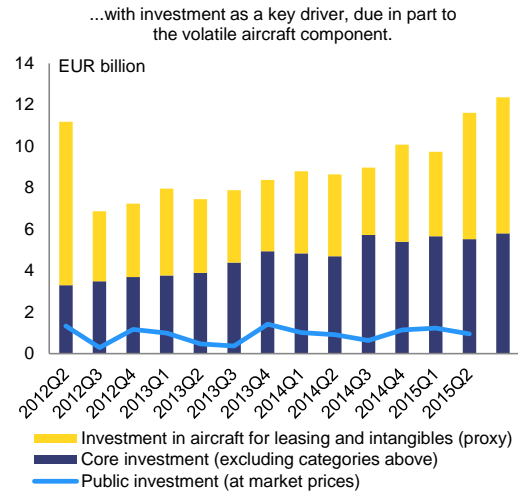
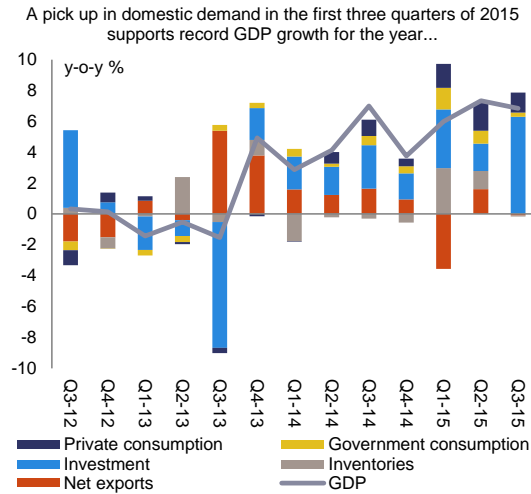
⁽⁷⁾ Total Eurosystem borrowings were down to EUR 8.6 billion by mid-October 2015.

⁽⁸⁾ These are the Liquidity Coverage Ratio (LCR) introduced in early 2015 and the Net Stable Funding Ratio (NSFR) due to be implemented in 2018. Both are required under the Capital Requirements Regulation (CRR). According to the CBI, all domestic banks met the 60% LCR in 2014, with AIB and PTSB meeting the full 100% that would not be fully phased-in until 2019.

the most impaired loan portfolio of the domestic banks remains CRE with 45.2% of all CRE loans impaired at end-September 2015, while SME/corporate loans had an NPL ratio of about 16.9%. At least 20% of SME loans have direct property exposure. The balance of mortgages in arrears of over 90 days represented 15% of total mortgages held by banks and non-banks in Ireland in the third quarter of 2015, down from a high of 19.9% in the third quarter of 2013. The balance of buy-to-let (BTL) mortgage arrears fell to 26.2% of total BTL mortgages in the third quarter, still much higher than primary dwelling home (PDH) arrears at 12.7% in the same period. In September 2015, mortgage accounts in long-term arrears declined for the first time, however as a proportion of the total arrears balance, long-term arrears increased to 64%. Non-banks held a significant proportion of these long-term arrears at 24.8% in the third quarter of 2015⁽⁹⁾. Repossessions continued to increase from a low base, but remain modest especially compared to the number of heavily impaired mortgage accounts. For example, there were 2,682 repossessed properties with lenders at end-September, compared to over 52,000 long-term mortgage arrears accounts.

⁽⁹⁾ For more information on mortgage arrears and non-bank holdings, see Box 2.2 in the *Spring 2015 PPS report*: http://ec.europa.eu/economy_finance/publications/eeip/ip005_en.htm.

Graph 2.4: Recent economic developments



Source: European Commission and Central Statistics Office. Investment in aircraft for leasing and intangibles is a proxy based on Commission Services' staff calculations.

NAMA continues with the sale of its development property and commercial loan portfolio. By end-October 2015, over EUR 30 billion had been generated by the sale of loans and debtors refinancing their debt. EUR 22.1 billion or 73% of senior bonds have been redeemed, boding well for the achievement of its goal of repaying 80% of senior bonds by end-2016. Should the favourable market conditions persist, NAMA expects to make a profit for the government of at least EUR 1.75 billion (or close to 1% of GDP) by the time it winds down in 2018.

In spite of deleveraging and interest rates higher than the euro-area average, there has been a pick-up in new lending. The domestic banks increased new lending by EUR 1.6 billion or 38% in the year to September 2015 and new SME lending rose by 30% in the year to mid-2015. However, loan repayments continue to outpace new borrowing, resulting in decreasing volumes of outstanding bank credit. Corporate net lending was down 7.7% yoy in October. For households, net bank lending in October was down 2.5% yoy in the banking sector. The banking sector's interest rates on new SME loans have declined to about 4.7% in the second quarter of 2015 compared to 5.2% at end-2014⁽¹⁰⁾, but they were still high compared to banks' average interest rate on outstanding SME loans of 3.1%. In September 2015 banks' average small corporate loan ⁽¹¹⁾ interest rate for new business was higher than the euro-area average, at 5.7% compared to 3.2% respectively. For mortgage loans, the average bank floating interest rate was over 4% at end-September, compared with 2.1% in the euro area.

Table 2.1: **Financial sector indicators**

	2008	2009	2010	2011	2012	2013	2014	2015
	(All year-end data, unless otherwise specified.)							
	Latest							
Total assets (in % of GDP)	945.9	1000.2	987.6	807.9	709.2	596.0	570.1	528.6
Share of assets of five largest banks (in % of total assets)	55.3	58.8	56.8	53.2	56.9	47.8	47.6	n/a
Non-performing loans ratio (in % of total loans)	1.9	9.8	13.1	16.1	25.0	25.7	20.7	18.9
Regulatory capital to risk-weighted assets (in %) (1)	12.1	12.8	14.5	18.9	19.2	20.5	22.5	22.6
Return on equity ratio (in %)	1.3	-35.8	-41.0	-10.8	-7.8	-6.8	6.1	n/a
Private credit growth (% yoy change)	1.4	-5.6	-12.3	-4.7	-2.6	-6.8	-10.0	-10.6
Lending for house purchase (% yoy change) (2)	-6.9	-4.1	-2.5	-0.9	6.6	-1.7	-3.9	-3.7
Loan to deposit ratio (in %)	191.0	173.0	171.0	162.0	152.0	142.0	125.0	116
Central bank liquidity (in % of total liab.) (3)	8.1	9.3	18.5	18.7	17.0	7.4	4.1	2.2

(1) Regulatory capital refers to total regulatory capital (Tier 1, Tier 2 and Tier 3) after supervisory deductions.

(2) Lending for house purchase: Data for end-2012 reflects the expiration of a mortgage interest relief for first time buyers.

(3) Central bank liquidity: 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).

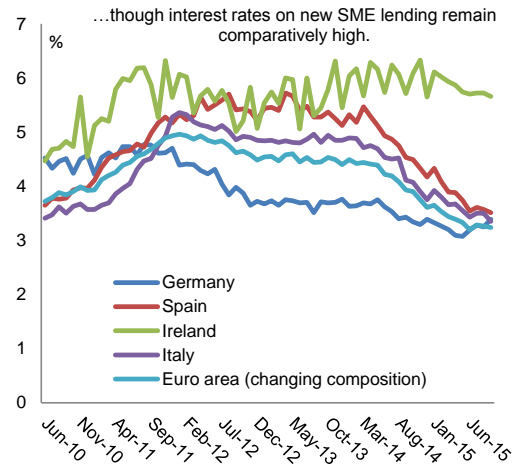
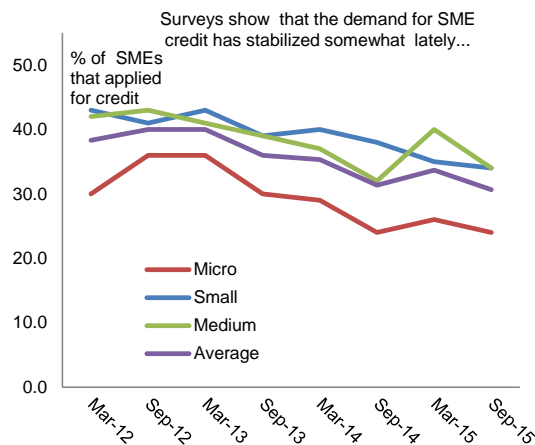
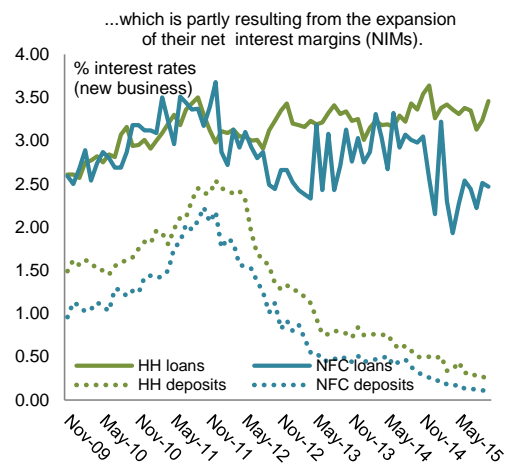
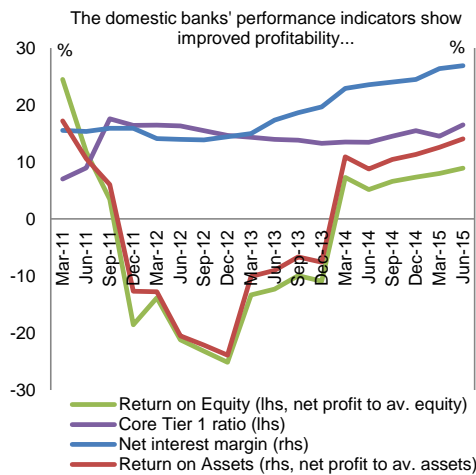
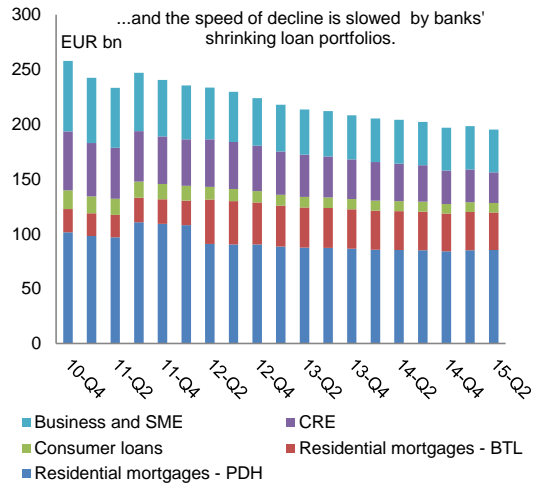
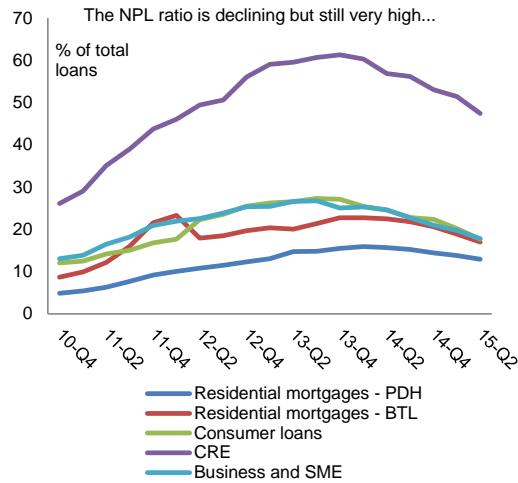
Source: ECB, European Commission and IMF

Unlike previous PPS reports, the assessment for the domestic banks presented is based on aggregated data only, in addition to what is publicly available. In May 2014, the Commission and the ECB reached an agreement with the Irish authorities to provide, as part of PPS and strictly on a confidential basis, data that are not in the public domain but necessary to carry out country surveillance under PPS in an effective manner. This included disaggregated financial and regulatory information and data on domestic individual Irish banks. Although the Commission and the ECB signalled their continued interest, the agreement concerning bank-by-bank data was not renewed after the initial 12 months, and in September 2015 the Irish authorities discontinued the provision of data for individual domestic banks. The data for individual domestic banks previously provided ensured a high standard of monitoring, since it ensured relevant, detailed and consistent time-series data comparable between the banks. Other EU countries under PPS continue sharing bank-specific data, subject to confidentiality requirements. The Commission is still discussing with the Irish authorities the possibility of resuming sharing bank-by-bank data under PPS.

⁽¹⁰⁾ This excludes financial intermediation enterprises.

⁽¹¹⁾ Loans up to EUR 1 million at floating rates and up to an initial one-year rate fixation are used as a proxy for SME lending.

Graph 2.5: Recent financial and credit developments



(1) PDH is primary dwelling housing, BTL is buy-to-let, HH is households, and NFC is non-financial corporation.

(2) The Core Tier ratio includes preference shares.

(3) The Irish SME interest rate in February 2015 was 3.13% which is clearly a significant outlier. Thus, the mean of January and March was applied to February in order to account for this abnormality.

Source: CBI, department of finance and ECB

2.2. OUTLOOK

In 2016 and 2017, real GDP growth is forecast to moderate towards more sustainable but still strong rates of 4.5% and 3.5% respectively while external downside risks increase. Supply constraints in housing or infrastructure may become more acute as the country gradually returns to net positive inward migration. Private consumption is forecast to grow at lower rates, as pent-up demand for durable goods normalises. Core investment (excluding aircraft for leasing and intellectual property) is expected to keep growing towards its long-run average, while public investment is forecast to increase only very gradually in line with the government's plans. Exports and imports are forecast to grow more moderately, in line with fundamentals. Risks to these forecasts are balanced. Domestic dynamics could prove stronger than anticipated while external risks are increasingly tilted to the downside as the slowdown in China and other emerging markets could affect global trade more widely. The high levels of private and public debt continue to make Ireland vulnerable to potential increases in interest rates and other shocks.

The situation in the labour market is expected to further improve in 2016 and 2017 while earnings and prices continue to recover. The unemployment rate is expected to fall to 7.9% in 2017, under more moderate employment growth than in the past with the uncertain outlook for the construction sector, expected population growth and, possibly, higher labour market participation. Average HICP inflation is forecast to be 0.3% in 2015 but significantly higher in 2016-17, as energy prices recover and salaries progress further, broadly in line with expectations for the rest of the euro area.

