TSG 06/04

Tax Strategy Group

Economic Framework for Budget 2007

The purpose of this paper is to inform the TSG of the Department's view regarding current and prospective economic developments and to highlight a number of key issues which should be taken into account when considering proposals in the context of the forthcoming Budget. Part I outlines the latest economic developments and sets out the likely economic trends over the short- to medium-term. Part II describes a number of structural aspects of the Irish economy which should be taken into account in framing and assessing possible budgetary packages.

Part I: Recent Economic Developments

1.1 **External developments:** The global economy continues to experience fairly solid growth. Moreover, global growth is more balanced than in the recent past, with most regions now performing reasonably well. However, higher oil prices and rising interest rates represent headwinds which could ultimately slow the pace of global expansion. In addition, significant exchange rate adjustments, if they were to materialise, have the potential to destabilise the global economy. A globally-integrated economy such as Ireland would not be immune to any significant downturn in world demand.

1.2 **Irish economic performance 2005-2006:** National income and expenditure data produced by the CSO show that GDP and GNP rose by 5.5 per cent and 5.4 per cent respectively last year. The Department's latest (unpublished) forecasts for 2006 have been revised upwards from those published on Budget day (by around ¼ per cent for both GDP and GNP). This upward revision mainly reflects stronger than expected investment spending, largely reflecting further very strong new housing output. The projections for household consumption have also been revised upwards marginally, mainly reflecting strong retail sales data.[1] The latest forecasts are shown in table 1 below. The headline growth projections compare favourably with the rest of the euro area.

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[1] In the period January-May of this year, the volume of retail sales was 6.3 per cent higher than in the same period of 2005.

Table 1: Economic performance in 2006, per cent change

	Budget Forecast (December 2005)	BSM (July 2006)
GDP	4.8	5.0
GNP	4.6	4.9
Employment	3.1	3.8
Unemployment (per cent of labour force)	4.3	4.3
Inflation - CPI	2.7	4.1[2]
HICP	2.0	2.9
General Government Balance (per cent of GDP)	- 0.6	0.7

Source: Stability Programme Update, December 2005 and unpublished BSM.

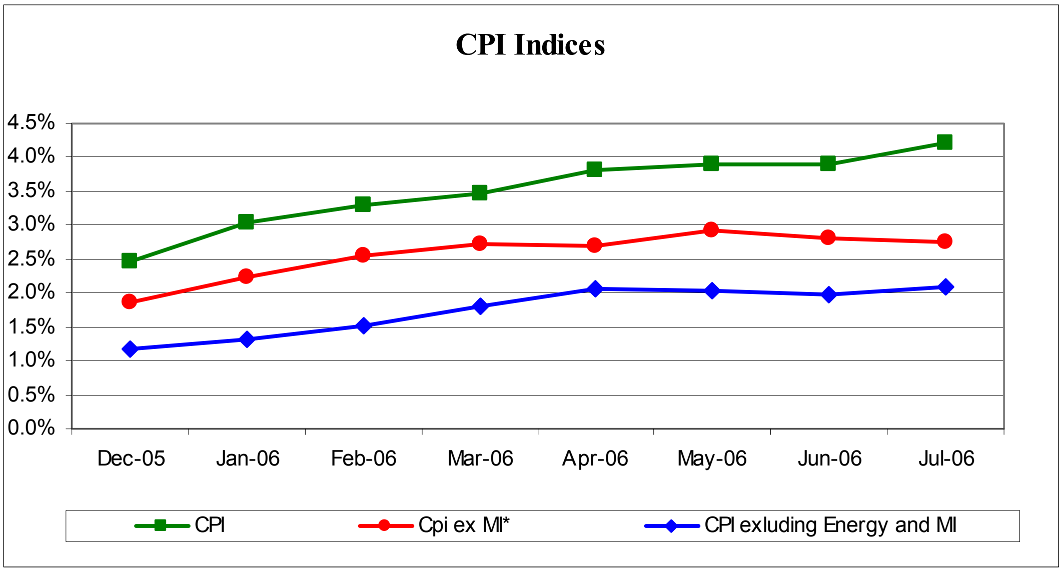
1.3 **Labour market:** The labour market continues to perform well. Total employment rose by 87,000 (4.7 per cent) last year, while the unemployment rate, at 4.4 per cent of the labour force, was the lowest in the EU25. This strong performance has continued into this year, with annual employment growth of 4.7 per cent in the first quarter. Much of the increase in employment was accounted for by increased employment of non-nationals; indeed, non-nationals now account for nearly 10 per cent of the labour force. For this year as a whole, total employment is now projected to rise by 74,000 (3.8 per cent), with the unemployment rate remaining stable at 4.3 per cent. Such a rate of employment growth would imply labour productivity growth of just 1.2 per cent; while this is stronger than last year, such a rate of growth would be well below the historical average.[3]

