BUDGET REVIEW
ECONOMIC TRENDS

IBEC

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Minister grasps nettle of harsh corrective action

The budgetary actions of any country with a mounting fiscal deficit attract the scrutiny of the international financial markets, the global investment community and the credit rating agencies. In the euro area it also attracts the attention of the European Central Bank, the European Commission and other euro area finance ministers. The current plight of the Irish economy, therefore, requires bold and indeed harsh measures to turn around the public finances. They are necessary because the growing debt levels are unsustainable. It is important that the Budget re-establish the confidence of international financial markets and make a solid and noticeable start to restoring stability to the public finances. Stability in the public finances is a prerequisite for economic growth; without it neither businesses nor consumers have the confidence to spend and invest. In a remarkably short Budget, the Minister in large measure met these challenges.

The dire economic situation required government to take further immediate, firm and credible action to contain the general government deficit that threatened to continue to spiral out of control. In the last 18 months, the government had taken adjustment measures amounting to €8 billion in 2009, without which the government estimates the deficit would have ballooned to 20% of GDP. Despite these measures, the planned deficit for 2009 of 10.8% of GDP announced in the April Supplementary Budget will come in at 11.8%. At such a high level there was no choice other than to take measures to stabilise the deficit in 2010 and commence the consolidation of the public finances to bring the deficit down to below 3% under the excessive deficit procedure of the Stability and Growth Pact.

The recent decision by the European Commission to extend by one year the adjustment period for a reduction in the deficit to below 3% of GDP to 2014 was in no way a signal to soften the pace of corrective action. On the contrary, it was a recognition that "unexpected adverse economic events with major unfavourable budgetary effects have occurred in Ireland due exclusively to a much worse than anticipated downturn".

IBEC in its pre-budget submission had argued that Budget 2010 was a defining moment for Ireland's economic prospects, which required government to take brave decisions to return the public finances to a sound footing. We argued for the need to frontload the fiscal consolidation process so that Budget 2010 delivers the majority of the adjustment needed, permitting less severe budgetary adjustments in subsequent years. This, we said would return the economy to trend growth much more quickly than the gradualism employed in the 1980s.

The Minister's approach was decisive, introducing a package of measures rightly focused on bringing the level of government spending a step closer to matching the greatly diminished quantum of tax revenue available to finance it. The Minister said that the mounting debt service costs, the fragility of the financial markets and the need to restore business and consumer confidence argued against a more gradual reduction in the deficit. He rejected further increases in taxation, drawing attention to the significant progressivity of the tax increases in 2009 and saying that we had reached the limit of increasing taxation. The burden of adjustment in 2009 therefore had to fall on expenditure. By acting decisively now, the further adjustments required in 2011 and 2012 will be less onerous.

Our major criticism of the budget is that it did not do more towards keeping people in work, rather than spending the same funds on those people as they lose their jobs. IBEC has repeatedly urged government that alongside restoring the functionality of the financial sector and stabilising the public finances, there is an equally important third leg in the economic recovery strategy, which is to support enterprise and employment. So far there has been only a minimalist response to the jobs crisis.

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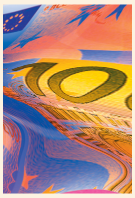

Economic analysis

According to government estimates, GDP fell by 7.5% in 2009, employment fell by 7.8% and the unemployment rate rose to 11.8%. Prices measured by the Consumer Price Index fell by 4.4% and on the EU Harmonised Index measure by 1.7%. The Stability Programme Update, which accompanies the Budget, sets out a forecast and budgetary targets out to 2014, the period agreed with the European Commission to reduce the deficit to below 3% of GDP. The government expects that the economy will return to positive growth in the next six to nine months, but that GDP for next year as a whole will decline by 1.3%. It estimates that the potential growth rate of the economy is 3% per annum, but given the significant current under-utilised capital and labour (negative output gap), the economy can grow at above trend. The Department of Finance's forecast assumes an annual average growth rate of 4% over the 2011-2014 period. The main economic aggregates are given in the table below.