Table 2.2: **Main features of the European Commission forecast - Autumn 2015**

	2014			96-11	Annual percentage change					
	bn EUR	Curr. prices	% GDP		2012	2013	2014	2015	2016	2017
GDP	189.0	100.0	100.0	5.1	0.2	1.4	5.2	6.0	4.5	3.5
Private Consumption	83.8	44.3	44.3	4.4	-1.0	0.1	2.1	2.9	2.5	2.0
Public Consumption	32.4	17.2	17.2	3.8	-1.2	0.0	4.0	2.6	1.9	2.2
Gross fixed capital formation	36.5	19.3	19.3	4.3	8.6	-6.6	14.3	16.8	11.9	8.8
of which: equipment	14.2	7.5	7.5	6.7	10.3	-8.1	27.2	17.0	14.0	11.0
Exports (goods and services)	215.0	113.7	113.7	8.7	2.1	2.5	12.1	12.7	7.0	6.7
Imports (goods and services)	180.3	95.4	95.4	8.0	2.9	0.0	14.7	14.1	7.7	7.6
GNI (GDP deflator)	163.9	86.7	86.7	4.4	0.6	4.6	6.9	7.9	4.1	2.7
Contribution to GDP growth:										
Domestic demand				3.7	0.8	-1.2	4.1	5.0	3.9	3.2
Inventories				0.0	-0.2	0.2	0.5	0.0	0.0	0.0
Net exports				1.6	-0.2	2.7	0.1	1.1	0.6	0.3
Employment				2.3	-0.6	2.4	1.7	2.0	1.5	1.4
Unemployment rate (a)				7.3	14.7	13.1	11.3	9.5	8.7	7.9
Compensation of employees / head				4.1	0.0	-0.7	1.8	3.2	2.2	2.2
Unit labour costs whole economy				1.3	-0.8	0.2	-1.6	-0.8	-0.7	0.1
Real unit labour cost				-0.9	-1.1	-1.0	-1.7	-2.7	-2.5	-1.2
Saving rate of households (b)				-	12.9	12.7	13.4	6.1	5.2	4.7
GDP deflator				2.2	0.4	1.2	0.1	2.0	1.9	1.3
Harmonised index of consumer prices				2.3	1.9	0.5	0.3	0.3	1.4	1.6
Terms of trade goods				0.2	-6.4	0.3	-1.3	0.4	0.3	-0.1
Trade balance (goods) (c)				21.5	21.5	19.5	22.4	28.0	28.7	29.5
Current-account balance (c)				-1.1	-1.5	3.1	3.6	5.9	5.7	4.7
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-0.7	-1.5	3.2	3.7	6.2	6.0	4.9
General government balance (c)				-3.0	-8.0	-5.7	-3.9	-2.2	-1.5	-1.5
Cyclically-adjusted budget balance (d)				-3.4	-6.4	-3.9	-3.3	-2.9	-2.2	-1.6
Structural budget balance (d)				-	-6.4	-4.3	-3.2	-3.0	-2.1	-1.6
General government gross debt (c)				47.6	120.2	120.0	107.5	99.8	95.4	93.7

(a) as % of total labour force (b) gross saving divided by gross disposable income (c) as a % of GDP (d) as a % of potential GDP

Source: European Commission

Despite new tax cuts and expenditure increases in 2016, Ireland's fiscal position is expected to further improve on the back of strong economic growth. The 2016 DBP targets a general government deficit of 1.2% of GDP, only half a percentage point lower than the figure presented in the April 2015 stability programme despite the significant upward revision to the GDP growth assumption since

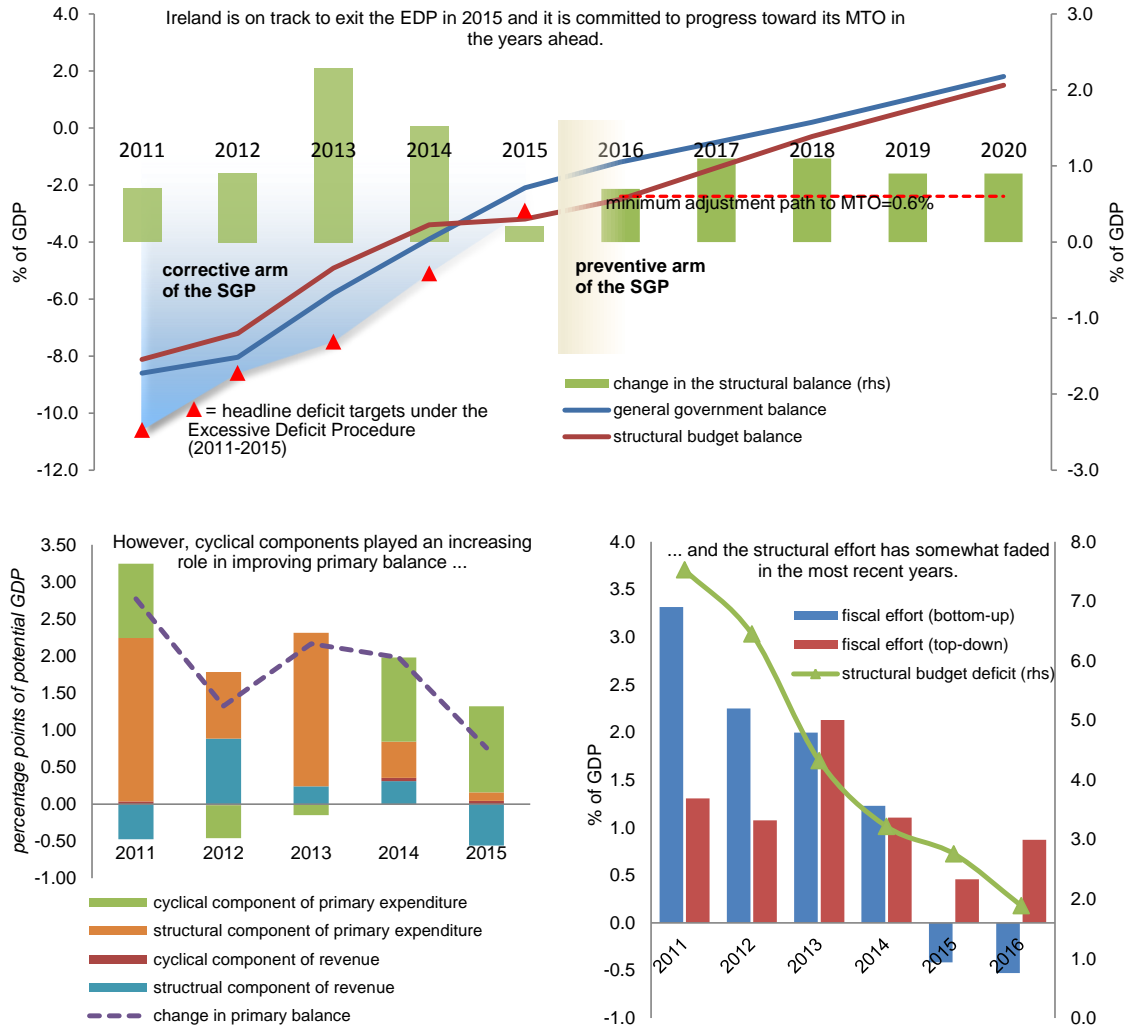
then ⁽¹²⁾. On top of the extra spending approved at the end of 2015 which carries over into 2016, the 2016 budget includes new measures of around 0.7% of GDP consisting of tax cuts and spending increases which largely offset the effects of better-than-expected economic growth. On the tax side, measures mainly focus on reducing income tax rates and raising the tax threshold under the Universal Social Charge (USC) ⁽¹³⁾. As a consequence, the marginal tax rate for middle-income earners is expected to decline to 49.5% from 51%. Businesses will benefit from the new Knowledge Development Box (KDB) which offers a reduced corporate tax rate of 6.25% for income arising from certain types of intellectual property, which are the result of research and development (R&D). On the expenditure side, increases mainly target public sector pay and social protection. The main changes in social protection include a EUR 3 per week increase in pension payments, a EUR 5 per month rise in child benefit and an increase of the carer's support grant. Government investment remains subdued: in 2016, it is projected to be 1.4% lower than the government's latest estimates for 2015.

General government gross debt is projected to fall marginally below 100% of GDP at end-2015 and reach 93.7% of GDP at end-2017. The marked improvement results from the combined effect of better-than-expected economic growth, low interest rates, primary surpluses, certain debt management operations and asset sales. In 2015, these include the cancellation of EUR 1.5 billion (0.7% of GDP) of the floating rate bonds purchased from the CBI, about EUR 0.5 billion (0.3% of GDP) from the sale of contingent capital notes and equity in Permanent TSB (PTSB), and the transfer of EUR 1.6 billion (0.9% of GDP) from the National Pension Reserve Fund (NPRF) held over from the redemption of BOI's preference shares in December 2013. After reducing government gross debt significantly in 2014, from 2015 the liquidation of the Irish Banking Resolution Corporation (IBRC) should no longer have a significant impact on debt reduction (see Annex 2 on debt sustainability analysis). In 2016, the expected receipts from the redemption of the AIB contingent convertible capital notes of EUR 1.6 billion (0.8% of GDP) will contribute further to the decline in debt ratio.

⁽¹²⁾ On account of the revised GDP growth assumptions in the DBP and the revised 2014 GDP outturn, the level of nominal GDP in 2015 and 2016 is now expected to be nearly 7% higher than in the 2015 stability programme.

⁽¹³⁾ Other tax measures include new tax credits for self-employed and an increase in tax credits for home carers, a cut in capital gains tax for entrepreneurs, a higher threshold for capital acquisition tax on inheritances, a reduction of the motor tax for commercial vehicles and an increase of excise duties on cigarettes.

Graph 2.6: General government deficit targets, cyclical versus structural components and fiscal efforts



(1) Figures in the top chart are taken from budget 2016.
 (2) The structural component of revenue and primary (excluding interest) expenditure in the bottom-left chart is obtained by adjusting the headline balance for the cyclical component and one-off measures. The adjustment is based on the commonly agreed EU methodology.
 (3) The "top-down" and the "bottom-up" metrics in the bottom-right chart refer to two complementary methods for the assessment of effective fiscal consolidation/action. The "top down" approach looks at the estimated change in the structural budget balance. The "bottom-up" approach consists in estimating, measure-by-measure, the budgetary impact of discretionary interventions on the revenue side and the expenditure side of the budget. The application of the two methods under the Stability and Growth Pact in the code of conduct on the "Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence Programmes" (http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/code_of_conduct_en.pdf). The structural balance is based on the information included in the 2016 DBP recalculated by the Commission according to the commonly agreed methodology.
Source: 2016 DBP and Commission 2015 autumn forecast

Box 2.1: Evolution of poverty indicators and social expenditure

Poverty and income inequality indicators before taxes and social transfers deteriorated in Ireland in the wake of the economic and financial crisis ⁽¹⁾. The at-risk-of-poverty rate is measured as the share of the population whose disposable income is below 60% of the national median income. The distribution of market-income worsened and the risk of poverty increased in all euro-area Member States during the post-2007 economic and financial crisis, with Ireland experiencing much larger changes in both indicators. This was due to the depth of the Irish crisis which combined mutually reinforcing difficulties in the banking sector and public finances. Among the euro-area countries requiring a financial assistance programme, only Greece recorded a higher poverty and income inequality before taxes and social transfers in 2013.

Nonetheless, poverty and income inequality after taxes and social transfers in Ireland remained below pre-crisis levels and euro-area averages. The at-risk-of-poverty rate after taxes and social transfers fell marginally during the recession and was 14.1% in 2013, down by four percentage points from its pre-crisis (2005-2007) average. The median disposable income of those at-risk-of poverty after taxes and social transfers is also higher in Ireland than in the euro area. The national median disposable income in Ireland has declined since the crisis in 2008, but in 2013 it was at its 2005 level. More recent data from the CSO indicate that the national median disposable income grew significantly in 2014, as the recovery strengthened and became more broad-based. Income inequality after taxes and social transfers also improved somewhat compared to the mid-2000s. The Gini coefficient measuring the distribution of disposable income was 30 in Ireland in 2013, down from 31.9 in 2005, and was slightly better than the euro-area average. The ratio of the average income of the richest 20% of the population to the poorest 20% evolved similarly during this period.

The risk of social exclusion and severe material deprivation in Ireland are above pre-crisis levels and the euro-area average, the latter due to low work intensity. The share of the population at risk of poverty or social exclusion (AROPE) after taxes and social transfers grew by 4.5 percentage points between 2005 and 2013 in Ireland. AROPE refers to people either at-risk-of poverty or severely materially deprived ⁽²⁾ or living in a household with low work intensity ⁽³⁾. Since the at-risk-of poverty rate has declined, the growth in the AROPE has been driven by its two other components. First, the share of people living in households with low work intensity in Ireland has been one of the highest in the EU since 2005. This rate has grown since 2008 to 2.2 times the euro-area average, pushed up by the rise in unemployment and the decline in labour market participation in Ireland. The latter has not yet recovered despite the strong rebound in GDP growth and employment. Still, among those who work, the risk of poverty in Ireland is nearly half the euro-area average. Second, severe material deprivation rose above the euro-area average from 2011 moving closer to the EU average. Material deprivation provides a more absolute indication of the prevalence of poverty than indicators based on relative income thresholds as it reflects goods or services that households cannot afford. To reduce AROPE, it is thus important to encourage policies to boost labour market participation and better align work incentives in the structure of social benefits. Some of these policies have been incorporated in budget 2016.

Expenditure on social protection and health in Ireland is above the euro-area average in euro per inhabitant, though below in percent of GDP. After an increase before 2007, total government expenditure has fallen significantly from 2010 but expenditure on social protection and health fell much less. Making fiscal adjustment compatible with maintaining a high level of social protection was a deliberate policy of the Irish government and was part of the EU-IMF financial assistance programme. In euros per inhabitant, social protection and health expenditure in Ireland have consistently been higher than the euro-area average, but they have been lower as a percent of GDP. As a share of total expenditure, social protection and health spending have been below the euro-area average until it converged in 2012. In 2013, Ireland allocated 56% of total expenditure to social protection and health, six percentage points more than in 2008.

⁽¹⁾ All the data referenced in this box are from Eurostat, unless otherwise stated.