1.4 **Inflation:** After averaging 2.5 per cent last year, the rate of CPI inflation[4] has re-accelerated this year, averaging 4.2 per cent in the first seven months of the year. This pick-up mainly reflects the impact of higher oil prices and (for the first time since 2000) rising interest rates (see figure 1). In addition, relatively strong domestic demand and the relatively low rate of unemployment may also be putting some upward pressure on consumer prices. For the year as a whole, CPI inflation is now forecast to average 4.1 per cent this year. On a harmonised basis, inflation in Ireland has been around ½ percentage points higher than the euro area average this year. For the year as a whole, harmonised inflation in Ireland is forecast to average 2.9 per cent in 2006, over a ½ per cent higher than the projected euro area

[2] This forecast for inflation reflects the BSM forecast updated to take into account the impact of the increase in interest rates in August as well as the recent announcement of a 34 per cent increase in gas prices.
[3] Over the period 1960-2005, labour productivity growth in Ireland averaged around 3½ per cent per annum.
[4] CPI refers to consumer price index. The annual change in this index is the main measure of inflation. In terms of international comparison, however, the appropriate measure of inflation is the Harmonised Index of Consumer Prices (HICP). The main difference between the two measures is the exclusion of mortgage interest repayments from the HICP.

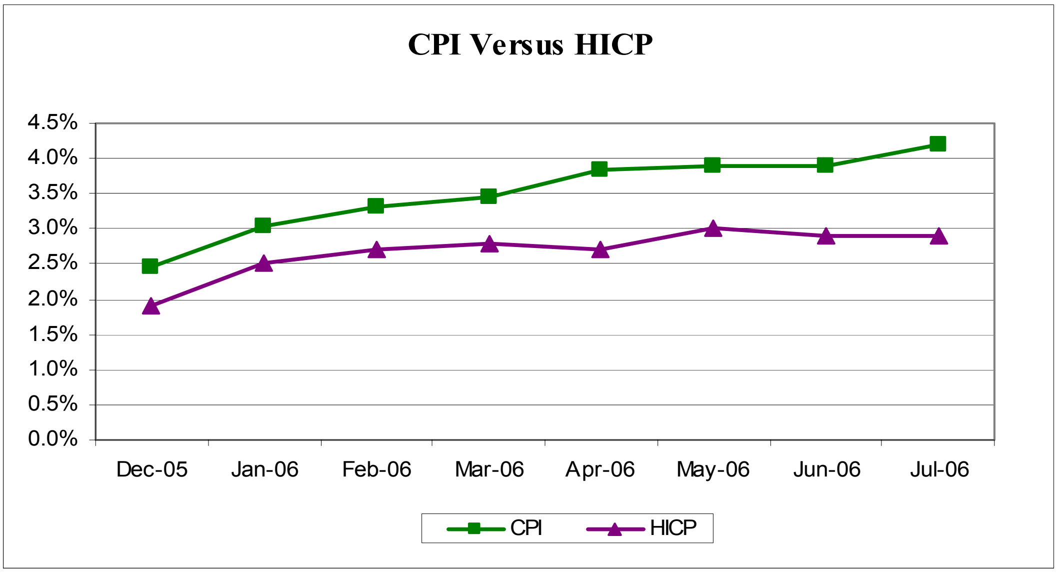
average[5]. With further increases in interest rates likely and the recently announced price increases in gas and electricity yet to impact, inflation is likely to remain high next year (see paragraph 2.2).

Figure 1: Different Measures of CPI



* MI = Mortgage Interest

Figure 2: Inflation measured by CPI and HICP



[5] The latest (June 2006) ECB forecast is for euro area HICP inflation to average 2.3 per cent this year.

1.5 **Public finances:** In terms of the public finances, the latest official forecast for the General Government Balance (GGB) in 2006, produced for the April 2006 Excessive Deficit Procedure (EDP) reporting, is for a deficit of 0.3 per cent of GDP, compared to the Budget day forecast of a deficit of 0.6 per cent of GDP. This improvement largely relates to an excess of first quarter tax receipts of €300 million. In July 2006, given the continuing strength of tax receipts, which are now expected to come in around €1,750 million above the Budget day profile, the estimate for the 2006 GGB was provisionally revised to a surplus of 0.7 per cent of GDP. A revised official GGB forecast will be produced for the October 2006 EDP reporting.