Government macroeconomic prospects

	2009	2010	2011	2012	2013	2014
GDP	-7.5	-1.3	3.3	4.5	4.3	4.0
Private consumption	-7.2	-3.0	2.6	3.4	3.3	3.2
Gov't consumption	-0.6	-3.0	-0.5	-0.5	-0.5	-0.5
Investment	-33.9	-19.2	4.5	7.8	8.5	7.8
Exports	-2.7	0.4	3.4	4.0	3.8	3.5
Imports	-9.0	-2.8	2.6	2.9	3.0	2.8
Inflation (CPI)	-4.4	-0.8	1.8	2.0	2.0	2.0
Inflation (HICP)	-1.7	-1.2	1.0	1.7	1.8	1.8
Employment growth	-7.8	-3.4	1.0	2.3	2.5	2.3
Unemployment rate (%)	11.8	13.2	12.6	11.8	10.8	9.5

Table 1

This is close to the ESRI's forecasts for the period and indeed uses the ESRI's HERMES forecasting model. In our view, though the economy might be capable of such growth, we believe that the forecasts are probably at the top end of the range and would depend on continued strong global growth. This is by no means certain and the Department forecasts for global growth do not go beyond 2011. In our view, growth over the period is more likely to be nearer to the potential growth rate. We are also a little sceptical that employment would record positive growth in 2011, the same year in which the economy is forecast to return to growth. We believe there could be more of a lag. While accepting that growth may emerge in the latter half of 2010, there is a risk that companies, possibly influenced by likely slower growth in the US economy in 2011, may hesitate before resuming employment growth. If this proves to be the case, there are implications for a somewhat higher rate of unemployment and therefore a more difficult consolidation of the public finances.

These, however, are only risks to bear in mind, and the government's forecast outcomes may well materialise. One major factor on the upside is the positive impact that the strong adjustment measures taken in this Budget will have on business and consumer confidence. The Minister said that the worst is over and his budgetary arithmetic suggests that the adjustment of €4 billion in 2010 will give way to €3 billion in 2011 and €3 billion in 2012.

The Budget has delivered a €4 billion adjustment in 2010 and a general government balance of -11.6% of GDP, thereby stabilising the deficit. Unlike the adjustments in 2009, the focus was rightly on expenditure reductions, which are likely to have a less damaging impact on the economy than further tax increases. The government also points to the fact that the corner is being turned, as the decline in tax receipts has already moderated, the cost of borrowing has reduced and the slowdown in the rate of increase in unemployment eases expenditure pressures.

As growth returns to the Irish economy from 2011, tax revenue growth will also resume but from a much lower base. As this growth will be export based and less tax rich, policy changes are necessary. Without change, the government estimates that tax revenues would still be below €40 billion by the end of the forecast period – less than the level of 2008. Ongoing changes resulting in an adjustment of €3 billion in each of 2011 and 2012 will be needed. The Commission on Taxation recommended that the tax base should be widened and subject to less volatility from activity such as property transactions. The Renewed Programme for Government has committed to the introduction of a property tax which will broaden the tax base. Other measures mentioned in the Budget that could have positive revenue implications for the Exchequer are the new system of income taxation in 2011 including a universal social contribution to replace the existing levies. Water metering for domestic dwellings is also in preparation.

Government debt and deficit

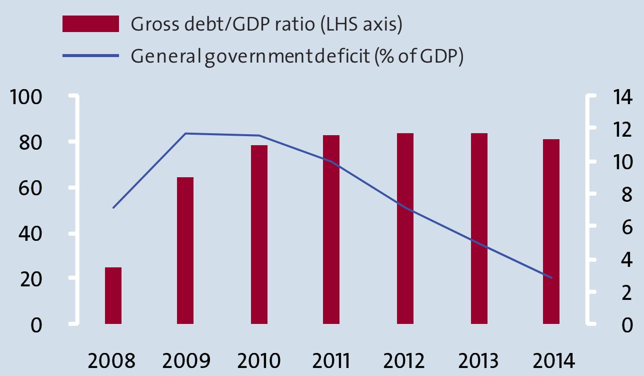

Figure 1

The strong consolidation measures taken in this budget together with tax changes to be introduced from 2011 and the return to global growth will set the public finances on a corrective path that would see the deficit reduce to 2.9% of GDP by 2014 and the debt ratio decline from 83.9% of GDP in 2012 to 80.8%