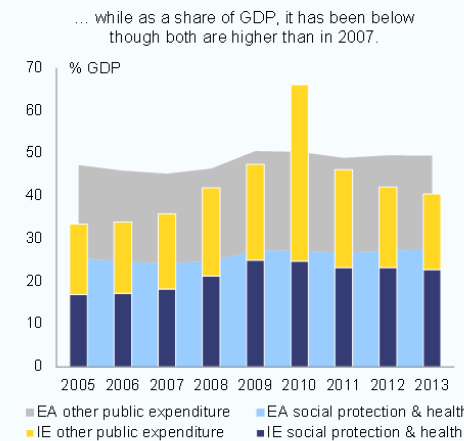
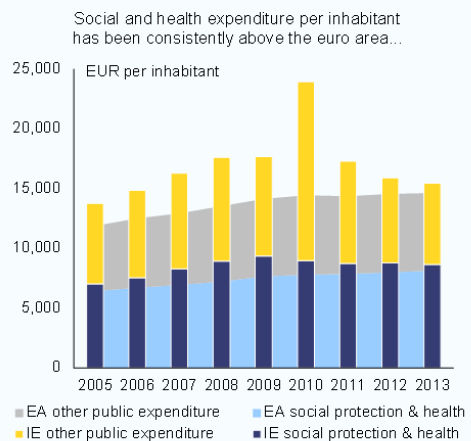
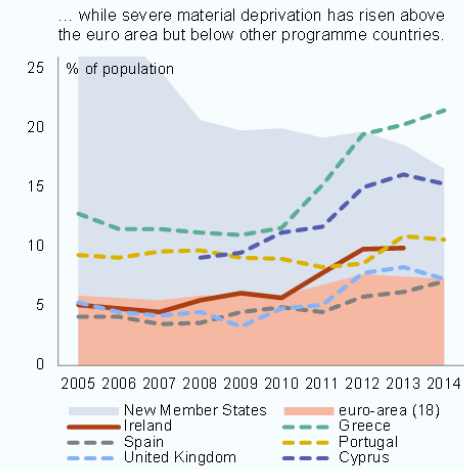
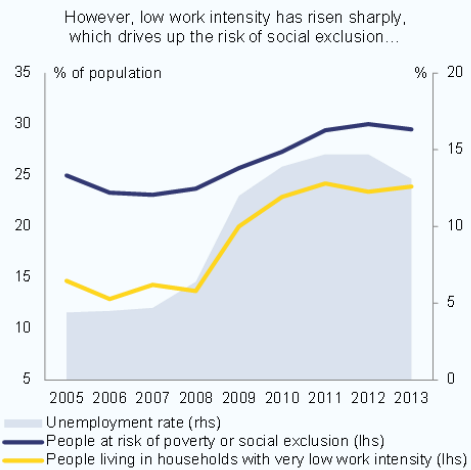
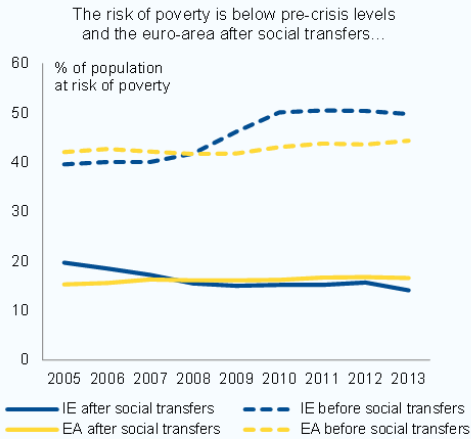
⁽²⁾ Severe material deprivation refers to the inability to pay for four or more of the following: unexpected expenses, a one-week annual holiday away from home, a meal involving meat every second day, adequate heating, durable goods (washing machine, television, telephone or car), or payment arrears (mortgage or rent, utility bills or other loans).

⁽³⁾ The work intensity of a household is the ratio of the total number of months that all household members have worked during the reference year and the total number of months that they theoretically could have worked.

(Continued on the next page)

Box (continued)

Graph 1: Poverty indicators



(1) EA is euro area.

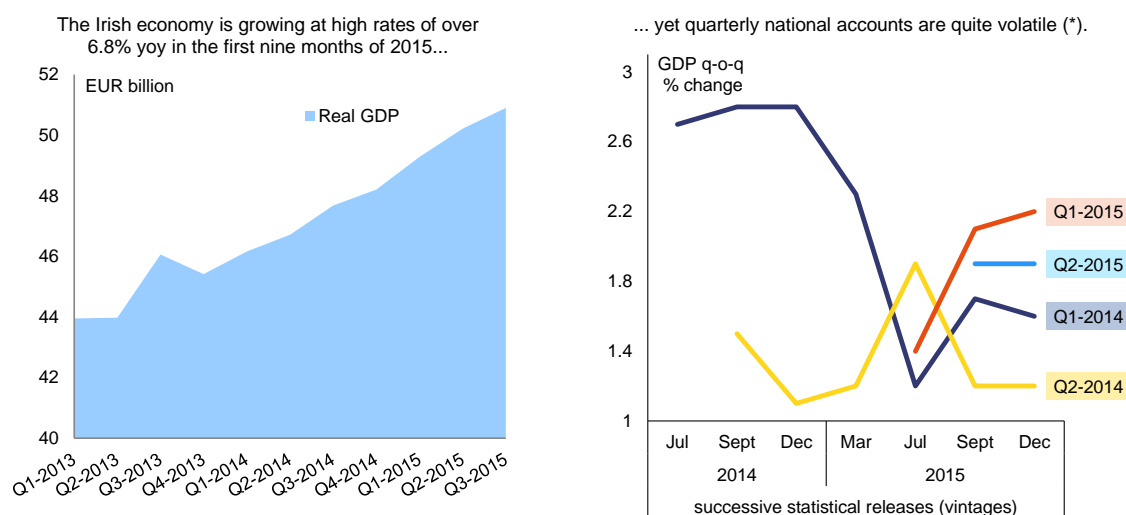
Source: Eurostat

3. POLICY ISSUES

3.1. NATIONAL ACCOUNTS

In 2015, the Irish Fiscal Advisory Council (IFAC) published a study assessing the scale, frequency and the potential for bias in revisions to Irish quarterly national accounts (QNA) data⁽¹⁴⁾. The study found that revisions were large in absolute terms and relative to other economies. Further, the report states that these revisions could not be entirely explained by the specific features of the Irish economy, which is among the most open economies in the World. It also found that large observations could revert to more moderate values over time but crucially concluded that revisions are not biased. Given the importance of QNA data to fiscal policy-making and surveillance more generally, the European Commission had dedicated exchanges with the Central Statistics Office (CSO) and the authorities. A reference to some of the issues and concerns raised by IFAC and other stakeholders was featured in the spring 2015 PPS report⁽¹⁵⁾.

Graph 3.1: Irish GDP growth and volatility of national accounts



(*) Evolution GDP growth rates for the given quarters across successive statistical releases (vintages).

Source: European Commission and CSO

The CSO has increased its cooperation with Eurostat to improve the transmission and validation of macroeconomic data⁽¹⁶⁾. A number of positive developments have taken place since the spring of 2015: The CSO has commissioned the Organisation Economic Cooperation and Development (OECD) to produce an analytical report on the revisions to Irish macroeconomic data. It also has committed to continue to improve the metadata available to Eurostat and data users, in order to facilitate their understanding of significant revisions to data. Moreover, in line with recent Eurostat initiatives, technical cooperation between the CSO and Eurostat has been noted for the transmission and validation of QNA data. The CSO continues to lead best practice in Europe in some areas of the production and dissemination of macroeconomic data, particularly in relation to the impact of globalisation on macroeconomic statistics.

⁽¹⁴⁾ See *Uncertainty in Macroeconomic Data: The Case of Ireland* (IFAC Working Paper, by Eddie Casey and Diarmaid Smyth, March 2015), <http://www.fiscalcouncil.ie/wp-content/uploads/2015/03/Uncertainty-in-Macroeconomic-Data.pdf>.

⁽¹⁵⁾ See Box 2.1: Quarterly National Accounts (QNA) in Ireland, in http://ec.europa.eu/economy_finance/publications/eqip/ip005_en.htm.

⁽¹⁶⁾ Eurostat is preparing the framework that will allow it to assess the quality of data transmitted by national statistical institutes. Article 4 Regulation (EU) No 549/2013 tasks Eurostat with assessing data quality, including of national accounts.

3.2. PUBLIC FINANCES

3.2.1. The momentum of fiscal adjustment is waning

While Ireland is on track to correct the excessive deficit procedure (EDP) in 2015, additional government expenditures comes when the economy is growing at exceptionally strong rates. Helped by a very strong economic recovery, the budget deficit is expected at close to 2% of GDP in 2015, the deadline for correcting the excessive deficit. This is notwithstanding the fact that the Irish government approved additional expenditure for 2015 of 0.7% of GDP in October. The extra spending, which carries over into 2016, comes at a time when economic growth is already very robust, and comes on top of the tax cuts and expenditure increases of around 0.7 % of GDP already implemented in the original budget for 2015. While output gap estimates for 2015 and 2016 differ across methods and institutions, most observers agree that the Irish economy is reaching its potential fast or is already above it. In fact, the estimates from the commonly agreed method used for EU economic surveillance signal a positive output gap from 2015 onwards. Moreover, several institutions, including the IMF, the CBI, and the IFAC point to the risk of pro-cyclical fiscal policy.

The DBP for 2016 is broadly compliant with the requirements of EU fiscal rules. Assuming a timely and durable correction of the excessive deficit in 2015, Ireland will be subject to the preventive arm from 2016 onwards⁽¹⁷⁾. The Commission assessment of the 2016 DBP points to the risk of some deviation from the appropriate adjustment path towards the medium-term budgetary objective (MTO). As a result, the Commission invited the Irish authorities to take the necessary measures to ensure that the 2016 budget will be compliant with the Stability and Growth Pact (SGP). While the estimated improvement of the structural budget balance of 0.8% of GDP in 2016 exceeds the required effort of 0.6% of GDP, the growth rate of government expenditure, net of discretionary revenue measures, is expected to outpace the limit imposed by the expenditure benchmark by some 0.4% of GDP. For Ireland, the medium-term reference rate of potential output growth underpinning the expenditure benchmark can be considered to provide a more stable and prudent reference for fiscal planning as it is based on ten-year averages of potential growth estimates⁽¹⁸⁾. The estimates of annual potential GDP growth used in the calculation of the structural balance, exhibit often considerable pro-cyclical variations due to the very open nature of the Irish economy and factors impacting on the supply side of the economy, notably migration, the real effective exchange rate or energy prices.

3.2.2. Speed and composition of fiscal adjustment

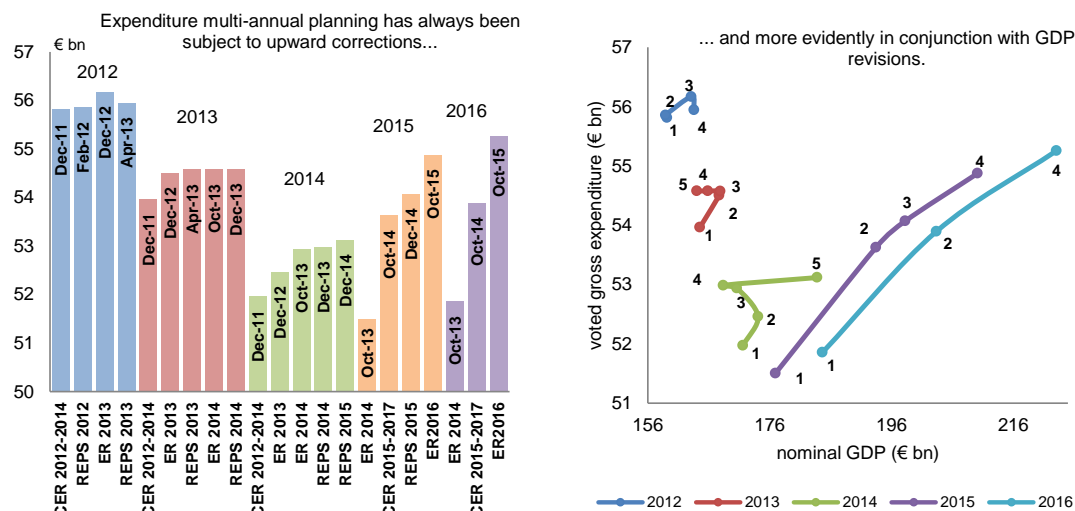
While broadly complying with EU fiscal rules, recent budgetary decisions give rise to some concern. Very strong economic growth allows the Irish government to achieve broad compliance with the provisions of the SGP while increasing expenditure in 2015 and budgeting additional expenditure and tax cut in 2016. However, the 2010 Council recommendation under the EDP and one of the 2015 CSRs have urged Ireland to use growth windfalls to accelerate debt reduction. A faster reduction of government debt would make Ireland less vulnerable to future economic shocks by creating the necessary fiscal space. The current vulnerability of public debt to growth and other types of shocks is highlighted in Annex 2.

The new measures in budget 2016 could have been more supportive of growth. On the revenue side, initiatives aim primarily at increasing the incentive to work through a reduction of the marginal income

⁽¹⁷⁾ Under the preventive arm, Ireland is required to ensure that the budgetary position is at, or moving at a sufficient pace, to the medium-term budgetary objective (MTO), which is a balanced budget in structural terms. Taking into account estimates of the output gap and the high level of government debt, 2016 Ireland is expected to pursue an annual structural adjustment of 0.6% of GDP and to limit the growth of nominal government expenditure, net of discretionary revenue measures, to a maximum of 1.9% (the applicable benchmark rate).

⁽¹⁸⁾ The medium-term reference rate underlining the expenditure benchmark is calculated by a ten-year average of potential GDP, comprising five years of outturn data, the year underway and four years of forward-looking data. Conversely, the structural balance indicator uses the annual "real-time" estimated potential GDP.

Graph 3.2: Expenditure targets (plans, revisions and outturns)



(1) Numbers on the right-hand chart represent the sequence of vintage expenditure plans indicated in the left hand chart.
Source: Comprehensive expenditure reports (CER) 2012-2014, 2015-2017; expenditure reports (ER) 2013-2014; and revised estimates for public services (REPS) 2013, 2014 and 2015.

tax rate. It would have been desirable to target increasing labour market participation of women, which remains below the EU 2020 target. Reducing the tax base, through for example raising the threshold for the USC, and postponing the revaluation of self-assessed property values weighs on the sustainability of revenue in the medium-term. On the expenditure side, measures focus on raising public sector pay and increasing a wide range of social protection payments which could have been better targeted. Government investment expenditure, which was significantly reduced during the post-2007 consolidation process, continues to be low by historical standards and compared to the euro-area average. Projections in the new Infrastructure and Capital Investment Plan show a slow increase of the investment-to-GDP ratio so that by 2021, it is near 1995 levels, but still quite far from its peak years in 2000 and 2007 (Box 3.1). On the other hand, the social transfers-to-GDP ratio, which has grown quite strongly since 2000, is projected to remain above the pre-crisis level (Box 2.1). Measures in budget 2016 could have addressed the need for more growth-friendly policies as highlighted during the National Economic Dialogue ⁽¹⁹⁾.

The government's expenditure projections for the medium term do not account for underlying trends. Following the same approach as in the 2015 Stability Programme, expenditure projections presented in the 2016 budget for 2015-2021 assume a continued sharp decline in the ratio of primary government spending-to-GDP to nearly 26% by 2021, almost 10 percentage points of GDP lower than in 1995. The absolute level of the main expenditure items is assumed to remain broadly unchanged, largely disregarding expenditure pressures that are very likely to emerge in the coming years including from demographic ageing. These conservative assumptions about primary expenditure lead to an optimistic assessment of the future budget balances.

Establishing an effective spending control mechanism is crucial for prudent and counter-cyclical fiscal policy making. With the introduction of a medium-term expenditure framework (MTEF) in 2012, expenditure ceilings were expected to operate as anchors of prudent fiscal policy making over the medium term. However, while specifying procedures and conditions for revisions, existing legislation and relevant circulars, leave ample room for changing the ceilings in a pro-cyclical manner as testified by recent experience. In particular, since the first Comprehensive Expenditure Report (CER) of December

⁽¹⁹⁾ See <http://www.budget.gov.ie/Budgets/2016/NED.aspx>.

