TSG 08/04

Tax Strategy Group

Economic Framework for Budget 2009

I. Introduction

The purpose of this paper is to twofold. Firstly, it updates the Group regarding the Department's view of current and prospective economic developments. Secondly, it highlights a number of key macro-economic issues which should be considered when assessing proposals in the context of the forthcoming Budget.

The paper is structured as follows. Developments in the external environment are summarised in section II. Recent trends in the domestic economy are outlined in section III, while the outlook for the period 2009 – 2011 is assessed in section IV. Section V outlines a number of important economic issues which should be considered when assessing possible budgetary packages.

II. External Environment

The pace of global economic expansion has slowed this year, with continued strong growth in emerging economies insufficient to fully offset more modest growth in the world's advanced countries. In terms of the latter – which are much more important for Irish economic trends – three key forces are weighing on short-term prospects. Firstly, the global credit crisis has entered its second year and the fall-out from these developments – the higher cost of credit and the stricter terms on which credit is being made available – is having a detrimental impact on the economic performance of many countries. Secondly, a lower level of residential investment in some countries (such as the US, UK and Spain) is restraining the pace of growth. Finally, rising commodity prices are eroding purchasing power in many of the world's advanced countries. For instance, oil prices rose significantly over the first half of the year, peaking at over $140 (€90) per barrel in July, although prices have subsequently eased somewhat to around $112 (€76) per barrel at end-

August. The impact of this is to transfer income from oil importing countries to oil producing countries, lowering living standards in the former.

From an Irish perspective, the bulk of our trade is with other advanced economies – nearly four-fifths of our exports are destined for three regions, namely the euro area, UK and US. All of these regions are likely to experience below-trend growth both this year and next (see table 1).

Table 1: Forecasts for GDP growth in our major trading partners

	2008	**2009**
US	1.3	0.8
UK	1.8	1.7
euro area	1.7	1.2

Source: World Economic Outlook July Update, IMF.

The changing international economic outlook and ongoing global credit market difficulties have been accompanied by major exchange rate shifts. The euro has borne much of the adjustment to date, appreciating by 10 per cent against the dollar since the onset of the financial market difficulties in August last year, although the dollar did begin to strengthen somewhat towards the end of the month.[1] The euro-sterling bilateral exchange rate appreciated by 17 per cent in the year to August, and in early September sterling weakened further on foot of increasingly negative sentiment regarding the outlook for the UK economy. Weighted in terms of our trade pattern, Ireland's effective exchange rate is now around 7 per cent higher than this time last year.

In summary, the external environment has clearly deteriorated this year. Lower external demand growth and competitiveness pressures associated with the appreciation of the exchange rate appear to be having a dampening impact on our export performance. For instance, merchandise exports rose by just 0.3 per cent year-on-year in the first quarter. Moreover, merchandise export prices declined by nearly 5 per cent over the same period, which when combined with a rise in import prices (mainly due to higher oil and food prices), resulted in a significant deterioration in the terms of trade (i.e. a transfer of Irish purchasing power abroad).

[1] Average of August 2008 compared with average for same month a year earlier.

III. Latest Domestic Developments

III.1 Economic growth…

A major adjustment is currently underway in the new house building sector. Given the demographic structure as well as other factors, new house production at recent levels was not sustainable. However, the speed and scale of adjustment is the source of considerable difficulty, both within the construction sector itself and, increasingly of late, in the wider economy. In this context, other factors may also be at play with, for instance, the higher cost of – and reduced access to – housing finance impacting negatively on demand.

Quarterly national accounts data show that new housing output declined at an annual rate of 30 per cent in the first quarter, and this was the key factor depressing GDP growth in the early part of the year – GDP declined at an annual rate of 1.5 per cent in the first quarter.

Table 2: Macroeconomic forecasts for 2008, per cent change

	Budget day	July forecast
GDP	3.0	0.5
GNP	2.8	0.5
CPI	3.0	4.3
Employment	1.1	0.6
Unemployment (per cent of labour force)	5.6	5.8
General Government Balance (per cent of GDP)	-0.9	-2.7

Source: Department of Finance.

On foot of these domestic and external developments, the Department of Finance published a revised GDP forecast of 0.5 per cent for this year in early July, a downward revision from the 3 per cent rate of increase projected on Budget day.[2] The data which have become available since then have been especially weak and the outlook has deteriorated further, with many commentators now projecting a negative growth rate for this year. In advance of data which will become available over the next few weeks – including second quarter national accounts figures due to be released at end-September – the Department has not revised its forecast for this year, but is monitoring the situation closely in advance of publishing a forecast in the mid-October Budget.

