Tax Strategy Group

Economic Framework for Budget 2010

Summary: In broad terms, the forecasts underpinning the April Supplementary Budget remain unchanged at this time. As is the norm, revised macro-economic and fiscal forecasts will be published in the Pre-Budget Outlook in October, incorporating data which will become available over the coming weeks.

While recent headline figures have generated some optimism regarding prospects for the global economy, key uncertainties remain. Even allowing for a more robust global pick-up, any recovery in Ireland will lag that elsewhere given the deterioration in competitiveness in recent years as well as ongoing structural issues such as the downsizing of the construction sector.

The fiscal challenge remains considerable and requires ongoing action to stabilise and bring sustainability to the public finances.

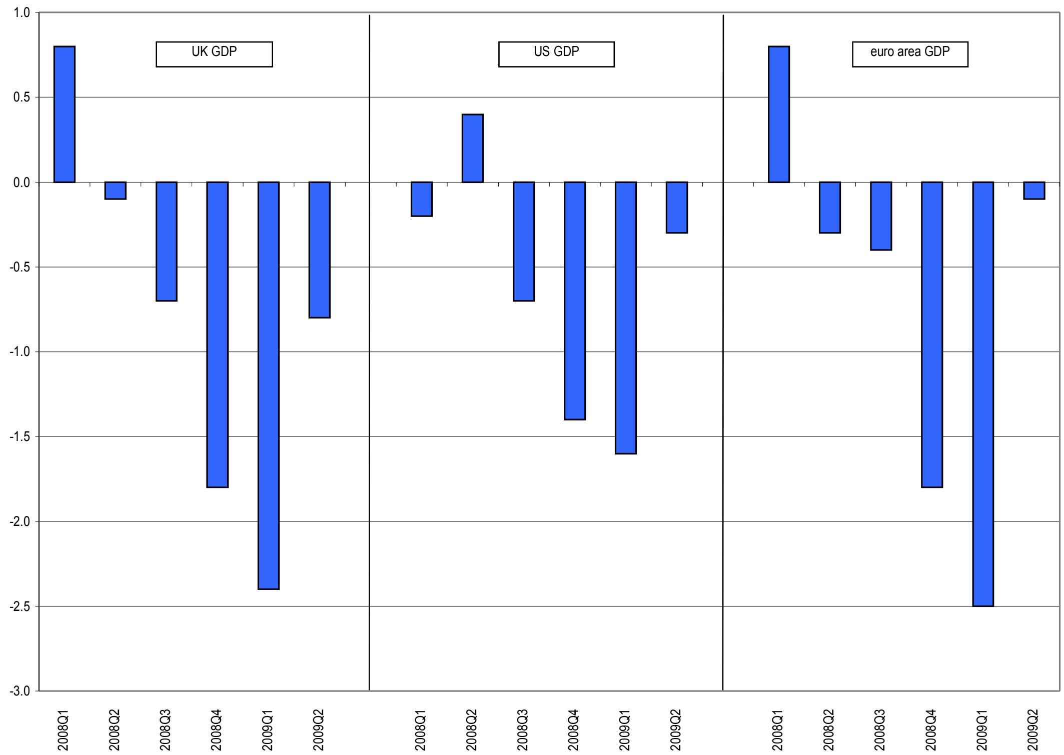
I. Introduction

The primary objectives of this paper are to update the Group on the current economic situation and to outline the most likely path for the economy over the next few years. The paper is structured as follows. Recent developments in the external environment are briefly summarised in section II. The main recent trends in the domestic economy are then outlined in section III, while the outlook for the period 2010 – 2013 is assessed in section IV. Finally, section V highlights the Department of Finance view regarding key macro-economic issues which should be considered when assessing various budgetary measures.