2011, expenditure ceilings have regularly been revised upwards, mostly in the wake of higher than expected economic growth (Graph 3.2). In 2015, due to stronger than expected tax receipts, the government will exceed expenditure allocations to departments from the CER 2015-2017 by 0.7% of GDP. Regular revisions of the domestic expenditure ceiling, weaken the Irish medium-term budgetary framework, increase the risk of pro-cyclical fiscal policy and reinforce doubts over the binding nature of key aspects of the MTEF.

3.2.1. Improving the tax base

The substantial activities of multinational enterprises (MNEs) expose Ireland to potential adverse revenue shocks that could arise from changes to international tax standards and practices. The success of Ireland's low corporate tax strategy can be seen in MNEs' contribution to the ongoing economic recovery, while corporate tax receipts are an increasingly important source of government revenue. However, changes in the international tax policy environment have led the government to adopt a number of new measures. Aside from the KDB (Box 3.2), the government introduced a measure for country-by-country reporting by multinationals in line with of the Base Erosion and Profit Shifting (BEPS) project⁽²⁰⁾. This follows the 2015 budget which initiated a gradual phasing out of the *double Irish*, by changing the Irish tax residency rules such that all companies registered in Ireland are also required to be tax resident in Ireland. This change took immediate effect for companies incorporated on or after 1 January 2015, and will be gradually be phased in for existing companies by 2020.

There is room to raise property taxes and adjust them more frequently. Revenues from immovable properties in Ireland are below the EU average⁽²¹⁾ as the current property tax rate is less than 0.2% of the value of the property up to one million euros. This kind of recurrent tax on residential property values is positive because it has been shown to be among the least harmful to growth⁽²²⁾. Moreover, the revaluation of self-assessed property values, used to calculate local property tax (LPT) liabilities, was due in 2016 but has been delayed by three years to November 2019. The last self-assessment of property values was in 2013. Residential property prices have increased substantially since 2013, so the delay represents a lost opportunity to broaden the tax base. Finally, although the compliance rate is high and the number of properties eligible for exemptions is low, the LPT does not cover non-agricultural land. Extending the coverage to adjacent non-agricultural land would broaden the tax base and enhance the efficiency of land use. The latter point should be of particular interest given the lack of housing.

3.3. MACRO FINANCIAL

3.3.1. Returning the domestic banks to private ownership

Plans for returning the domestic banks to the private sector remain on course. The government's total stakes in PTSB, BOI and AIB are valued at about 8.8% of 2015 GDP and will be used to repay public debt. The authorities' main focus in 2015 has been on the restructuring of AIB's capital in order to prepare the bank to begin repayment of the government's past EUR 20.7 billion investment in the bank. A maximum 25% stake in AIB will likely be sold in 2016, which will be decided by the next government.

⁽²⁰⁾ The measure requires an Irish resident parent company of large multinational groups to provide annually, and for each tax jurisdiction in which they do business, a country-by-country 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.

⁽²¹⁾ Revenues from immovable properties stood at 1.1% of GDP in 2013 and remain below the EU average of about 1.5% of GDP in 2012. See http://ec.europa.eu/economy_finance/publications/ecip/pdf/ip008_en.pdf.

⁽²²⁾ See Arnold, J.M., B. Brys, C. Heady, A. Johansson, C. Schwellnus and L. Vartia (2011), 'Tax Policy for Economic Recovery and Growth', *Economic Journal*, 121 (550), F59-F80.

First a capital restructuring was undertaken with the redemption of EUR 1.4 billion of preference shares at 125% of their nominal value, for which the state received EUR 1.7 billion (0.8% of GDP). There will also be a conversion of the remaining EUR 2.1 billion of the government's preference shares into common stock. The redemption of the preference shares is being funded by the recent AIB issuances in late 2015 of EUR 1.25 billion in LT2 and AT1 instruments. The government will also receive EUR 1.6 billion in July 2016 when AIB's contingent capital (cocos) instrument matures. These developments bode well for the disposal of the government's stakes in BOI and PTSB, though no dates have been set for these yet.

3.3.2. Improving bank solvency

The domestic banks are adjusting to more stringent capital requirements though challenges remain. The implementation of the Capital Requirements Regulation (CRR) and the Capital Requirements Directive (CRD IV) is putting more emphasis on fully-loaded CET1 capital ratios, which raises challenges for BOI and AIB due to their significant holdings of deferred tax assets and preference shares both of which are gradually deducted from capital from 2015⁽²³⁾. Nonetheless, AIB's capital restructuring plans are expected to bolster their CET1 capital ratios⁽²⁴⁾. PTSB's CET1 ratio is higher than its domestic peers, although the bank remained loss making in the first half of 2015 and its capital position will remain under pressure until mandatory deleveraging under its restructuring plan is completed. The SSM has recently communicated its finding under the annual Supervisory Review and Evaluation Process (SREP) and additional capital requirements could have been set to individual banks to guard against identified risks.

The introduction of macro-prudential capital buffers will further raise solvency standards for the domestic banks in the medium term. In accordance with CRD IV, from 2016 the countercyclical capital buffer (CCB) will be set on a quarterly basis. The CCB aims to enhance the resilience of the banking system by requiring banks to raise capital levels when the economy is doing well, which then can act as a buffer when the economy is in a downturn. The CBI has decided to initially set the CCB at 0% of banks' total risk exposures given the considerable contraction in credit since the crisis⁽²⁵⁾. In addition, the buffer requirements for other systemically-important institution (O-SII), which goes on top of the CCB, will be phased in for domestic banks designated systemic. For BOI and AIB, the O-SII buffer requirement will be 0.5% of risk-weighted assets from July 2019, 1% from July 2020 and 1.5% from July 2021.

Continuing to build up profitability will be key to raising capital levels, though caution is warranted with provision releases. In the context of low lending volumes and the persistent low interest-rate environment, the sustainability of banks' profitability over the medium term should be closely monitored. Net interest-rate margins are unlikely to materially improve further in the low interest-rate environment. Improved profitability has recently been supported by the high level of loan loss provision write-backs. The supervisory authorities should continue to carefully monitor banks' collateral valuations and make sure banks are not prematurely writing back provisions and lowering provision coverage ratios. On the positive side, profitability will over time continue to be supported by the gradual amortisation of low-yielding tracker mortgages, whose stock in the banks in Ireland has already declined faster than previously assumed, by 15% since 2012. The pace of amortization of the trackers has also picked up as a significant number of interest-only tracker mortgages are resetting in 2014-16 to principal-and-interest mortgages.

⁽²³⁾ In Ireland, CRR/CRD IV involves a phasing out of the counting of DTAs towards CET1 capital by 10% annually from 2015 until end 2023 for AIB and BOI. In addition, preference shares issued to the government will no longer count as regulatory capital own funds, after 1 January 2018.

⁽²⁴⁾ AIB's CET1 capital position is expected to rise from 8.3% at end-June to 11.3% through the capital restructuring.

⁽²⁵⁾ The CCB will be phased in and will range from 0 to 0.625%, with the upper limit growing each year until 2019, when it will range between 0 to 2.5%. For more details on the CCB, see Box 6 in CBI's Macro-financial Review for Q1 2015 <http://www.centralbank.ie/publications/Documents/Macro-Financial%20Review%202015.1.pdf>.

Domestic banks will be subject to stress tests in 2016 to assess their financial strength. Along with 51 other EU banks, the EBA will be undertaking stress tests on AIB and BOI to evaluate the banks' capital ratios during an adverse economic shock. However, no minimum capital threshold is defined as the objective of the exercise is to enlighten the annual SREP to be carried out later in 2016, and to influence banks' future capital plans. The test will be based on a static balance sheet and with a macroeconomic scenario founded on end-2015 figures and covering the years 2016 to 2018. The results will be published in the third quarter of 2016. Along with other smaller banks in the euro area, PTSB may also be subject to a non-public SSM stress test in 2016. The profitability of the domestic banks and the level of NPLs are expected to be of particular focus for the stress tests.

3.3.3. Reducing high non-performing loans

Further efforts are required to reduce mortgage arrears, particularly long-term arrears as their share continues to increase. The restructuring proposals of five main mortgage lenders are monitored by the supervisory authorities through a more granular data-reporting framework that has replaced the Mortgage Arrears Restructuring Targets (MART) introduced under the EU-IMF financial assistance programme. As of September 2015, 86.6% of the restructuring mortgages were meeting the terms of new arrangements. Although almost 40% of concluded arrangements and the majority of long-term mortgage arrears involve a potential loss of ownership, repossessions remain few and very lengthy⁽²⁶⁾. There is also a need for more re-engagement to tackle protracted arrears by lenders and debtors. The recent reform of court rules aims to streamline court proceedings and is expected to lead to a reduction in the number of adjournments⁽²⁷⁾. However, these rules will not apply to the more than 12,000 repossession cases already in the pipeline. To increase the use of sustainable debt solutions, including personal insolvency, for mortgage restructurings, representatives of the Money Advice and Budgeting Service (MABS) and of the Insolvency Service of Ireland (ISI) are now present at court premises for all repossession hearings⁽²⁸⁾. For those cases where the lender refuses to accept a personal insolvency arrangement, the option of appealing to the court came into effect in November, effectively removing the bank veto if certain conditions are met. With more non-banks holding mortgage loan arrears, especially long-term arrears, these entities should also be carefully monitored⁽²⁹⁾.

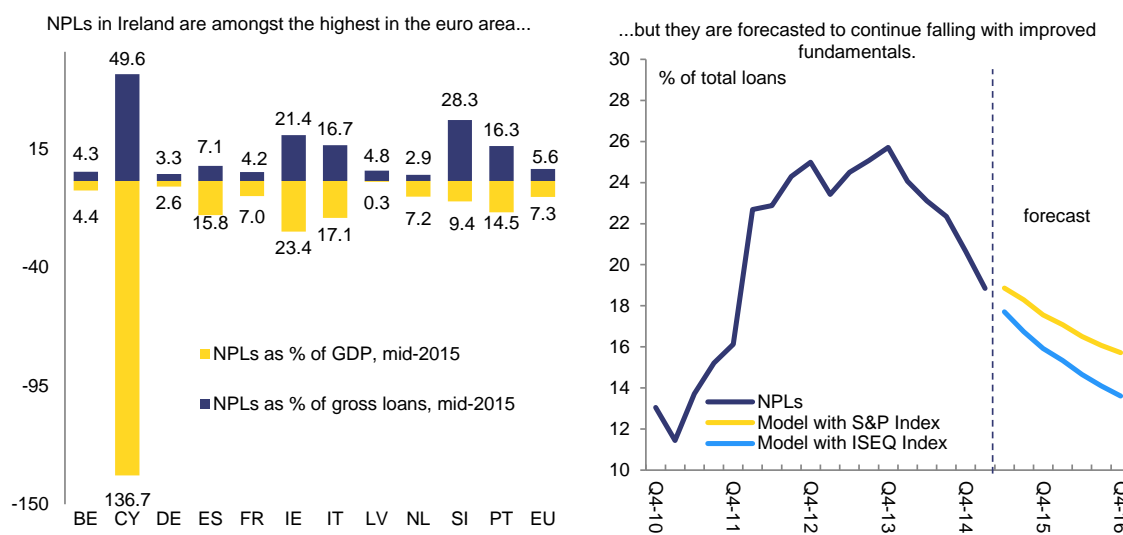
⁽²⁶⁾ Moody's reports that it takes 250-540 days to obtain an order for possession and 270-900 days to repossess and sell a property, depending on its condition, location and the title. See Moody's report *Increased Use of Restructurings Is Credit Positive for Irish RMBS, Covered Bonds and Banks*, September 2015.

⁽²⁷⁾ Under the proposed rules, banks will not be able to use civil bills (the initial document that the lender seeking repossession of a property can issue) for strategic purposes anymore, as they will need to show the steps undertaken prior to addressing the court. This should reduce the high incidence of adjournments arising from inadequately prepared court applications for repossession.

⁽²⁸⁾ The take-up of the insolvency scheme remains low. Between the establishment of the Insolvency Service of Ireland in late 2013 and end-September 2015, only 661 personal insolvency arrangements have been approved.

⁽²⁹⁾ Non-bank holders of mortgage loans can be divided into two main categories: entities that purchased banks' loan portfolios and former banks that surrendered their banking licenses but retained some mortgage loans.

Graph 3.3: Non-performing loans in Ireland



(1) For details on how NPLs are forecasted, see Box 3.1 in the Commission Services' Ireland Post-Programme Surveillance Autumn 2014 Report.

Source: European Banking Association (EBA) and Commission Services' calculations

Though advancing, the resolution of commercial NPLs remains a lengthy process. Continued efforts by banks to implement sustainable commercial restructuring arrangements are warranted, especially as commercial real estate NPLs take considerably more time to restructure even with an improved macroeconomic environment, when such exposures form part of a diverse/multi-debt relationship between the lender and the borrower. Assets disposals should be continued as a resolution method. For certain SME/corporate NPL restructurings, it will be important to separate the viable businesses from legacy (property) debt.

3.3.4. Enhancing resilience to shocks

The macro prudential measures aim to strengthen financial stability and resilience in the event of a negative shock to the property market. According to the CBI, it is still too early to conclusively measure the direct impact of recent mortgage lending regulations on credit but they have reduced property inflation expectations. Surveys of property market professionals do reveal lower house price expectations with a large number of respondents citing these macro prudential measures as a reason for lower price forecasts⁽³⁰⁾. This could dampen the demand for mortgage credit both by containing speculative property investment and diminishing early participation in the mortgage market by first-time-buyers in expectation of future rapid price increases. A high proportion of transactions, over 40% in the second quarter of 2015, still involved cash purchasers which would not be directly impacted by mortgage lending rules.

The central credit registry (CCR) will support prudent lending though its implementation has been pushed back. Challenges identified in the process of setting up the CCR are the capacity of lenders to deliver quality data within the set time limits, potential data privacy considerations and a number of stakeholder concerns. Moreover, inconsistencies in the definition of arrears among lenders may have a negative impact on the harmonization of data. Lenders can start submitting data on individuals from end-September 2016, while the deadline for the submissions for all categories will be only at the end of 2017. Inquiries to the CCR when granting new loans to individuals will become mandatory for lenders from 2018 onwards, while it will become obligatory for all categories of loans in mid-2018. The credit registry

⁽³⁰⁾ See address by CBI Deputy Governor Stefan Gerlach to the Society of Chartered Surveyors Ireland, 15 October 2015, <https://www.centralbank.ie/press-area/speeches/5CSPages/5CSGerlachSCSI.aspx>.

underpins careful lending by improving the assessment of borrower's creditworthiness. It may also help to calibrate possible future macro prudential measures, such as total debt-to-income ratios.