Personal taxation and incomes

It is difficult to recall a previous Budget with as few taxation measures as this one. The Minister for Finance had increased the taxation burden considerably in his previous two Budgets and the focus of Budget 2010 was firmly on the expenditure side. This is not to say that further tax changes will be avoided in future years. Indeed, in his speech the Minister indicated that significant reform of the income taxation system, including levies and PRSI, will be introduced in 2011. Further base broadening of the income tax system and introduction of other taxes such as on property are also on the way. It is also possible that the upcoming Finance Bill might introduce changes to income tax relief on personal pension contributions.

For 2010, however, the changes to personal taxation are minimal and largely relate to high earners. The horizontal tax measure which applies a minimum effective tax rate to high earners has been amended. The minimum tax rate has been increased from 20% to 30% and the income threshold for the tax has been reduced from €250,000 to €125,000. This is expected to raise about €55 million per annum. It will greatly restrict the degree to which high income earners can avail of various tax reliefs. In addition to the minimum tax rate, the income of high earners is also subject to PRSI and the levies. A new levy has also been introduced for Irish domiciled individuals who are neither resident nor ordinarily resident in Ireland. In cases where these individuals have assets worth over €5 million in Ireland and whose worldwide income exceeds €1 million, a new annual levy of €200,000 will apply. No estimates were provided for the likely Exchequer yield from this levy and many of the details remain to be clarified in the Finance Bill. It is unlikely, however, that a large number of people will be affected by the measure.

Mortgage interest relief has been extended for a further seven years for those currently eligible but the relief is to be scrapped entirely by the end of 2017. Full relief will be available to eligible persons buying property before July 2011 and transitional measures will apply from then until the end of 2013. This is a significant change to the tax treatment of owner occupied housing in Ireland and comes after the OECD and others have recommended this. In his speech the Minister also signalled significant changes to the income tax system for 2011. The system of PRSI, income and health levies will be tidied up into a single universal social contribution. The Minister indicated that this would apply to income on a wide base, which suggests that a ceiling and perhaps a floor will not apply. Reliefs are likely to be minimal and issues raised by the Commission on Taxation report in relation to PRSI on aspects of employee financial involvement (share options etc) will be examined in the design of this new social security charge.

Substantial cuts have been implemented in public sector salaries. Following the introduction of the public sector pensions levy in April, the Budget 2010 cuts bring the cumulative reduction in average public sector pay to about 14%. Given that one in five workers are employed in the public sector this will have a severe impact on disposable household income in 2010. The reforms announced to public sector pensions are also significant and will yield considerable savings in future years. While the public sector pay reductions are unlikely to result in further immediate knock-on cuts in private sector wages, they should reduce administrative prices and will inevitably have a dampening effect on wages over the coming years. In the private sector, the largest wage reductions are likely to be seen for new employees.

Business taxation and measures

Similar to the income taxation regime, a few minor adjustments but no substantial changes were introduced in the area of business taxation. The three-year corporation tax exemption for new companies will be extended to eligible businesses for 2010. This exemption applies to both trading income and certain capital gains in cases where tax liability does not exceed €40,000. The accelerated capital allowance regime for certain energy efficient equipment has been extended to a further three new categories of equipment. An employers' PRSI exemption has been introduced for one year for businesses employing those who have been on the Live Register for at least six months. Significantly, the Minister again provided a strong endorsement of the current corporation tax regime. He said that the 12.5% corporation tax rate had become an 'international brand' and that it was 'here to stay'. This was an important message to send to existing and potential foreign investors and will dispel any fears about future changes to corporation tax rates.