[2] Technical Update of Current Year Macro-Economic Forecasts, July 2008.

III.2 Labour market developments…

Lower output growth has been accompanied by a deterioration in the labour market, where the rate of employment growth slowed to a virtual standstill in the second quarter. This is partly a reflection of the labour-intensive nature of new house production: 27,000 construction sector jobs were shed in the year to the second quarter, a decline of 9.5 per cent. The survey-based unemployment rate rose to 5.2 per cent in the second quarter, its highest rate since 1999. Moreover, live register data (which do not measure unemployment but do provide a timely indication of the health of the labour market) show a continued increase in the claimant count over the summer months – the number of people on the register increased by 42 per cent year-on-year in August. On a live register basis, the unemployment rate reached 6.1 per cent in August, its highest rate in almost a decade. Moreover, employment growth is expected to weaken further over the second half of the year, and indeed will probably turn negative in annual terms, with a resulting increase in unemployment.

III.3 Inflationary developments…

Another poor inflation performance is in prospect for this year, with CPI inflation averaging 4.6 per cent in the first seven months of the year. While there has been some modest easing of inflationary pressures in the services sector (albeit from initially very high rates), price inflation in the goods sector has accelerated sharply. This is in common with the experience elsewhere, and reflects developments in global commodity prices, especially those for oil and food. In addition, there is some evidence that the stronger exchange rate (especially vis-à-vis sterling) has not been passed through to retail goods prices to the same extent as in the past.

The latest published forecast is for CPI inflation this year to average 4.3 per cent. This does not take into account the July policy increase in interest rates and so the outturn may prove to be slightly higher than this. For next year, increased slack in the economy and the recent easing of oil prices (if sustained) should have some beneficial impact on the inflation performance, and this is reflected in the consensus forecast for CPI inflation which is for an average of 2.8 per cent for the year as a whole.

On a harmonised basis, inflation in Ireland tracked that in the euro area in the first half of the year, with an average rate of 3.5 per cent in both regions. In July, however, the Irish HICP figure was 0.4 percentage points below the euro area equivalent, Ireland's best relative inflation performance since the beginning of EMU in January 1999.[3] And, while this is obviously a positive development, it must be remembered that price levels for consumer goods and services in Ireland remain the highest in the euro area, with consumer prices being 26 per cent higher than the average.

Lower rates of employment growth combined with higher inflation have reduced household disposable incomes. Together with historically low levels of consumer confidence, this has taken its toll on consumer spending. Retail sales data show that the volume of consumer spending (excluding new car sales) declined at an annual rate of 2.3 per cent in the second quarter. Consumer spending is by far the largest component of domestic demand, and weak spending data will have negative implications for overall growth.

III.4 Public finances …

The public finances worsened considerably over the summer. At end-June, Exchequer tax receipts were €1.45 billion behind target. In July and August the tax shortfall worsened by a further €1.3 billion, meaning that end-August, tax receipts for the year were nearly €2.8 billion (10 per cent) behind expectations and down 9.4 per cent on the same period in 2007. The most significant weaknesses are in VAT, CGT and Stamp Duty. At this stage a tax shortfall of at least €5 billion is now likely this year. This will be reviewed in light of the end-September tax receipts.

While expenditure savings of €440 million were announced by the Government in July, pressures continue to emerge. At end-August, total expenditure was €218 million or 0.7 per cent above profile and was up €2,922 million or 10.4 per cent on a year-on-year basis.

In July, based on a forecast tax shortfall of €3 billion, a general government deficit of 2¾ per cent of GDP was projected for this year. Given the significantly higher tax shortfall

[3] A -0.4 percentage point gap between Ireland and the euro area was also recorded in May 2004.

now emerging, the deficit is now likely to be above 3 per cent of GDP. The Minister has already stated, in announcing the bringing forward of the Budget to October 14th, that Budget 2009 will set out steps to stabilise and restore balance to the public finances.

IV. Economic outlook 2009 – 2011

In the context of the Budget, and as is normally the case, the Department of Finance is currently assessing the macroeconomic situation and this will underpin Budget 2009. In terms of next year, a number of factors will have a crucial bearing on economic trends in Ireland, such as the external environment as well as developments in the domestic economy including in the construction sector. As a result of these developments, spill-over effects to other parts of the economy (such as the labour market, consumption trends and the public finances) which have already materialised are likely to intensify next year.