Rapid price increases in the CRE market are not credit-driven though the authorities should remain vigilant. In the run-up to the crisis, the Irish CRE market was dependent on debt funding from banks. More recently, bank credit to the CRE sector declined consistently, following the substantial losses on CRE loans experienced by Irish banks during the crisis. Macro prudential tools targeting banks' CRE exposures exist, in the form of sectoral capital requirements. The CBI also focuses on domestic banks' CRE portfolios from a micro-prudential perspective, assessing risk appetite on new lending, ensuring sustainable resolution of non-performing exposures and the adequacy of provisioning practices. However, CRE developments are being financed predominantly by equity from non-banks and foreign institutional investors. This notwithstanding, the authorities should remain cautious as a collapse in CRE prices would have spill over effects on banks and the rest of the economy. It is also important to develop CRE official statistics to provide reliable data. Such an initiative is being undertaken by the CSO, in cooperation with NAMA, and would greatly improve the ability of the authorities to monitor risks in the CRE market.

The government recently announced an extensive package of new measures in an effort to address housing supply constraints, which should also eventually help relieve price pressures ⁽³¹⁾. The measures include a revision of national building standards for apartments, which specify minimum requirements such as on size, aspect, and ceiling heights. This is being done as evidence suggested that the current guidelines are excessively onerous and could be constraining housing supply by increasing the cost of construction. The authorities estimate that the proposed revision of apartment planning conditions will lead to an average cost reduction of EUR 20,000 per unit in Dublin City. The government also announced measures to increase the supply of more affordable homes and social housing. These include a targeted rebate of development contributions paid by developers to certain urban local authorities, where the price of eligible units may not exceed EUR 300,000 in Dublin and EUR 250,000 in Cork. The Infrastructure and Capital Investment Plan also aims to increase the provision of social housing with a target of 35,000 new social housing units by 2021. This plan aims to contribute to the delivery of transport, water, and other infrastructure essential to facilitate an increase in property development. However, the implementation of the vacant site levy, to boost land for construction, has been delayed until 2018 ⁽³²⁾.

The government has outlined rental market reforms aimed at providing increased certainty to tenants and at tempering rent price rises. These measures include a reduction in the frequency of rent reviews to once every two-years as well as a longer minimum notification period for rent rises. There is a risk that these measures may hinder investment in rental properties ⁽³³⁾. However, the measures announced do not constitute outright rent controls as they do not impose rent caps ⁽³⁴⁾. Some studies suggest that regulations that enhance tenure security may increase the attractiveness of rental housing relative to homeownership. The latter finding may be supportive of the broader goals of the new government policies, namely to make renting a more viable long-term proposition for tenants. Nevertheless, the impact of the new rental and property market measures should be carefully monitored.

⁽³¹⁾ See Department of Environment, Community and Local Government (2015) *Stabilising Rents, Boosting Supply*, <http://www.environ.ie/en/Publications/DevelopmentandHousing/Housing/FileDownload,43556,en.pdf>.

⁽³²⁾ See Urban Regeneration and Housing Act 2015, <http://www.irishstatutebook.ie/eli/2015/act/33/section/15/enacted/en/html>.

⁽³³⁾ Research shows no clear evidence that comparative average rent levels are lower in countries with stricter rent controls. Stringent rent regulations potentially discourage new construction and maintenance by capping the price of rentals, thus lowering the net return on such investments. See Andrews, D., A. Caldera Sánchez and Å. Johansson (2011), 'Housing Markets and Structural Policies in OECD Countries', *OECD Economics Department Working Papers*, No. 836, OECD Publishing. <http://dx.doi.org/10.1787/5kgk8t2k9vf3-en>.

⁽³⁴⁾ Rent controls have been shown to have a significant destabilizing impact on the aggregate housing market. See Cuerpo, C., Kalantaryan, S. and Pontuch, P. (2014), 'Rental Market Regulation in the European Union', *European Commission Economic Papers*, No. 515, http://ec.europa.eu/economy_finance/publications/economic_paper/2014/pdf/ecp515_en.pdf.

3.3.5. Improving financing to companies to underpin growth

While outstanding domestic bank credit continues to decline, publicly-supported agencies and non-bank entities are increasingly active in funding the construction sector. For example, the Ireland Strategic Investment Fund (ISIF) offers equity financing, while NAMA is providing vendor financing and is committed to delivering an additional 20,000 homes by 2020 mostly in the Dublin area. Real estate investment trusts (REITs) are also becoming an important, albeit limited, source of co-development equity finance for domestic developers, while some large overseas developers with access to international capital (such as Hines and Kennedy Wilson) have entered the Irish market. However, many pre-crisis domestic developers are no longer operating and those that remain are still struggling to adapt to equity-based financing in the absence of 100% bank debt funding. The involvement of NAMA in property development is currently the subject of a complaint by several Irish developers to the competition directorate of the European Commission for an alleged breach of State-aid rules.

The take-up of numerous policy initiatives to boost financing to SMEs has been relatively slow with an undiminished need to boost awareness. Irish SMEs are still reluctant to employ equity financing due to a long-time reliance on bank lending and to some extent also to a lack of financial literacy. The Irish SME lending market is effectively a duopoly between AIB and BOI. However, Ulster Bank has committed to a more active role by joining the Credit Review Office (CRO). The Strategic Banking Corporation of Ireland (SBCI) began channelling lower cost loans to SMEs in March through on-lenders AIB, BOI and more recently, Finance Ireland and Merrion Fleet. With EUR 800 million to lend by the end of 2016, at the end - September the SBCI had provided EUR 110 million in loans to 3,200 SMEs. The majority of the loans were for investment purposes and the largest group of borrowers were from the agricultural sector. On-lending partners of the SBCI are required to pass on to borrowers the full extent of the financial advantage from the SBCI's discounted interest rate. Practices here differ among lenders though AIB has publicly stated it lends at a 4.5% variable rate. The recourse to the CRO remains limited, in spite of it upholding a majority of SME appeals to credit refusals⁽³⁵⁾. Numerous SMEs report that their lenders are not making them aware of the credit redress services offered by the CRO and the SBCI.

The effectiveness of other ECB/CBI schemes to support bank lending to SMEs and corporates will depend on loan demand. The ECB's Targeted Longer-Term Refinancing Operations (TLTRO) aims at supporting bank financing to the real economy (excluding mortgages). The take-up of the TLTRO by the Irish lenders has so far been modest in the first two operations⁽³⁶⁾. To boost SME lending, a reduction in capital requirements for SME loans was introduced in the CRR, the SME Supporting Factor (SF)⁽³⁷⁾. So far it has been little used: based on four Irish banks, about 2.2% of total exposures were SME exposures subject to the SF in the second quarter of 2015, compared with an EU mean of 6.1%. The CBI is also undertaking a review of the Code of Conduct for Business Lending to SMEs. The revised rules will take the form of regulations and are expected to be published by the end of 2015, with a phased implementation period. It aims to promote greater transparency around credit applications and refusals, to protect guarantors and expand the grounds for appeal.

⁽³⁵⁾ Out of 394 applications reaching the final CRO conclusion stage, 219 or 56% have been upheld in favour of the borrowers.

⁽³⁶⁾ Estimates show low levels of borrowing by Irish counterparties (less than EUR 5 billion). This compares with EUR 93 billion in Italy, EUR 65 billion in Spain and EUR 69 billion in France according to Barclays Bank PLC, from *SME Market Report H1 2015*, published by the CBI at <http://www.centralbank.ie/publications/Documents/SME%20Market%20Report%202015H1.pdf>.

⁽³⁷⁾ The SME SF requires exposures to SMEs being multiplied by a factor of less than one. It applies to corporate and retail exposures and loans secured by immovable property, on amounts up to a total of EUR 1.5 million.

3.4. STRUCTURAL REFORMS

3.4.1. Improving activation and further education and training

While its effectiveness still needs to be assessed, additional activation support for the long-term unemployed is coming on stream. The effective roll-out of the *JobPath* activation services contracting-out programme has started in close to 20 offices around the country. Although only about 3,000 long-term jobseekers have been referred to private contractors so far, it is expected that the latter will provide activation support to anywhere between 60,000 and 100,000 people in 2016. Once fully operational, the programme will release significant resources in *Intreo* offices and bring the ratio of caseworkers to jobseekers closer to best practice levels. A formal evaluation of the effectiveness and impact of the sweeping activation reforms of the past few years remains to be done, but efforts under the *Pathways to Work Strategy* and *Action Plan for Jobs* have likely helped generate twelve consecutive quarters of positive employment growth.

Employment programme evaluations are becoming more engrained. An evaluation of the *Back to Education Allowance* scheme was conducted by the Economic and Social Research Institute (ESRI) recently. It found that the scheme failed to increase jobseekers' likelihood to return to employment. This analysis was made possible by the department of social protection's new jobseeker dataset. The study is subject to some caveats – including that the conditions to access the programme were tightened in 2014 and more closely linked to labour market needs – but it highlights the need to evaluate resource-intensive activation programmes to adjust policy as needed. The new dataset should make this possible and the government intends to assess other activation programmes soon, such as the *JobBridge* and *Community Employment* programmes. In addition, the government will soon start publishing performance data on *Intreo* offices. These efforts should enhance its ability to improve reform programmes.

Further education and training (FET) programmes are adjusting progressively. SOLAS – the entity established in 2013 to fund, plan and co-ordinate the FET sector – is implementing its five-year strategy as planned in coordination with education and training boards (ETBs). Although adjusting programmes and re-directing resources is time-consuming, new service planning models with ETBs enable a better usage of labour-market intelligence as provided by the SOLAS' strategic labour market research unit and others. Outcome-based funding models are also being introduced on a pilot basis for some ETBs. In addition, 25 new apprentice schemes will be established to cater to labour market needs.

The minimum wage is rising by about 6% as of 1 January 2016 but it is not expected to have a significantly adverse impact on employment. The Low Pay Commission made its first recommendation in July 2015 to increase the hourly minimum wage from EUR 8.65 to EUR 9.15. The government followed its non-binding recommendation but moved forward the effective date for the increase⁽³⁸⁾. The Low Pay Commission indicated that the effect of a moderate incremental adjustment to the minimum wage with a low coverage is unlikely to be significantly adverse for labour demand, basing its opinion on research papers and national as well as international evidence. It did, however, state that a parallel change in the structure of the pay-related social insurance (PRSI) was necessary in order to avoid detrimental effects on small businesses' costs and hours worked. Budget 2016 does introduce changes to PRSI to avoid higher rates applying to earnings at certain levels.

3.4.2. Increasing efficiency in the delivery of healthcare

Pressures on the healthcare system and spending are prominent. The health budget was increased in 2015 for the first time in years, leading the department of health to express confidence in its ability to remain within allocations. However, spending overruns have again materialised at a significant scale in 2015 as structural reforms to improve the cost-effectiveness of the health system are not making sufficient

⁽³⁸⁾ The Low Pay Commission recommended that the change should be implemented no sooner than the second quarter of 2016.

progress and as demand pressures continue. In the year to November, current health expenditure was EUR 489 million (4.3%) above budget plans, with a supplementary allocation of EUR 665 million planned for the year.

Structural efforts to increase cost effectiveness remain incomplete. While important reforms have been launched in the past few years to reduce costs without affecting the delivery of healthcare services more needs to be done. The department of health has only just initiated preliminary discussions for a new agreement with the Irish Pharmaceutical Healthcare Association (IPHA), even though the previous agreement ended in October 2015. Negotiations are likely to take months, which could put at risk the EUR 125 million of savings on medicine costs in Budget 2016. Negotiations with IPHA will focus on international reference pricing (frequency of realignments, reference basket), access and high-technology medicines. The department still is reluctant to activate its pricing powers. While the system of internal reference pricing has generated significant savings on off-patent medicines and increased the use of generics, the authorities have so far not adopted legislation requiring prescriptions for domestic dispensing to be done by international non-proprietary name (INN). Similarly, the use of e-prescriptions has been slow, leaving room for improved prescription practices.

The universal health insurance (UHI) reform process is in doubt. The ESRI recently completed an assessment of the potential costs of moving from the current two-tiered system, which provides unequal access to patients, to a single-tiered UHI. The ESRI's findings are negative for the UHI model as they indicate that it would raise expenditure, partly by increasing services to match unmet needs, but mainly *"because of the intrinsic additional costs that arise when healthcare financing is channelled through insurance companies, which require market margins"* ⁽³⁹⁾. The ESRI study also stresses the uncertainty with its costing exercise and the shortage of reliable data. This makes fast progress in implementing financial management systems reforms – including common charts of accounts across hospitals – all the more essential. While an action plan to implement activity-based funding in hospitals was adopted in May 2015, the actual transition from block-funding of hospital activities is slow. Similarly, the implementation of the eHealth strategy has been slow and the establishment of individual health identifiers, use of e-prescription or electronic health records will take time. These reforms should continue independently of the doubts surrounding the UHI.

3.4.3. Reforming the water sector

Eurostat confirmed Irish Water's classification as part of general government. In July 2015, Eurostat indicated that, based on currently available information, Irish Water should be considered as a non-market entity controlled by government and that it should thus be classified inside the government sector ⁽⁴⁰⁾. It cited a number of factors underpinning its decision, including government control over the company, significant and continuous government funding, the absence of economically significant prices and the 50% test not being met ⁽⁴¹⁾. The Irish government has questioned Eurostat's classification of Irish Water and is still of the view that the utility will eventually pass the market test. Irish Water's inclusion in general government accounts is expected to raise the budget deficit by 0.2% of GDP in 2015 and 2016. Thanks to budgetary impact of much better than expected economic growth, this should not compromise Ireland's ability to comply with the EU fiscal rules.

Safeguarding Irish Water's capital investment plan is critical. The impact of Eurostat's ruling may have implications for Irish Water's capital investment plan. Irish Water's Strategic Plan and Business Plan highlight major infrastructure needs, key priorities and deliverables until 2021. It projects infrastructure investments to increase from EUR 522 million in 2016 to EUR 806 million in 2021. The constraints that

⁽³⁹⁾ See ESRI (2015), *An Examination of the Potential Costs of Universal Health Insurance in Ireland*.

⁽⁴⁰⁾ See <http://ec.europa.eu/eurostat/documents/1015035/6761701/Advise-2015-IE-Classification-of-Irish-Water-Summary.pdf/fdbd9e8f-4823-40c5-9ae8-a08e19324635>.

⁽⁴¹⁾ The test stipulates that sales must cover at least 50% of the production costs over a sustained multi-year period.

inadequate water supply and wastewater treatment facilities impose on growth, competitiveness, housing development and the environment are becoming increasingly visible. Irish Water's investments are a capital item in the budget to be funded mainly through borrowing by the company. As such, Irish Water's investments are not part of the government-funded capital projects in the Infrastructure and Capital Investment Plan 2016–2021. However, Irish Water's classification within general government means that its investments will be part of the budget and will fall within the constraints imposed under the SGP as of 2016.

Acceptance of water charges could gradually improve. There is a need for Irish Water to better explain the necessity to improve infrastructure to the public to increase acceptance of water charges, and to meet its commitments to improve service, deliver significant efficiency gains and reduce costs. Recent figures on payment compliance are moderately encouraging as 745,000 households made a payment during the second billing cycle, compared with 675,000 in the first. Revenue also increased by 24% between the two cycles, but compliance rates remain low given the total customer base of about 1.5 million households.