II. External Environment

Some tentative signs of stabilisation in the global economy have emerged in recent weeks. The most important data are those relating to the second quarter of this year, with preliminary figures suggesting that the pace of deterioration in the euro area, the US and the UK has slowed (see figure 1). These regions constitute around four-fifths of our export markets, and any improvement in the outlook would clearly be encouraging. However, it appears likely that part of the relative improvement reflects the positive impact of various fiscal measures implemented in these regions and the supports provided to the financial system. A key issue is the extent to which extent to which private sources of demand will be able to compensate for the withdrawal of such measures and supports which is inevitable at some stage.

Figure 1: Growth rates in our major trading partners (q/q-1 seasonally adjusted)

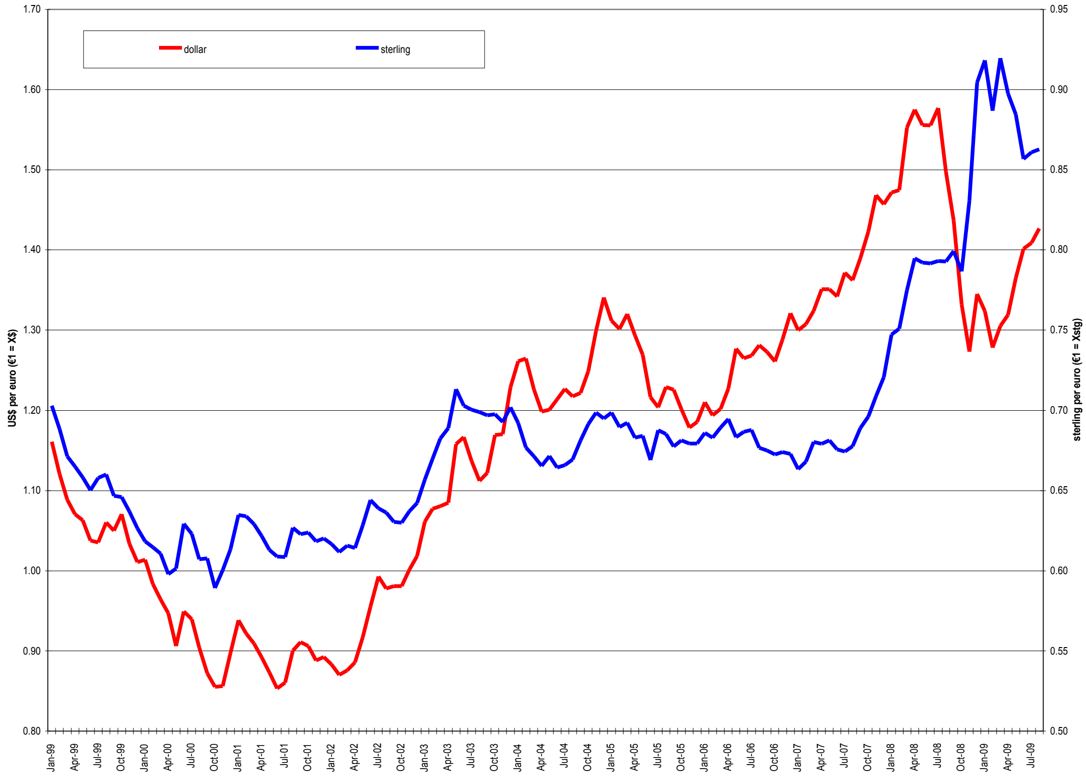


Source: Eurostat.

In the early part of this year, concerns regarding the UK economy and, in particular, its exposure to the financial sector, resulted in a sharp depreciation of sterling (see figure 2 below). Over the second quarter, sterling has appreciated somewhat, with the euro-sterling bilateral rate averaging €1 = stg£0.86 in August. Nevertheless, this is still around 9 per cent higher than this time last year, and puts Irish firms at a competitive disadvantage. Against the dollar, the euro has appreciated to around €1 = $1.43 in August, having been as low as €1 = $1.26 in early-March.