1.6 **Economic outlook 2007-2008:** The forecasts for 2007 and 2008 are currently under review and will be published in October as part of a new pre-Budget *Economic Review and Outlook*. At Budget time, forecasts covering the period 2007-2008 were published in Ireland's *Stability Programme Update* (see Table 2 below). Average GNP growth of 4.7 per cent per annum (GDP of 4.9 per cent) was projected. These projections were based on the assumption that oil prices would average $60.3 (€49.4) per barrel in 2007. However, over the last ten working days (i.e. to 31 August 2006), the spot price of oil has averaged $70 (€54) per barrel, suggesting that the original assumption may be too low. Moreover, interest rates have risen by a cumulative 75 basis points since Budget day, and there is a growing consensus that further increases are likely in the short-term. Therefore, while the economy is performing well this year, higher interest rates and oil prices may have some restraining impact on growth going forward. All factors affecting the economy will be kept under review and incorporated into the Budget day economic forecast.

Table 2 - Medium Term forecasts, per cent change

	2007	2008
GDP	5.0	4.8
GNP	4.8	4.6
Employment	2.2	1.9
Unemployment (per cent of labour force)	4.4	4.5
CPI	2.5	2.2

Source: Stability Programme Update, December 2005.

1.7 **Risks:** In overall terms, therefore, the short-term outlook for the Irish economy remains reasonably favourable, with growth evolving broadly in line with the economy's potential growth rate. Nevertheless, there remain significant downside risks – both domestic and external – which could result in below trend growth. Moreover, the rise in household indebtedness raises the vulnerability of the economy to 'shocks'. The key identifiable downside risks include:

external risks

- The possibility of a sharp dollar depreciation, given the magnitude of the US current account deficit[6];
- The prospect of high and volatile oil prices is a significant risk to the global economy, and by extension to the Irish economy;
- The economic recovery currently underway in the euro area could lose momentum, while there are tentative signs of a slowdown in the US economy[7].

domestic risks

- The possibility that new housing output adjusts downwards to more sustainable levels in a sharp, disorderly manner[8];
- With one in eight workers now directly employed in construction, economic activity is overly concentrated on one particular sector and hence exposed to a shock affecting this sector[9];
- The economy is exposed to a further deterioration in 'domestic' competitiveness, through, for example, continued high inflation or further low productivity growth.

Views of external commentators

1.8 The *IMF* (article IV report, August 2006) noted that Ireland's economic performance has been impressive, supported by sound policies. The review states that while the public finances are sound, a modest fiscal tightening in 2007 would be desirable[10] given the strength of domestic demand, the risk of a hard landing and the need to prepare for population ageing. The IMF believes that further efforts are needed to improve value for

[6] The US current account deficit amounted to over 6 per cent of US GDP last year.
[7] Preliminary data show that the annual growth rate of GDP in the US slowed to 2.5 per cent in the second quarter from 5.6 per cent in the first quarter.
[8] Last year, 81,000 new houses were completed; the medium term demand for housing is estimated to be in the region of 60-70,000 units per annum.
[9] When services directly related to construction (real estate, conveyancing, gardening, mortgage lending, etc.) are included, the percentage of employment accounted for by construction rises further.
[10] This was the view of most, although not all, of the executive directors.

money in the delivery of public services. The review also notes the exposure of the economy to the construction sector, and states that an abrupt correction of new housing output to more sustainable levels cannot be ruled out. Recent growth is seen as unbalanced, partly due to a loss in competitiveness. In this context, wage moderation and labour market flexibility are considered essential. Finally, the review identifies Irish households as being amongst the most indebted in Europe.

1.9 The *OECD* (spring forecasts, June 2006), stated that real wage increases in excess of productivity gains could compromise the future performance of the economy. In this context, rolling back anti-competitive practices in some services sectors is identified as a priority, as this would act as a spur to productivity and help restrain inflation.

1.10 The *European Commission* (spring forecasts, May 2006) noted that growth in Ireland has become somewhat unbalanced. The analysis highlighted the risks posed by the extended boom in residential construction, rising house prices and the increase in household indebtedness.