3.4.4. Reducing legal services costs

It remains to be seen whether the new Legal Services Regulation Act will be effective in lowering costs, following numerous concessions. The Legal Services Regulation Bill, first published in October 2011 under Ireland's commitments of the EU-IMF financial assistance programme, was at last passed by both Houses of the Oireachtas at the end of December 2015. Its passage was made possible following significant additional concessions to the Law Society and Bar Council. Thus, a large number of amendments were introduced at a late stage and affect major issues such as complaints, limited liability partnerships and membership. The new regulatory framework is welcome as it introduces new modes of operations and competitive pressures, and it establishes an oversight of the legal services profession by an external body. However, the concessions granted put the responsibility on the soon-to-be-established Legal Services Regulatory Authority to demonstrate its independence from the legal services profession and to defend the interest of society against vested interests. Close monitoring will therefore be required to assess whether the new regulatory framework lowers costs and delivers improved services. It is encouraging that the authority is required to conduct a review no later than two years after the act's establishment and at least every three years subsequently.

Box 3.1: Infrastructure needs and the Infrastructure and Capital Investment Plan 2016–2021

With the economic crisis, capital expenditure was one of the first items to be cut in order to address large budgetary shortfalls, as occurred in other EU countries. After peaking at 5.2% of GDP in 2008, government capital spending fell to a low of 1.8% of GDP in 2013 before slightly recovering in 2014. The share of capital expenditure in total government expenditure shrank from on average 11.7% in 2000–2008 to 4.4% in 2013. A similar pattern is observed in other programme countries: from comparable starting levels, the Portuguese and Spanish governments also reduced capital expenditure by roughly equal amounts by 2014 (Graph 1).

Capital spending on transport and housing were most affected. By far the largest government capital expenditure item before the crisis, spending in transport infrastructure was cut by two thirds between 2008 and 2013. Still, transport's share in total capital expenditure increased to an average of 35.9% in 2008–2013 as the collapse in housing development was even more severe. From its peak of 1.2% of GDP in 2007, government investment in housing fell by over 95% by 2013 to less than 0.1% of GDP. Capital expenditure in other policy areas like education, health and water also fell significantly but their share in the total remained stable or increased somewhat.

While acknowledging the importance of efficiency and quality, cuts in government infrastructure projects can weigh on the economy's growth potential and the provision of public services. Pressure points have emerged in housing and water services. The government estimates that there is unmet demand for 35,000 social housing units. Irish Water indicates that close to 50% of water is lost through leaks, that capacity headroom in the sector is minimal, and that there are issues with drinking water quality and overloaded wastewater treatment plants. In turn, Dublin is the fourth most congested city with a population fewer than 800,000 people on the TomTom traffic index, with morning and evening peak hour travelling time 80% longer than under non-congested conditions. The World Economic Forum ranked Ireland 27th in the world on infrastructure in its global competitiveness index. Key domestic stakeholders have called for an increase in public investment to sustain competitiveness and long-term growth.

In September 2015, the authorities issued the Infrastructure and Capital Investment Plan for 2016–2021. The plan aims to hold government-funded investment steady at EUR 3.8 billion in 2015 and 2016 before gradually increasing it to EUR 5.4 billion by 2021. The capital investment-to-GDP ratio would remain at historic lows of about 1.7% in 2016 before marginally increasing to 2.0% by 2021, well below the still depressed EU average of 2.9% in 2013–14. The share of gross fixed capital formation in total government expenditure would only increase to around 7.4% by 2021 from 5.6% in 2015. To avert possible negative effects on Ireland's growth potential and on the delivery of key public services the adequacy of capital investment will have to be reviewed regularly.

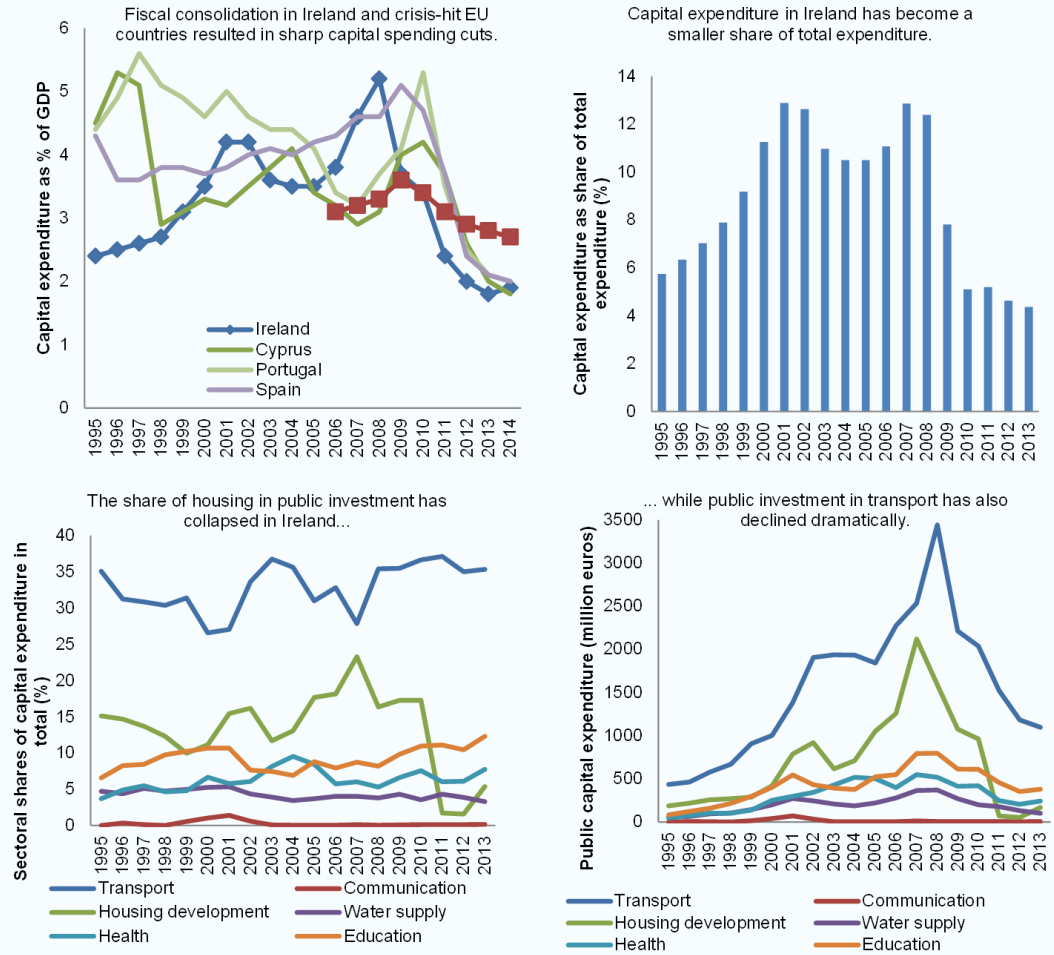
The capital plan projects a reallocation of spending across sectors, including housing. It foresees government investment in transport to remain the largest component, though with a lower share of the total at 29% over 2016–2021. Investment in housing is planned to increase to about EUR 500 million per year (0.3% of GDP in 2016). This is still far below the levels of the early 2000s as a change in the public housing model, to less construction of social housing and more rental housing payments, has resulted in social housing being funded through current rather than capital expenditure. The shares of the education and health sectors are planned to rise significantly compared to 2008–2013.

On top of government spending, the capital plan also reports non-government funded investment from state companies or the Ireland Strategic Investment Fund. Over the period covered by the plan, EUR 14.5 billion are expected to be made available through these channels for investment projects in energy, connectivity, housing and water supply. EUR 4 billion is to be invested in the water sector. Given Eurostat's ruling that Irish Water is currently part of the general government, these investments will count as government expenditure and will therefore enter in the assessment of compliance with the Stability and Growth Pact's expenditure benchmark.

(Continued on the next page)

Box (continued)

Graph 1: Public investment in Ireland and comparator countries



Source: Eurostat

Box 3.2: Knowledge Development Box

The 2016 budget introduced a new corporate tax relief known as the Knowledge Development Box (KDB), a type of patent box. This measure offers a reduced corporate tax rate of 6.25% for qualifying incomes arising from certain types of intellectual property, such as patented inventions and copyrighted material, including software, which are the result of R&D in Ireland. Creating an economic environment attractive to foreign direct investment (FDI) has formed a key pillar of the economic development strategy of Ireland since the late 1950s. Among other factors, the statutory corporate tax rate of 12.5% is generally considered to be one important factor in attracting multinational enterprises (MNEs).

The KDB signals the responsiveness of the Irish government amid changes in the international tax policy environment. The OECD *Base Erosion and Profit Shifting* (BEPS) initiative regarding harmful tax practices has presented a comprehensive reform of international tax rules. In addition, in June 2015 the European Commission has issued its *Tax Transparency Package* which aims to introduce the automatic exchange of information between Member States on tax rulings and it is now re-launching the proposal for a *Common Consolidated Corporation Tax Base* (CCCTB). These developments illustrate the changing international tax policy environment. The KDB shows the Irish government's response to such policy developments, which is to participate in international tax discussions and adapt the domestic corporate tax regime. The ultimate goal is to maintain Ireland's tax competitiveness ⁽¹⁾.

The Irish government designed the KDB with the stated aim of being the first country to offer an intellectual property box that complies with BEPS guidelines. If this is achieved, the KDB will be attractive because it will be unique in providing certainty for tax planners over a longer period. This contrasts with patent boxes in other nations, some of which have less stringent eligibility requirements and lower tax rates, but which will need to be modified or phased out to comply with BEPS.

The European Commission does not advise its Member States against using patent boxes provided that they comply with the *modified nexus* approach. This approach was developed by the OECD as part of the BEPS project and it should prevent companies from exploiting patent boxes to artificially shift profits away from locations where real economic activity takes place to countries offering tax incentives. All Member States, including Ireland, committed to adhering to the *modified nexus* approach for Intellectual Property regimes, in the EU Council's Code of Conduct Group (Business Taxation) in 2014.

Under the new KDB, MNEs will need to provide evidence of substantive real R&D activity in Ireland. Ireland is below the EU average in innovation indicators such as total R&D expenditure as a percentage of GDP and patents per capita. This may partly be explained by the fact that innovation is imported via FDI. While the KDB may also act as an incentive for domestic firms to increase their R&D, many of them may struggle to qualify as they do not have qualifying intellectual property. Foreign-owned companies already account for the majority of R&D activity but spillovers to domestic SMEs have been limited ⁽²⁾.

Nevertheless, a recent European Commission study of R&D tax incentives was critical of existing patent box schemes ⁽³⁾. The research argues that a rationale for patent boxes to stimulate innovation is not evident because it is not clear which market failures patent boxes address. Specifically, it is not obvious why innovations for which clear property rights are already defined should receive special tax incentives. The report concludes that in general patent boxes were more likely to relocate corporate income than to stimulate innovation and suggests that there are alternative measures that are more effective in encouraging R&D activity such as expense-based based tax incentives generally, and particularly wage-based incentives ⁽⁴⁾.

⁽¹⁾ See http://www.budget.gov.ie/Budgets/2016/Documents/Update_on_Irelands_International_Tax_Strategy_pub.pdf.

⁽²⁾ See [European Commission 2015 Country Report on Ireland p.46](#) and [2013/2014 European Commission Annual Report on SMEs](#).

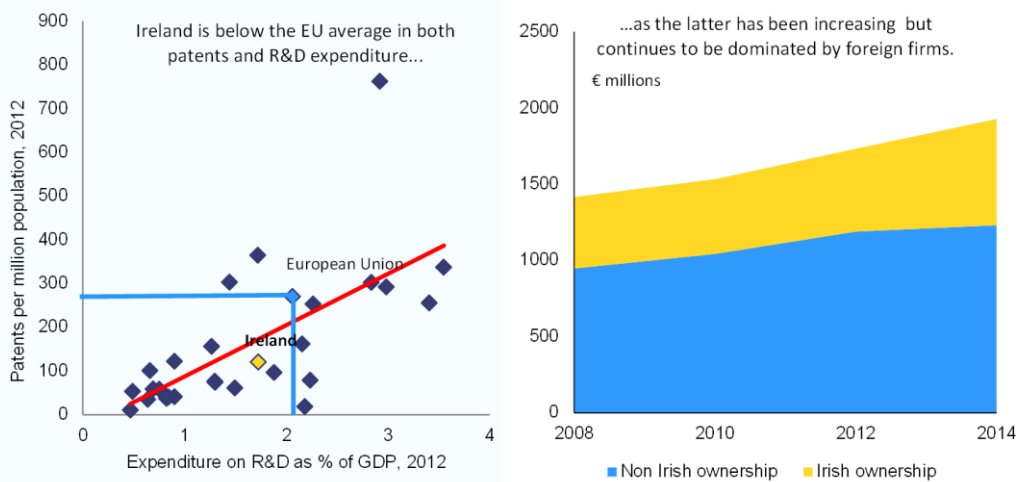
⁽³⁾ See http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_papers/taxation_paper_52.

⁽⁴⁾ Tax incentives based on the wage bill paid to researchers can be considered best practice because they are likely to generate higher knowledge spillovers than other types of R&D expenditure as researchers can move from one employer to another and take their former employer's knowledge with them.

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Box (continued)

Graph 1: **Research and development in Ireland**



(1) The chart on the right shows estimated total current expenditure on R&D by nationality of ownership of the firm.

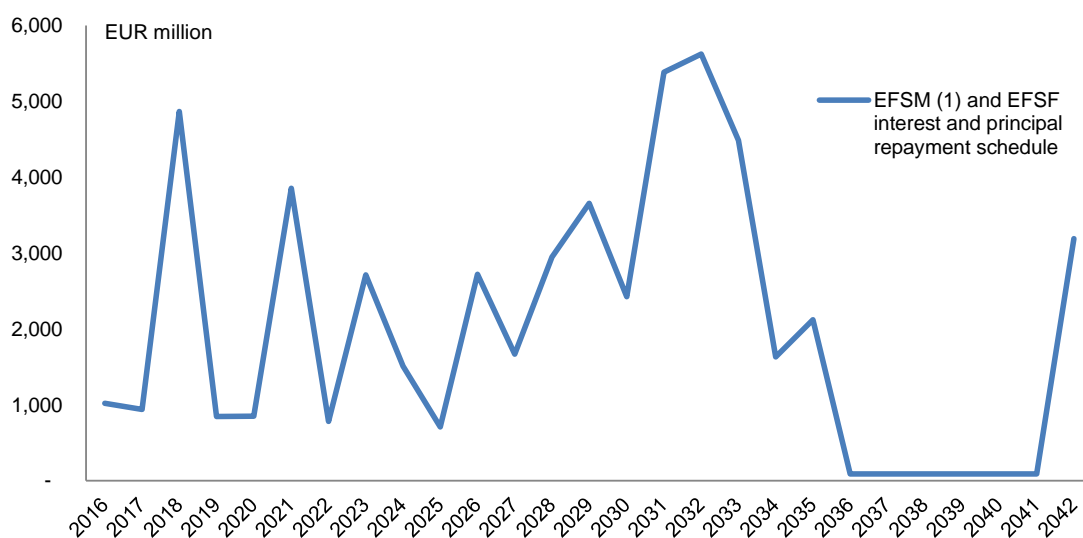
Source: World Bank and CSO

4. FINANCING ISSUES AND CAPACITY TO REPAY

In line with the Eurogroup agreement of 12 September 2014, the EFSM successfully refinanced the EUR 5 billion loan due in December 2015 at the request of Ireland. The EFSM issued bonds in capital markets this autumn in three separate tranches. The operations targeted the longest possible maturity extension without creating peaks in redemptions for Ireland. The EFSM obtained an average maturity extension of 14 years and a funding advantage of nearly 50 basis points, relative to the yields on comparable Irish bonds recently issued. This equates to annual savings for Ireland of approximately EUR 18 million over the next 14 years. The country bears however some one-off costs linked to the operation, mostly bank fees and cost of carry. Ireland has EUR 22.5 billion of EFSM loans outstanding currently, which in 2013 the European Council agreed to an aggregate maturity extension of up to seven years.