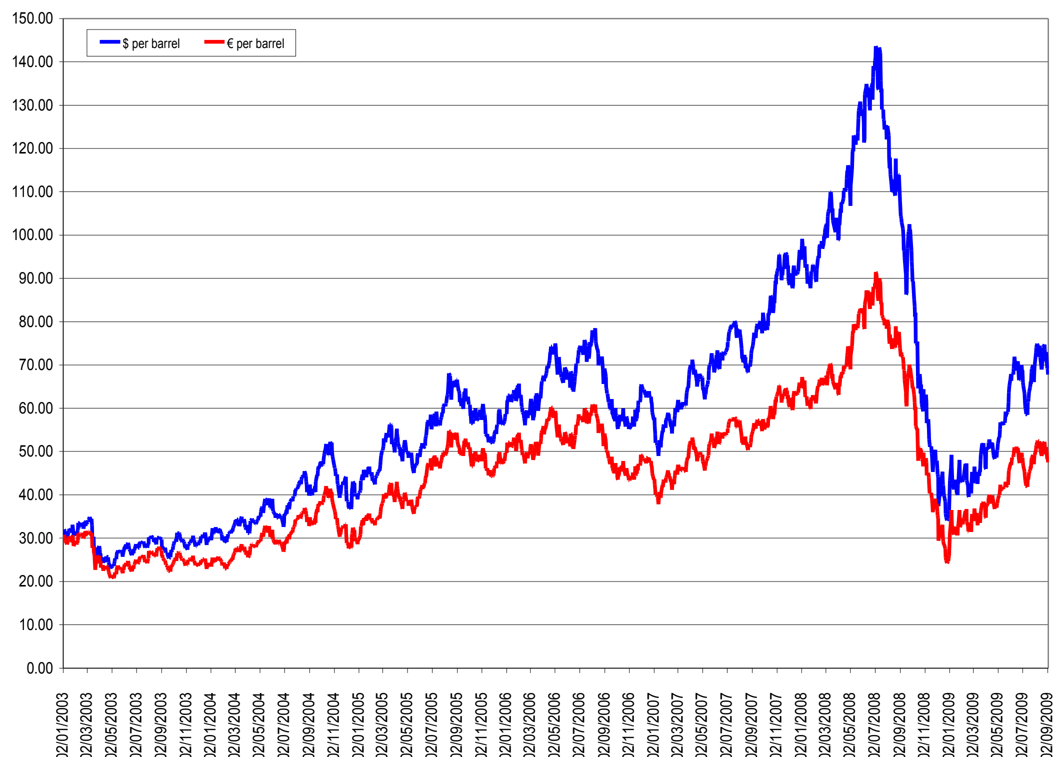
Turning to commodity prices, figure 3 shows that oil prices have risen since bottoming out in the early part of this year. Restrictions on supply as well as the depreciation of the dollar in recent months partly explain the rise in prices. Notwithstanding these increases, prices remain below the historic highs reached last year.

Figure 2: Exchange rate developments, 1999 to present



Source: Central Bank of Ireland.

Figure 3: Oil Price Developments, 2003 to present



Source: Ecowin

In summary, these adverse international developments have weighed on economic activity in Ireland this year – restraining exports, reducing confidence, increasing the cost of funds, lowering inward investment, etc. If a more robust international recovery were to take hold, then clearly this would be encouraging. At this stage, however, it would be premature to expect foreign demand to underpin any significant recovery in Irish economic conditions. The deterioration in competitiveness in recent years, combined with the need for further adjustments in the domestic economy (e.g. further downsizing of the construction sector), mean that any recovery in Ireland will, in all likelihood, lag that elsewhere.

III. Latest Domestic Developments

III.1 Economic developments in 2009…

National accounts data show that GDP fell at an annual rate of 8.5 per cent in the first quarter of this year, the sharpest rate of contraction ever recorded.[1] The main forces weighing on activity were lower residential construction and falling consumer spending.

In relation to residential construction, the housing market correction is continuing apace. The number of new house completions in the first quarter was 45 per cent below levels a year earlier. For the year as a whole, house completions are forecast to amount to just over 20,000 which would constitute a 60 per cent fall compared to last year, and subtract nearly 4 percentage points from the level of overall economic activity (note that, while 20,000 units per annum is probably below medium term sustainable levels, the overhang of unsold new homes will weigh on investment in the short term). Commercial property investment also remains weak, and over-supply will likely restrain investment in this sector for some time.