IV.I The external environment…

There remains considerable uncertainty regarding the timing and scale of a recovery in the world's advanced economies. On the one hand, global commodity prices have eased of late and, if sustained, this should result in lower inflation and with a consequent improvement in household real income. On the other hand, there is an emerging view that difficult conditions in global financial markets could persist for some time, while there is also a possibility that spill-over effects to the real economy could intensify. In this context, some commentators have highlighted the possibility of a situation in which economic weakness exacerbates financial market difficulties which, in turn, lead to a further deterioration in economic performance.

On the basis of recent IMF forecasts, growth in our major trading partners is set to remain fairly muted next year (see table 1 in section II). Taken in conjunction with the loss in competitiveness resulting from the appreciation of the real exchange rate, the outlook for exports next year is for modest growth at best.

IV.2 Developments in the domestic economy…

Available data suggest that the outlook for the new house building sector continues to deteriorate (see table 3 below). New house starts were down by nearly 60 per cent year-on-year in the second quarter, while the continuing decline in prices – new house prices were down by 9½ per cent in annual terms in the second quarter – will weigh on supply in the short term. The overhang in supply and the deterioration in the financing environment for new housing also suggest that conditions in this sector will remain difficult for some time. At this stage, a further significant fall in the level of completions is now in prospect for next year, which will exert a negative drag on GDP growth once again (the third successive year).

Table 3: Leading Indicators of New Housing Output

	period	year-on-year, per cent
New house completions	2008 Q2	- 27.6
New house registrations	2008 Q2	- 58.9
New house commencements	2008 Q2	- 51.4
New house prices	2008 Q2	- 9.4
Mortgage lending ^	2008 M7	+ 9.6

Source: Department of Environment, Central Bank and permanent tsb.
^ the 9.6 per cent annual growth rate was the first single-digit rate of increase since end-1987.

Available evidence – some of it anecdotal – suggests that activity in the commercial building sector has slowed in recent months, which will compound difficulties in the overall construction sector. Slowing demand elsewhere in the economy and a more difficult financing environment appear to be the main factors weighing on prospects for this sub-sector.

The labour-intensive nature of construction activity means that the level of economy-wide employment is expected to decline next year, and this will weigh on household incomes and hence consumer spending.

In overall terms, therefore, the current working forecast is that the pace of growth will not exceed 1 per cent next year. Such a rate of growth would be considerably lower than the economy's potential growth rate, with a resultant rise in unemployment likely. Such developments will have implications for the public finances, on both the revenue and expenditure sides. The consensus forecast – published by Reuters at the end of August – is for GDP growth of 0.7 per cent in 2009.

In terms of prospects beyond next year, it had initially been hoped that the economy would return to its trend rate of growth - which is estimated to be nearly 4 per cent per annum - by 2010. At this stage, this is becoming increasingly unlikely and it now appears that it will be 2011 before the economy returns to potential. Even this is contingent upon restoring international confidence in the Irish economy (through for instance prudent management of the public finances) and on implementing measures to restore our cost competitiveness.

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 Irish economy…

The changed economic and fiscal environment in Ireland has received considerable international attention. In this regard, the deterioration in the public finances should be limited in as far as possible in order to minimise the impact on investor sentiment. The economic research in this area has tended to conclude that reductions in public expenditure have the most positive impact on private sector behaviour, as these are more credible than tax increases from a long-lasting fiscal consolidation perspective.[4] Economic growth-enhancing reforms of public expenditure can also have favourable effects on private sector consumption and investment behaviour as well as enhance the long term sustainability of the public finances.

V.2 Improving competitiveness…

Our ability to benefit from the global recovery when this eventually emerges will be contingent upon implementing measures which improve our competitiveness. While we

[4] In the literature, the fiscal consolidation in Ireland in the late 1980s is sometimes put forward as an example of when reductions in public expenditure actually had a favourable impact on GDP.

cannot influence exchange rates, there are several channels through which fiscal policy can positively affect our competitiveness. Maintaining a relatively low tax burden is one example. Continuing to invest in human and physical capital is also crucial in terms of the boosting the attractiveness of Ireland for inward foreign direct investment. Reforms of the public sector can also help minimise the burden on the private sector.

V.3 Addressing inflation…

Consumer price levels in Ireland are the highest in the euro area, exceeding the euro area average by 26 per cent. In these circumstances, it is important that budgetary policy on the whole is cognisant of the need to bring down the rate of inflation and, over time, addressing the high level of prices compared to those prevailing in our main trading partners.

V.4 Ageing population…

Budgetary policy now 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 economic outlook.

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