The sovereign's financing situation remains comfortable. Ireland raised EUR 13 billion out of a planned issuance of EUR 12-15 billion in government bonds in 2015 and it plans to issue EUR 6-10 billion in long-term bonds in 2016. The sovereign had EUR 15 billion of cash balances at end-September 2015. Having completed the planned IMF repayment earlier in 2015, the NTMA aims to gradually reduce its cash balance holdings. It intends to end 2015 with EUR 10-11 billion in cash in anticipation of a bond redemption of EUR 8.1 billion in April 2016. The redemption profile of EFSF and EFSM loans to Ireland currently extends until 2042, with the next principal repayment technically due in 2018. However, owing to the maturity extensions granted in 2013, the 2018 EFSM maturities will be refinanced ⁽⁴²⁾.

Graph 4.1: EFSM and EFSF repayment schedule



(1) Ireland is not expected to have to refinance in the markets any of its EFSM loans prior to 2027.

Source: European Commission and EFSF/ESM

Under ECB's APP, the CBI purchases mainly government debt, in line with its capital key share of the Eurosystem monthly asset purchase volume objectives. The CBI can purchase up to EUR 700 million of Irish government bonds per month and held EUR 19.8 billion (or 9.7% of GDP) of bonds at end-November 2015, according to the NTMA investor presentation (November 2015). The central bank is expected to purchase EUR 1.9 billion of bonds in the remainder of 2015 and a further EUR 6.4 billion until the APP expires in September 2016. The programme, initially expiring in September 2016, was prolonged last December until the end of March 2017 or in any case until the Governing Council of the

⁽⁴²⁾ On 21 June 2013, the Council adopted Implementing Decision 2013/313/EU to increase the average maturity of EFSM loans to Ireland to by seven years to 19.5 years. Thus, Ireland has the option to request that any maturing tranche under its EFSM loans be extended. This needs to be formally notified four months prior to the relevant expiry date.

ECB sees a sustained adjustment in the path of inflation consistent with its mandate. The ECB also decided to reinvest the principal repayments on the securities purchased and to extend purchases to euro-denominated debt instruments issued by regional and local governments.

The repayment risks for the EFSM and EFSF loans remain low over the medium term. This assumes that the authorities continue to implement agreed fiscal consolidation, financial sector policies and structural reforms, while access to capital markets is maintained. General government debt is expected to decline markedly, as reflected in the debt sustainability analysis. The average maturity of public debt in Ireland is one of the longest in Europe. The replacement of most of the IMF loans with long-term government bonds extended the overall maturity of Irish public debt by about one year⁽⁴³⁾. At end-November 2015, the average weighted maturity of Irish debt stood at an estimated 12.4 years. The average effective interest rate on general government debt stood at a moderate 3.5% in 2014 and is estimated to decline to 3.3% in 2015. For EFSF and EFSM loans, the rates were lower at 2.3% and 3% respectively in 2014⁽⁴⁴⁾. Total interest payments due on EFSF and EFSM loans in 2016 will be close to 0.5% of GDP.

Table 4.1: **Government financing plans**

EUR billion	2015 Provisional Outturn	2016 Estimate
Funding requirement		
Exchequer borrowing requirement (EBR) (1)	0.1	1.7
Medium/long-term debt redemption (2)	14.7	8.2
Other (3)	0.0	1.5
Total requirement	14.8	11.3
Funding sources		
Government bonds (4)	13.7	9.0
Net short-term paper funding	-1.7	1.0
Other (5)	2.6	0.9
Use of cash & other short-term investment balances (- represents an increase)	0.2	0.4
Total sources	14.8	11.3
Financial buffer (6)	10.9	10.5

(1) 2016 EBR estimate as per department of finance and budget 2016.

(2) Includes bond maturities and, in 2015, bond purchases/cancellations/switches and early IMF loan repayments.

(3) Includes contingencies, including for potential bond purchases in 2016.

(4) In its funding statement for 2016 issued on 22 December 2015, the NTMA announced that it plans to issue EUR 6 – 10 billion of government bonds in 2016. EUR 9 billion is used as an indicative amount in this presentation.

(5) Includes net state savings (retail), other medium/long-term funding and, in 2016 and rebate of pre-paid margin on initial EFSF drawdown in 2011.

(6) End-year cash and other short-term investment balances.

Source: NTMA

⁽⁴³⁾ Between the end of the third quarter of 2014 and the end of the first quarter 2015, the weighted average maturity of government bonds and EU/IMF programme debt increased by about one year.

⁽⁴⁴⁾ The difference in the effective interest rates of EFSF and EFSM loans is explained by the type of loan (fixed or variable interest rate), the timing of the issuance and the applicable funding costs.

ANNEX 1

State of play with Macroeconomic Imbalance Procedure (MIP) relevant recommendations

Public finance and taxation			
<i>Fiscal policy and fiscal governance</i>			
<i>Announced measures</i>	<i>Adopted measures</i>	<i>Implemented measures</i>	<i>Source of commitment</i>
	<ul style="list-style-type: none"> Budget 2016 projects an improvement of the structural balance in 2016 of 0.8% of GDP, above the 0.6% of GDP required to ensure sufficient progress towards the MTO. Based on the Commission forecast, the improvement of the structural balance in 2016 also exceeds the required 0.6% of GDP. Conversely, based on the Commission forecast the growth rate of government expenditure, net of discretionary revenue measures, is expected to exceed the expenditure benchmark by some 0.4% of GDP in 2016, pointing to the risk of some deviation. The domestic expenditure 	<ul style="list-style-type: none"> For 2015, the authorities project a general government deficit of 2.1% of GDP, well below the 3.0% of GDP reference value in the Treaty. The Commission 2015 autumn forecast projects Ireland to bring its general government deficit durably below 3% of GDP in 2015 and within the forecast horizon. 	<p>CSR 1 – 2015</p> <ul style="list-style-type: none"> Ensure a durable correction of the excessive deficit in 2015. Achieve a fiscal adjustment of 0.6 % of GDP towards the medium-term budgetary objective in 2016. Use windfall gains from better-than-expected economic and financial conditions to accelerate the deficit reduction and debt reduction. Limit the existing discretionary powers to change expenditure ceilings beyond specific and predefined contingencies.

	<p>ceilings have been significantly revised on the back of better than expected growth. Such revisions affect the underlying purpose of expenditure ceilings notably to anchor government expenditure over the medium term and to avoid pro-cyclical expenditure policies.</p> <ul style="list-style-type: none"> Part of very significant revenue windfalls from much stronger than expected economic growth are being used to finance increased permanent expenditure and tax cuts in 2015 and 2016, rather than to accelerate the reduction of still high government debt. 		
<i>Broaden the tax base</i>			
	<ul style="list-style-type: none"> Measures implementing internationally agreed efforts to reduce tax avoidance can contribute to broadening the tax base. The changes to the Universal Social Charge and the introduction of further tax credits in budget 2016 are likely to further narrow the 	<ul style="list-style-type: none"> 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. 	<p>CSR 1 – 2015</p> <ul style="list-style-type: none"> Broaden the tax base and review tax expenditures, including on value-added taxes (VAT).

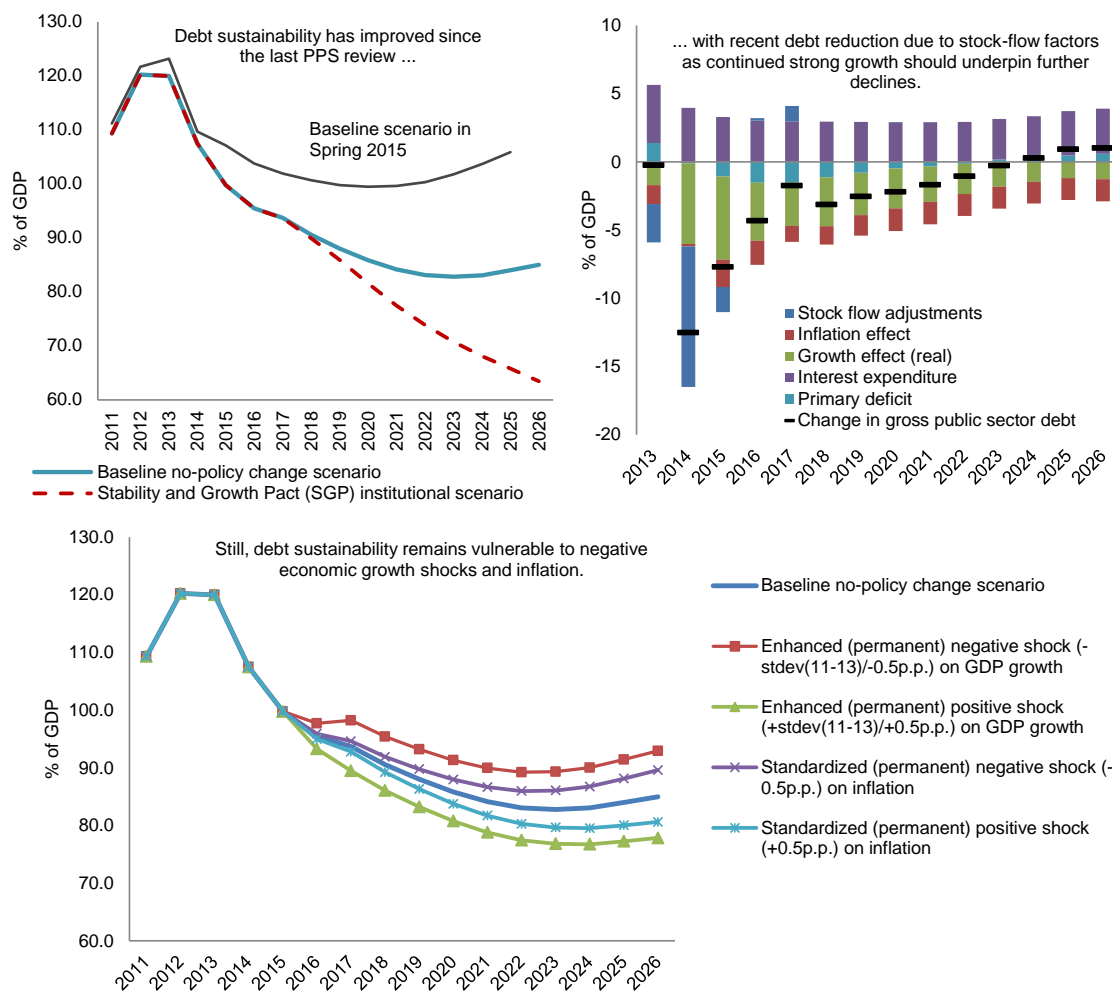
	<p>tax base.</p> <ul style="list-style-type: none"> The decision to postpone by two years the revaluation of self-assessed property values, used to calculate local property tax (LPT) liabilities, represents a lost opportunity to broaden the tax base. No other measures have been taken to broaden the tax base. The Irish authorities completed a rolling programme of tax expenditure reviews and publish an annual report in this regard. However, the review process does not cover VAT related tax expenditures. 		
Financial sector			
<i>Financial services</i>			
<ul style="list-style-type: none"> The recent reform of court rules aims to streamline court proceedings and is expected to lead to a reduction in the number of adjournments. Under the proposed rules, banks will not be able to use civil bills for strategic purposes anymore, as they will 	<ul style="list-style-type: none"> A revised plan for the implementation of the central credit registry (CCR) has been adopted, pushing back the timeline for effective implementation. Lenders may start submitting data on individuals from end 	<ul style="list-style-type: none"> The five main mortgage holders' mortgage restructuring proposals are now monitored by the central bank through a more granular framework that has replaced the Mortgage Arrears Restructuring Targets (MART). As of end-June, the majority of the concluded 	<p>CSR 4 – 2015</p> <ul style="list-style-type: none"> Finalise durable restructuring solutions for a vast majority of mortgages in arrears by end-2015 and strengthen the monitoring arrangements by the Central Bank of Ireland (CBI).

<p>need to show the steps undertaken prior to addressing the court. This should reduce the high incidence of adjournments arising from inadequately prepared applications to court in repossession.</p> <ul style="list-style-type: none"> In proceedings under the Personal Insolvency Act, a new review mechanism introduced the option, under certain conditions, of appealing to the court if creditors refuse to accept a personal insolvency arrangement. This effectively removes the bank veto in existence so far. 	<p>September 2016, while the deadline for the submissions for all categories will be only at the end of 2017. Inquiries to the CCR when granting new loans to individuals will become mandatory for lenders from 2018 onwards, while it will become obligatory for all categories of loans in mid-2018. The development of secondary legislation is ongoing, with the intention to finalize the regulations by March 2016.</p>	<p>restructuring solutions were meeting the terms of arrangements. The CBI has requested banks to provide plans on how they intend to conclude sustainable solutions with the majority of mortgage borrowers in arrears by the end of March 2016.</p> <ul style="list-style-type: none"> The CBI started publishing statistics on non-bank lenders mortgage arrears portfolios in early 2015, as more non-banks hold mortgage loan arrears, especially long-term ones. To increase the use of sustainable debt solutions, including the personal insolvency procedure, representatives of the Money Advice and Budgeting Service (MABS) and of the Insolvency Service of Ireland (ISI) are now present at court premises for all repossession hearings. NAMA continues ahead of its original schedule with the sale of its development property and commercial loan portfolio. By end-October 2015, over EUR 30 billion had been generated by the sale of loans and debtors refinancing their debt. 	<ul style="list-style-type: none"> Ensure that restructuring solutions for loans to distressed SMEs and residual commercial real-estate loans are sustainable by further assessing banks' performance against own targets. Take the necessary steps to ensure that a central credit registry is operational by 2016.
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ANNEX 2

Debt sustainability analysis

Graph A2.1: Gross government debt projections



(1) The baseline scenario assumes no-policy change from 2017 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.