First quarter national accounts show an annual volume decline of 9.1 per cent in consumer spending. Lower disposable income growth – on foot of declining employment, falling wages and rising income taxes – is impacting on household spending. The deterioration in confidence may also have prompted households to set aside a larger portion of disposable income for precautionary savings purposes. In addition, credit data suggest that households are running down their indebtedness (another form of saving). While

[1] Quarterly figures are available since 1997 while annual figures are available since the mid-1950s. Annual GDP contractions have only ever been recorded in 1956 (-1.2 per cent), 1958 (-2.2 per cent) and 1983 (-0.7 per cent).

households need to repair their balance sheets, a risk is that sustained 'deleveraging' could weigh on consumption for some time.

III.2 Employment and earnings developments…

Nowhere has the decline in activity been more apparent than in the labour market. In the first quarter of this year, employment fell at an unprecedented annual rate of 159,000 (7.5 per cent). Job losses in the construction and retail sectors have been particularly severe, accounting for around two-thirds of all employment losses. The unemployment rate rose to 10.2 per cent in the first quarter.

The Live Register does not measure unemployment but does provide a timely indication of the health of the labour market. In this regard, the rate of increase has slowed significantly in recent months, with the monthly increase in August being the lowest since April last year (the unemployment rate in August was 12.4 per cent). Nevertheless, further employment losses over the coming months are certain, and it is likely that by the end of next year, (at least) a quarter of a million jobs will have been lost since employment peaked in early-2008.

One somewhat puzzling development relates to earnings data. A number of surveys undertaken in recent months had consistently suggested that firms were responding to the changed labour market situation by reducing nominal wages. The available hard data – albeit limited – do not bear this out yet. It is not clear whether this reflects timing issues or compositional effects (the lowest paid losing their jobs, mechanically raising average wages), or the fact earlier surveys were not sufficiently representative. However, it remains likely that unit labour costs will rise more rapidly in the euro area than in Ireland this year, implying some relative improvement in competitiveness.

III.3 Inflationary developments…

Consumer prices continue to fall at a rapid rate. In July, the consumer price index fell at an annual rate of 5.9 per cent, reflecting lower mortgage interest repayments, declining food and energy prices as well as the general weakness in the economy. On an internationally comparable basis, the harmonised index of consumer prices (which excludes mortgage interest costs) fell by 2.6 per cent in July, the fastest rate of decline in the euro area.

The rate of CPI price decline is to reach a trough of around -6 per cent in the next few months, so that for the year as a whole, prices are expected to fall by around -4 per cent (and by -1½ per cent on a harmonised basis). This is in line with the supplementary budget forecasts. However, there are growing indications that consumer prices may remain in negative territory next year, although not to the same extent as this year.

III.4 Public finances…

In recent years a large gap has emerged between revenues and expenditure – in 2009 tax revenues are forecast to be 27 per cent below 2007 levels and in the same period total gross voted expenditure has increased by 13 per cent. Another way of looking at it is that taxes are now below the 2004 level while since 2004 total voted expenditure has grown by 57 per cent. This, in turn, leads to large-scale borrowing. Borrowing is not a long-term solution as increased borrowing in turn leads to very high interest costs and ultimately represents deferred taxation. As debt servicing costs have a first call on resources, an increasing debt interest burden will reduce our productive capacity, increase unemployment, over-burden the taxpayer and undo past efforts to help the vulnerable.

2009

The Supplementary Budget forecast an Exchequer deficit of €20.35 billion and a General Government deficit of 10¾ per cent of GDP for 2009. Since then a capital injection of up to €4 billion into Anglo Irish Bank was agreed. This increases the forecast Exchequer deficit by that amount but does not impact upon the General Government Balance (GGB) under GGB accounting rules.