Part II: The "Structural" aspects of tax initiatives

From an economic perspective, initiatives which take account of a potentially more challenging budgetary position and promote, or at least do not work against, the following would help sustain Ireland's continued economic development:

2.1 **Competitiveness:** As a small and very open economy, living standards in Ireland are largely determined by our ability to supply goods and services to the global market. In these circumstances, competitiveness is a key factor in Ireland's continued success. However, the competitiveness of the economy has been eroded in recent years, and this has resulted in employment losses in some of the exposed sectors of the economy, mainly in the manufacturing sector. In these circumstances, it is imperative that tax policy does not further undermine the competitiveness position of the economy.

2.2 **Inflation**: The re-acceleration in inflation since the beginning of this year is a cause for considerable concern, given that the Irish consumer price level is already the highest in the euro area. While some of the factors currently influencing inflation are external in origin, budgetary policy can play an important role in dampening inflationary pressures. Firstly, tax policy must have due regard to the potential impact on the inflation rate (see annex 1). Secondly, increases in public expenditure must be consistent with the growth in available resources; otherwise revenue-raising measures will be necessary. Finally, overall budgetary policy should not add to demand. The impact of other non-tax areas on inflation must also be borne in mind, especially changes to administered prices. Appropriate policy initiatives include measures to enhance competition, increase productivity, particularly in the services sector[11] and retaining an open and flexible labour market.

2.3 **Infrastructural deficit:** Public spending must make clear choices between present and future consumption. A failure to invest adequately in infrastructure would be at the expense of economic growth and consumption in the future. Priority must be given to those measures which raise the productive capacity of our economy, particularly those aimed at reducing the significant infrastructural deficit.

2.4 **Ageing population:** Budgetary policy must take into account the fact that over the longer-term, our changing demographic profile will involve a substantial burden on the public finances. To put this into perspective, there are currently four persons in employment for every person aged 65 and over. By 2025, this figure will decline to three and by the middle of the century, it is projected that there will be less than two persons in employment for every person aged 65 and over. In other words, over time each person in employment will have to support a larger number of older people, through pension provision (Exchequer and social welfare) as well as other age-related costs such as healthcare.

The Group may wish to discuss the emerging budgetary and economic outlook.

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[11] The National Competitiveness Council has recently noted that in terms of tradable services, productivity in tourism remains low and Ireland's financial sector appears to be underperforming. In non-tradable services, a substantial productivity gap exists in utilities between Ireland and other economies, while the wholesale and retail trades, as well as transport services, also appear to perform poorly.

Annex 1 – Indirect Taxes and Inflation

The option of targeting inflation by reducing indirect taxes raises a number of issues.

Road Fuels - With respect to excises on motor fuels, the scope to make changes at national level is constrained by the EU Energy Tax Directive which sets EU minima for petrol and diesel. Moving to the EU minima, would lead to reductions in excise on petrol and diesel by 8.4 cent and 6.2 cent respectively. Such a reduction would reduce the CPI by 0.3%. However, it should be noted that Ireland's excise rates on motor fuel are around the EU average and are below many of our EU trading partners, particularly the UK.

A number of other issues need to be borne in mind. Firstly, reductions are costly - a one cent excise reduction in petrol and diesel costs €40m per annum. Secondly, some will be critical that such a move gives off all the wrong signals insofar as it indirectly conveys a message that increasing consumption can be tolerated (especially in terms of CO2 emissions control/reduction). Thirdly, a dangerous precedent is established at a time when the prospect of ever-increasing prices is very real. Fourthly, it should not be forgotten that the commercial sector is already subsidised by the current vehicle tax regime already in that there is only a nominal charge of €50 on the registration of commercial goods vehicles, compared with private cars owners who pay between 22.5% and 30% of the open market selling price of vehicles depending on engine size.

Alcohol - With respect to excise taxes on alcohol, it is accepted that Ireland has the highest in the EU. This is despite the fact that there has been a policy of leaving alcohol excise rates unchanged in most Budgets since 1994. Obviously this has served to reduce tax as a percentage of price over this time but the lack of tax increases has not prevented retail prices growing significantly in that time and consequently one must be mindful that any future excise reductions might not be passed on to consumers and consequently have little or no impact on inflation . In any event, reducing alcohol excises would likely conflict with health and social policy considerations at present.

Tobacco – Likewise, a reduction on tax on tobacco products would not be consistent with Government health policy.

VAT reduction – Reducing the VAT rates is a very costly exercise – a 1 per cent decrease in the standard rate would cost €440 million in a full year and a 1 per cent decrease in the reduced rate would cost €402 million in a full year. Experience shows that a reduction in VAT would not be fully passed on to consumers, as was the case when the standard VAT rate was reduced from 21 per cent to 20 per cent in January 2001.