(2) The 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 point until the medium-term objective (MTO) is reached.

(4) The strong contribution of stock-flow adjustment to debt reduction 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.

(3) The sensitivity tests on real GDP growth consists of enhanced (permanent) negative and positive shocks (-1 standard deviation/+1 standard deviation for the first 2 projection years, followed by -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 (2026). 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.

Source: European Commission

The debt sustainability analysis (DSA) for Ireland shows important changes compared to the last PPS review but the high debt still remains a major source of vulnerability. From 2017, the baseline scenario of the DSA is based on the no-policy-change assumption i.e. only currently adopted and sufficiently detailed measures are considered. Under this scenario, the general government debt-to-GDP ratio would bottom out at around 83% in 2023 and then rise again, mainly on account of increasing costs of ageing, to reach 86% of GDP in 2026 (Graph A2.1). This is estimated to be 20 percentage points of

GDP lower than the previous DSA carried out for the third PPS review (Spring 2015). This is mostly on the back of the significant revision to the level of nominal GDP in 2014 and 2015 of about EUR 3.6 billion and EUR 11.9 billion respectively, which carries over into the subsequent years. The better-than-expected primary budget balance significantly contributes to lower debt level by 0.2%, 0.4% and 0.9% of GDP in 2014, 2015 and 2016 respectively. Under the SGP scenario⁽⁴⁵⁾, public debt is projected to decline to 63.4% of GDP in 2026 (19.6 percentage points less than in the baseline no-policy change scenario). However, this would require an average primary surplus over the projection horizon of 2.5% of GDP, 2.2 percentage points higher than that projected under the no-policy change scenario. Moreover, the projected effect of the budgetary impact of ageing would still lead to an increasing debt-to-GDP ratio in the early 2020s. These debt projections do not take into account the potential positive stock-flow impact on the level of debt of the state's share disposals in the domestic banks which are valued at about 8.8% of GDP.

The debt profile remains exposed to negative economic growth shocks. Given the high level of initial debt, negative shocks to economic growth and to interest rates would have a sizeable impact on the projected profile of government debt. In the no-policy-change scenario, an enhanced sensitivity test on real GDP growth, combining the country-specific historical variability of output and a permanent negative shock of 0.5 percentage point on GDP growth⁽⁴⁶⁾, would increase the public debt-to-GDP ratio by 7 percentage points to about 93% of GDP by 2026. In addition, a permanent positive shock of 1 percentage point to the short- and long-term interest rates on newly issued and rolled over debt would increase the public debt-to-GDP ratio by 4.1 percentage points to about 89% of GDP by 2026.

The high stock of public debt and age-related expenditure still pose risks to medium and long-term debt sustainability. While sustainability indicators have significantly improved compared to the May 2015 Ageing Report, Ireland still faces significant challenges beyond the medium term.

- The S1 medium-term sustainability indicator⁽⁴⁷⁾ is 2.7% of GDP, 2.4 percentage points of GDP lower than in the previous PPS review, mostly on account of the more favourable initial budgetary position, but still above the EU average. Compared to the baseline scenario, it assumes a cumulative improvement in the structural primary balance of 2.7% of GDP over five years (from 2018 to 2022) to reach the debt reference value of 60% of GDP by 2030. Amongst other factors, this structural primary balance improvement chiefly stems from the high debt requirement (or the additional adjustment due to the initial distance from the debt target, estimated at 3.1% of GDP) given the current high level of government debt and less so, to the additional required adjustment due to the projected costs of ageing (1.3% of GDP). By contrast, the favourable initial budgetary position (i.e. the gap to the debt-stabilizing primary balance) improves the sustainability indicator by -1.6% of GDP.
- In the longer term, risks remain less pronounced, but still important with the S2 indicator⁽⁴⁸⁾ pointing to a required permanent fiscal adjustment of 1.3% of GDP, compared to the baseline scenario, to ensure that the debt ratio remains on a sustainable path. The S2 improvement compared to the previous PPS review is also primarily due to a more favourable initial budgetary position which partly offsets the projected costs of ageing from the estimated increases in pension, health care and long-term care expenditures.

⁽⁴⁵⁾ The SGP scenario assumes that, for countries under the EDP, the structural adjustment is in line with effort recommended by the Council, and thereafter, an annual structural consolidation effort of 0.5 percentage point of GDP or 0.6 percentage point if public debt exceeds 60% of GDP, is maintained until the medium-term objective is reached.

⁽⁴⁶⁾ This enhanced sensitivity test is based on a reduction/increase of real GDP growth by one standard deviation, calculated over the last three years of historical data, for two years. After two projection years, the usual -0.5/+0.5 percentage point permanent shocks on GDP growth would be applied till the end of the projections horizon.

⁽⁴⁷⁾ See Table A2.1 for definition.

⁽⁴⁸⁾ See Table A2.1 for definition.

Table A2.1: Sustainability indicators (in % of GDP)

	Ireland		
	No-policy-change scenario	Previous PPS review (Spring 2015)	SP scenario
S2*	1.3	2.5	-2.9
<i>of which:</i>			
Initial budgetary position (IBP)	-0.5	0.3	-3.8
Long-term cost of ageing (CoA)	1.9	2.2	0.9
<i>of which:</i>			
pensions	1.0	1.1	0.2
healthcare	1.0	1.0	0.9
long-term care	0.7	0.7	0.8
others	-0.8	-0.7	-0.9
S1**	2.7	5.1	-2.0
<i>of which:</i>			
Initial budgetary position (IBP)	-1.6	0.4	-4.8
Cost of delaying adjustment	0.4	-	-0.4
Debt requirement (DR)	3.1	3.1	2.5
Long-term cost of ageing (CoA)	1.3	1.6	0.7
S0 (risk for fiscal stress)***	0.38	:	:
<i>Fiscal subindex</i>	0.14	:	:
<i>Financial-competitiveness subindex</i>	0.48	:	:
Debt as % of GDP (2014)		107.5	
Age-related expenditure as % of GDP (2014)		21.6	

* The long-term sustainability gap (S2) indicator shows the immediate and permanent adjustment required to satisfy an inter-temporal budgetary constraint, including the costs of ageing. The S2 indicator has two components: i) the initial budgetary position (IBP) which gives the gap to the debt stabilising primary balance; and ii) the additional adjustment required due to the costs of ageing. The main assumption used in the derivation of S2 is that in an infinite horizon, the growth in the debt ratio is bounded by the interest rate differential (i.e. the difference between the nominal interest and the real growth rates); thereby not necessarily implying that the debt ratio will fall below the EU Treaty 60% debt threshold. The following thresholds for the S2 indicator were used: (i) if the value of S2 is lower than 2, the country is assigned low risk; (ii) if it is between 2 and 6, it is assigned medium risk; and, (iii) if it is greater than 6, it is assigned high risk.

** The medium-term sustainability gap (S1) indicator shows the upfront adjustment effort required, in terms of a steady adjustment in the structural primary balance to be introduced over the five years after the forecast horizon, and then sustained, to bring debt ratios to 60% of GDP in 2030, including financing for any additional expenditure until the target date, arising from an ageing population. The following thresholds were used to assess the scale of the sustainability challenge: (i) if the S1 value is less than zero, the country is assigned low risk; (ii) if a structural adjustment in the primary balance of up to 0.5 p.p. of GDP per year for five years after the last year covered by the autumn 2015 forecast (year 2017) is required (indicating an cumulated adjustment of 2.5 pp.), it is assigned medium risk; and, (iii) if it is greater than 2.5 (meaning a structural adjustment of more than 0.5 p.p. of GDP per year is necessary), it is assigned high risk.

*** The S0 indicator reflects up to date evidence on the role played by fiscal and financial-competitiveness variables in creating potential fiscal risks. It should be stressed that the methodology for the S0 indicator is fundamentally different from the S1 and S2 indicators. S0 is not a quantification of the required fiscal adjustment effort like the S1 and S2 indicators, but a composite indicator which estimates the extent to which there might be a risk for fiscal stress in the short-term. The critical threshold for the overall S0 indicator is 0.43. For the fiscal and the financial-competitiveness sub-indexes, thresholds are respectively at 0.35 and 0.45.

Source: European Commission and 2015 Stability Programme

ANNEX 3

Supplementary tables

Table A3.1: **Fiscal accounts**

	2010	2011	2012	2013	2014	2015	2016	2017
	<i>% of GDP</i>							
Indirect taxes	10.9	10.2	10.5	10.7	11.2	11.0	10.9	10.9
Direct taxes	11.8	12.0	12.8	12.8	13.2	13.2	12.8	12.7
Social contributions	5.7	5.7	5.5	5.7	5.8	5.7	5.5	5.4
Sales	3.2	3.0	2.8	2.5	2.2	2.3	2.1	2.0
Other current revenue	1.5	1.6	1.9	1.9	1.6	1.5	1.1	0.9
Total current revenue	33.0	32.5	33.5	33.7	34.0	33.6	32.4	31.8
Capital transfers received	0.3	0.5	0.3	0.3	0.4	0.4	0.4	0.4
Total revenue	33.3	33.0	33.8	34.0	34.4	34.0	32.8	32.2
Compensation of employees	11.6	11.0	10.8	10.4	9.8	9.6	9.2	9.1
Intermediate consumption	5.4	4.9	4.7	4.6	4.6	4.8	4.5	4.4
Social transfers in kind via market producers	3.0	2.9	3.0	2.8	2.7	2.5	2.4	2.4
Social transfers other than in kind	14.3	13.7	13.8	13.1	12.1	11.3	10.5	10.2
Interest paid	3.0	3.4	4.1	4.3	4.0	3.3	3.0	3.0
Subsidies	1.1	1.0	1.1	1.0	1.0	1.0	0.9	0.9
Other current expenditure	1.6	1.5	1.4	1.6	1.4	1.2	1.3	1.2
Total current expenditure	40.0	38.4	38.9	37.7	35.7	33.6	31.9	31.2
Gross fixed capital formation	3.3	2.4	2.1	1.8	2.0	2.0	2.0	1.9
Other capital expenditure	22.3	4.8	0.9	0.1	0.6	0.5	0.5	0.5
Total expenditure	65.7	45.5	41.8	39.7	38.2	36.2	34.3	33.7
General government balance	-32.3	-12.5	-8.0	-5.7	-3.9	-2.3	-1.5	-1.5
Underlying government balance (EDP)	-13.3	-8.6	-8.0	-5.7	-3.9	-2.2	-1.5	-1.5
	<i>EUR billion</i>							
Indirect taxes	18.1	17.8	18.3	19.3	21.1	22.5	23.8	24.9
Direct taxes	19.6	20.8	22.3	22.9	24.9	26.9	27.9	28.9
Social contributions	9.5	10.0	9.7	10.3	10.9	11.6	11.9	12.3
Sales	5.3	5.2	4.9	4.6	4.2	4.6	4.5	4.5
Other current revenue	2.4	2.7	3.3	3.4	3.1	3.0	2.4	1.9
Total current revenue	54.8	56.5	58.5	60.4	64.2	68.6	70.5	72.5
Capital transfers received	0.6	0.9	0.6	0.6	0.7	0.8	0.9	0.9
Total revenue	55.4	57.3	59.1	61.0	65.0	69.5	71.4	73.4
Compensation of employees	19.3	19.2	18.9	18.7	18.6	19.5	20.0	20.8
Intermediate consumption	9.0	8.6	8.2	8.2	8.8	9.7	9.8	10.0
Social transfers in kind via market producers	5.0	5.0	5.2	5.0	5.2	5.2	5.3	5.4
Social transfers other than in kind	23.8	23.8	24.2	23.5	22.9	23.0	22.9	23.4
Interest paid	4.9	5.9	7.2	7.7	7.5	6.8	6.6	6.8
Subsidies	1.8	1.7	1.9	1.8	1.9	2.0	2.0	2.1
Other current expenditure	2.7	2.5	2.4	2.8	2.6	2.5	2.8	2.7
Total current expenditure	66.5	66.7	68.0	67.7	67.4	68.7	69.3	71.1
Gross fixed capital formation	5.6	4.1	3.6	3.3	3.7	4.2	4.3	4.4
Other capital expenditure	37.0	8.3	1.5	0.3	1.2	1.1	1.1	1.2
Total expenditure	109.1	79.1	73.1	71.2	72.3	74.0	74.7	76.8
General government balance	-53.7	-21.8	-14.1	-10.2	-7.3	-4.5	-3.3	-3.4
Deficit-increasing financial sector measures	31.575	6.8	0.0	0.0	0.0	0.1	0.1	0.0
Underlying government balance (EDP)	-22.1	-15.0	-14.1	-10.2	-7.3	-4.4	-3.2	-3.4

Source: European Commission

Table A3.2: General government debt projections (based on 2015 Autumn forecast)

	2010	2011	2012	2013	2014	2015	2016	2017
Government deficit (% of GDP)	-32.3	-12.5	-8.0	-5.7	-3.9	-2.2	-1.5	-1.5
Government gross debt (% of GDP)	86.8	109.3	120.2	120.0	107.5	99.8	95.4	93.7
levels, EUR billion								
Government deficit	-53.7	-21.8	-14.1	-10.2	-7.3	-4.5	-3.3	-3.4
Gross debt	144.2	190.1	210.2	215.3	203.2	204.0	207.7	213.7
Change in gross debt	39.6	45.9	20.1	5.1	-12.1	0.8	3.7	6.0
Nominal GDP	166.2	173.9	174.8	179.4	189.0	204.5	217.6	228.1
Real GDP	166.2	170.5	170.7	173.2	182.2	193.2	201.8	208.9
Real GDP growth (% change)	0.4	2.6	0.2	1.4	5.2	6.0	4.5	3.5
Change in gross debt (% of GDP)	23.8	26.4	11.5	2.8	-6.4	0.4	1.7	2.6
Stock-flow adjustments (% of GDP)	-8.5	13.9	3.5	-2.8	-10.3	-1.8	0.2	1.1
% of GDP								
Gross debt ratio	86.8	109.3	120.2	120.0	107.5	99.8	95.4	93.7
Change in gross debt ratio	25.0	22.5	10.9	-0.2	-12.5	-7.7	-4.3	-1.8
Contribution to change in gross debt								
Primary balance	-29.3	-9.1	-4.0	-1.4	0.1	1.1	1.5	1.5
"Snow-ball" effect	4.2	-0.5	3.5	1.2	-2.1	-4.7	-2.9	-1.4
of which								
<i>Interest expenditure</i>	3.0	3.4	4.1	4.3	4.0	3.3	3.0	3.0
<i>Real growth effect</i>	-0.3	-2.1	-0.2	-1.7	-5.9	-6.0	-4.2	-3.2
<i>Inflation effect</i>	1.5	-1.7	-0.4	-1.4	-0.2	-2.0	-1.8	-1.2
Stock-flow adjustments	-8.5	13.9	3.5	-2.8	-10.3	-1.8	0.2	1.1
<i>Implicit interest rate</i>	4.7	4.1	3.8	3.6	3.5	3.3	3.2	3.3

Source: European Commission

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