The Supplementary Budget forecast that tax receipts would total €34.4 billion in 2009 – a decline of €6.4 billion (15½ per cent) on 2008 levels and €12.8 billion (27 per cent) on the amount received in 2007. Expenditure was forecast to increase by 2.4 per cent year-on-year (current +6 per cent; capital -19 per cent).

By end-August expenditure was close to target but taxes were weaker than had been expected. After eight months €20.8 billion in tax revenue had been received – a year-on-year decline of €4 billion. This was €427 million or 2 per cent below target. The most significant weaknesses were on VAT and Income Tax which were €436 million and €263 million respectively behind target. While the annual targets for the capital taxes are relatively small and large year-on-year deteriorations were forecast, these taxes continue to under-perform target and had a combined shortfall of €207 million at end-August. On the other hand, Excise Duties and Corporation Tax have performed better than expected – in particular the receipt of a one-off unbudgeted Corporation Tax payment boosted August receipts - and to date this has partly offset the shortfall on other tax-heads.

Tax receipts overall at this point in the year are weak and large targets remain to be met. Tax performance during the month of September will be critical to our assessment of the likely end-year position. The Department of Finance will review the likely end-year position with the publication of the third-quarter Exchequer Returns which are scheduled for Friday 2 October.

Outlook for 2010-2013

The Supplementary Budget set out a path to reduce the deficit to 3 per cent of GDP by end-2013. This fiscal correction plan has been welcomed by the EU Commission and also supported by both the IMF and OECD in their commentaries on Ireland. Delivering on this requires significant tax and expenditure adjustments to be made over each of the next four years. For 2010 an adjustment of €4 billion was signalled. The Minister for Finance has indicated that the bulk of the adjustment will have to come on the expenditure side of the account. In this regard the findings of the Special Group on Public Service Numbers and Expenditure Programmes and the Commission on Taxation report will be important elements.

III.5 Projections for this year…

The Department's latest forecasts for this year, published alongside the Supplementary Budget in April, are shown in table 1. The data which have become available in the intervening period are, for the most part, consistent with these numbers. The exception to this is the GNP figure, which is likely to be worse than projected. A revised set of macro-economic projections will be published in the Pre-Budget Outlook in October, taking on board additional data such as second quarter national accounts figures which will be available at end-September. In the meantime, the latest consensus forecasts (i.e. those published at end-August) are shown for illustrative purposes.[2]

Table 1: Macroeconomic forecasts for 2009, per cent change

	Budget day, April	Consensus, end-August
GDP	-7.7	-8.0
GNP	-8.0	-9.3
CPI	-3.9	-4.3
Unemployment (per cent of labour force)	12.6	14.0 *

Source: Department of Finance and Reuters.
* the consensus unemployment figure is an end-year forecast; the Dept. Finance figure is an annual average.

IV. Economic outlook 2010 – 2013

IV.I The external environment…

Clearly, any recovery in Ireland will have to be export-led. As outlined earlier, the economic data which have been published in recent weeks have generated some optimism that recovery is underway in key regions, and forecasting institutions have revised upwards their projections for next year (see table 2).

Table 2: GDP forecasts for our major trading partners

	2009	2010
UK	-4.3	0.9
US	-2.6	2.3
euro area	-4.3	0.6

Source: Consensus Economics, August 2009.

However, a key uncertainty relates to the strength and resilience of any global recovery, with evidence suggesting that recoveries from recessions caused by financial and banking crises tend to be more protracted than recessions triggered by other events. It is also apparent that the financial crisis has left a permanent scar for many countries – the future will be different from the past. Finally, a renewed bout of weakness – a double-dip recession – cannot be ruled out. A double-dip recession could occur *inter alia* in the event of:

[2] Each month, Reuters surveys around ten private sector forecasters (mostly in the financial sector) and publishes the median projections for the key macro-economic variables.

- supply-driven increases in commodity prices;
- further reductions in global asset prices;
- a renewed bout of financial market turmoil;
- inappropriate monetary and fiscal “exit strategies”.