There was a mixed outcome for investment in training measures. The budget for Skillnets has remained unchanged at €17 million but the FÁS budget for training for people in employment has been cut by 25% to €79 million. A new activation fund has been established which is to be targeted at construction and low skilled workers with a budget of €20 million. Funding of €9.5 million has been provided for training and support measures for the food industry.

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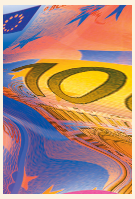
The Minister flagged that improvements to the R&D offer and measures aimed at enhancing Ireland's attractiveness as a hub for the international funds industry would be brought forward in the Finance Bill. The recent changes to intellectual property (IP) taxation introduced in the UK mean that Ireland must also continue to review the attractiveness of its IP taxation regime.

Indirect taxation

The Budget made a number of significant changes in the indirect taxation area. In order to help stem the economic losses associated with cross-border shopping the Minister has reduced the average excise content on alcohol by 20%. He has also reduced the standard rate of VAT from 21.5% to 21%. Unfortunately this will cause considerable administrative problems for business. Combined with the increase in the UK VAT rate, however, the differential in our VAT rates with our nearest neighbour has fallen from 6.5% to 3.5%. The new carbon tax will increase fuel costs by between 3.5% and 11%. The impact on auto-diesel and petrol was immediate and most other fuels will see the price increases introduced from 1 May 2010. While the companies engaged in the Emissions Trading System (ETS) will not be subject to a carbon tax, there was no mention in the Budget measures of exemptions for those companies engaging in voluntary agreements with Sustainable Energy Ireland, as recommended by the Commission on Taxation report.



Social welfare

The Budget introduced a total social welfare savings package of €760 million, reflecting the fall in the cost of living during 2009 and the need to achieve cost savings. Jobseeker's allowance and benefit and other schemes provided for people of working age were cut by 4.1%.

Additional reductions were introduced for younger people eligible for jobseeker's allowance and the supplementary welfare allowance. For new applicants aged 20 to 21 a rate of €100 per week will apply; for those aged 22 to 24 the rate will be €150. These reductions only apply to those not engaged in training or education schemes. A reduced rate of €150 per week will apply to all of those on jobseekers allowance in cases where a job offer or activation measure has been refused. Child benefit rates will be reduced by €16 per month.

Capital spending

The 2010 Exchequer capital allocations amount to €6.4 billion - in the period 2010-2016 allocations amount to €39 billion. Each year from 2011, €5.5 billion will be available; details of the programme will be published shortly.

The 2010 capital expenditure will amount to 5% of GNP and is supplemented by a carryover of allocations from 2009 of €126 million. This allocation taken with asset disposals represents a €961 million saving towards the government's overall target. A significant drop in tender prices will help maintain output. Key priorities are the promotion of the smart/green economy (especially through the Strategy for Science Technology and Innovation (SSTI) investment and energy efficiency measures); support for sustainable long-term employment through investment in enterprise; and funding immediate employment in schools, domestic energy efficiency and tourism.

Capital funding for education and science is €715 million, but including carryover from 2009, total funding will be €794 million. The school building programme will be significant at €579 million. €141 million will go to infrastructural investment in higher education.

Enterprise, trade and employment will receive €474 million. The SSTI will receive capital funding of €276 million; this combined with other departments and agencies will bring the total current and capital SSTI budget to over €600 million. Funding for IDA will be €85 million and €76 million for Enterprise Ireland.

Transport will receive €2.1 billion, €1.1 billion of which will be used for the completion of the major inter-urban road network, the M50 upgrade and other key routes. Public transport will receive €625 million and the planning of Metro North will continue. PPP projects of over €5.5 billion in private investment are anticipated in transport, education and wider social infrastructure sectors over the medium term.

€176 million is allocated to communications, energy and natural resources. Within this, sustainable energy programmes will receive €98 million, including €50 million from the proceeds of the carbon tax.