IV.2 Developments in the domestic economy…

Even allowing for an improvement in the external environment, weakness in domestic economic conditions and lost competitiveness means that it is likely to be the second half of next year before growth returns to positive territory. A supply over-hang, declining prices and wider economic uncertainty will all weigh on housing investment next year, and leading indicators confirm that a further decline in residential construction is in prospect. Falling employment, especially in the construction and exporting sectors, will depress household incomes which will weigh on consumer spending. A higher tax burden together with a less rapid fall in consumer prices will also restrain spending.

In overall terms, therefore, activity is projected to continue contracting in annual terms during the first half of next year. For the year as a whole, a GDP contraction of 2.9 per cent was projected for next year in the April Supplementary budget. While the Department will revisit this projection over the coming months, it is of interest to note that the consensus forecast at end-August was also for a GDP contraction of 2.9 per cent next year.

As the drag from construction wanes and on the assumption that demand in our major trading partners gains momentum, a return to positive growth territory is projected in 2011. Positive growth is also predicated on the resumption of a fully functioning domestic banking system, supported by various Government actions already taken and those in the pipeline.

Over the medium term, it is estimated that the economy will grow slightly in excess of our trend growth rate (estimated to be somewhere in the region 2½ – 3 per cent per annum) as unemployed resources are brought back into productive use.[3] Therefore, it is possible that growth of around 4 per cent per annum will be achieved over the 2012/13 period. Very few forecasters project beyond next year; in terms of those who do, the ESRI view is that we can achieve growth rates in excess of this, while the IMF / OECD / EU Commission view is that growth will be lower.

V Macro-economic effects of fiscal policy

From an economic perspective, a number of issues (some of which are related) pertinent to Ireland's future economic development should be borne in mind when framing budgetary policy.

V.1 Restoring confidence in the public finances…

The speed and scale of the fiscal deterioration has received considerable negative international attention. International sentiment towards Ireland has changed dramatically, with capital markets penalising the rapid deterioration in the public finances through higher risk premia. Along with a rising volume of public debt, this higher unit cost of funding is adding significantly to debt service costs.

Addressing the deterioration in the public finances without damaging the wider economy is a key challenge. The Supplementary Budget sets out a framework for reducing the deficit over the period to end-2013, and the Minister for Finance has signalled that more of the adjustment will be undertaken on the expenditure rather than the revenue side.

A further consideration is the endorsement by the EU Commission of our plan to reduce the deficit to the 3 per cent of GDP threshold by 2013. Any slippage from this may be a cause for concern internationally. For instance, the rating agencies, the EU Commission, IMF, OECD and, most importantly, capital markets are all expecting significant consolidation over the coming years. In later years, our EU commitment means that we will have to start running down our stock of public debt by running large, sustained surpluses.

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[3] In Ireland, as in many other countries, the supply-side of the economy has been affected by recent developments. In other words, even when contractionary forces recede, our capacity to grow will be lower than in the past.

V.2 Improving competitiveness…

The necessary re-balancing of the economy towards export-led growth will require a substantial improvement in our cost competitiveness. In a monetary union, the main way in which this can be achieved is through relative dis-inflation (involving both consumer prices and wages costs). The main channels through with taxation policy can positively influence our external competitiveness are through maintaining a pro-enterprise tax system while at the same time addressing the challenges of a narrow base.

V.3 Ageing population…

While short- and medium-term fiscal considerations are paramount at present, longer term aspects cannot be ignored. Ireland's changing demographic profile will involve a substantial burden on the public finances over the longer term. To put this into perspective, there are currently four persons in employment for every person aged 65 and over. By 2025, it is projected that 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.

Prior to the recent deterioration in the public finances, our low level of public indebtedness meant that at least our 'starting point' was relatively favourable. However, the fairly large increase in public debt which is in prospect over the next few years means that the long term position is considerably worse than originally thought and that our demographic 'window of opportunity' has passed.

The Group may wish to discuss the emerging economic outlook.

September 2009