TSG 07/02

Tax Strategy Group

Economic Framework for Budget 2008

Confidential

The purpose of this paper is to inform the Group of the Department's view regarding current and prospective economic developments and to highlight a number of key macro-economic issues which should be borne in mind when considering proposals in the context of the forthcoming Budget.

The paper is structured as follows. The latest economic developments as well as the likely economic trends over the short- to medium-term are outlined in part I. In part II, the views and concerns of various external commentators regarding economic trends are highlighted. Part III describes a number of important economic issues which should be considered when assessing possible budgetary packages.

Part I: Recent Economic Developments

1.1 **External developments:** The international economic environment remains generally supportive with world output forecast to expand by 5.2 per cent this year,[1] the fifth successive year of strong global growth. It is notable that the global economic expansion has become more geographically balanced over the last year or so, with both the euro area and Japan experiencing stronger growth. On the other hand, the US economy is likely to record below-trend growth this year. Moreover, if the spill-over effects from current difficulties in financial markets to the 'real' economy were to become more widespread, then below-trend growth in the US could persist for some time. Given our strong trade and investment links, the Irish economy is potentially more exposed than most to developments in the US economy.

1.2 **Irish economic performance 2006 – 2007:** The Irish economy recorded another strong performance last year, with GDP and GNP rising by 5.7 and 6.5 per cent respectively.

[1] IMF World Economic Outlook Update, July 2007.

Looking towards this year, the outlook is somewhat less favourable than envisaged on Budget day, mainly reflecting the prospect of a sharper than expected reduction in new housing output. In addition, interest rates have risen by more than had been priced in by financial markets at Budget time last year, and this may be having a detrimental impact on consumer confidence. On the other hand, the exporting sector appears to be performing reasonably well (especially software, chemicals and services). In overall terms, the Department's latest unpublished forecasts for 2007, which underpinned the July *Budget Strategy Memorandum* to Government, have been revised downwards by around ¼ percentage points for both GDP and GNP, with growth of the order 5.0 per cent projected. This is in line with the current market consensus (see table 1). This assessment is currently being evaluated in light of later data and emerging trends and a revised forecast will be published in mid-October in the *Pre-Budget Outlook* (PBO).

Table 1: Economic performance in 2007, per cent change

	Budget Forecast (December 2006)	DoF - BSM (July 2007)	Central Bank July	ESRI July	Private Sector end-August
GDP	5.3	5.0	5.0	4.9	5.0
GNP	5.3	5.0	5.0	4.8	5.0
Employment	3.5	3.3	3.0	2.8	3.1
Unemployment rate	4.4	4.5	4.5	4.7	4.7
Inflation - CPI	4.1	4.8	5.0	4.9	4.9
HICP	2.6	2.7	2.8	n.a.	n.a.
GGB (per cent of GDP)	2.3	1.3	1.1	1.1	1.0

Source: Stability Programme Update, December 2006 and unpublished BSM.

1.3 **Labour market:** Total employment rose by 86,500 (4.4 per cent) last year. This was broadly in line with the growth of the labour force, so that the unemployment rate remained unchanged at 4.4 per cent, the third lowest rate in the EU. On a headline basis, labour market conditions remain generally healthy, with annual employment growth of 3.9 per cent in the second quarter of this year. However, the data also suggest that employment in construction – which has been the single largest driver of employment growth in recent years – appears to have peaked. Given prospective developments in the new housing market, together with the employment-intensive nature of this activity, construction employment and hence overall employment is expected to soften over the remainder of the year. In overall terms, employment is projected to expand by 3.3 per cent this year, while a small increase in the average unemployment rate to around 4.5 per cent is currently expected. Such a rate of employment growth would imply labour productivity growth of just 1.6 per cent (measured in terms of GDP per person employed).

1.4 **Inflation:** In the first seven months of this year, the annual rate of CPI inflation averaged 5.0 per cent. This poor performance is a cause for concern, and has prompted a meeting between IBEC, ICTU and senior members of the Government.[2] The high rate of inflation mainly reflects the impact of higher interest rates, relatively strong domestic demand as well as the current low rate of unemployment which may be putting some upward pressure on consumer prices. With oil prices likely to add to the annual rate of inflation over the second half of the year, together with the potential for continued food price inflation, no significant improvement is likely over the short-term. As a result, CPI inflation is now forecast to average 4.8 per cent this year. Moreover, any further increase in wholesale interest rates would add to CPI inflation, while any increases in administered prices or indirect taxes would also affect our inflation performance. On a harmonised basis, inflation in Ireland was amongst the highest in the euro area in the first seven months of 2007, with a positive gap of nearly 1 percentage points between the Irish and euro area average pertaining over this period. For the year as a whole, harmonised inflation in Ireland is forecast to average 2.7 per cent, compared to a euro area average of about 2.0 per cent.[3] The forecasts for both the harmonised and CPI rates of inflation this year are currently under review in the context of the PBO.

1.5 **Public finances:** In terms of the public finances, the latest official forecast for the General Government Balance (GGB) in 2007, produced for the April 2007 Excessive Deficit Procedure (EDP) reporting, is for a surplus of 1.1 per cent of GDP, compared to the Budget day forecast of a surplus of 1.2 per cent of GDP. A revised official GGB forecast will be produced for the October 2007 EDP reporting.

While there are significant tax revenues due for collection over the course of the remainder of the year, particularly in November, we currently expect that the overall tax revenue outturn for the year will be close to Budget target, but with downside risks potentially

[2] In addition, the anti-inflation group (established under *Sustaining Progress*) has been reconvened under *Towards 2016*.
[3] The latest (June 2007) ECB forecast is for euro area HICP inflation to average between 1.8 and 2.2 per cent this year.

arising. While this would represent a strong performance, it is clear that the large tax surpluses of recent years will not be repeated.

As a result, a key objective is to ensure that current expenditure is kept at a sustainable level. Year-on-year increases in gross voted current expenditure going forward should grow broadly in line with nominal economic growth. Gross current expenditure has risen in recent years by 10 per cent (2005), 11 per cent (2006) and by an estimated 12 per cent this year. These levels of growth are simply unsustainable in the context of much lower revenue growth over the coming years and the various existing demands on resources including the National Development Plan, the Towards 2016 Social Partnership Agreement and the Government's other commitments.

1.6 **The Housing Market:** New housing completions amounted to 88,200 units[4] last year, representing an annual addition of around 5 per cent to the housing stock. However, it is now generally accepted that annual completions peaked last year, and that future output will be lower. Given the large weight of this sector in overall output – new housing construction amounted to 11½ per cent of GDP (13½ per cent of GNP) last year – this will exert a significant drag on aggregate economic growth rates over the short- to medium-term. A modest decline in output was projected on Budget day, as completions were assumed to revert to more sustainable levels in a gradual, orderly manner.[5] However, a sharper than expected decline is now underway, with leading indicators of output turning increasingly negative in recent months (see table 2 below). While actual completions in the first half of the year were in line with last year's level, the July figures show a 36 per cent annual decline in completions. For the year as a whole, the consensus among economic forecasters is for output of just under 80,000 units, although some commentators are projecting output in the region 70,000 – 75,000 units. This is an aspect of the Department's forecasts that is currently under consideration in the context of the PBO.

[4] Headline completions were higher at 93,400 units, although around 5,000 of these were actually completed in 2005.
[5] The underlying demand for housing is tentatively estimated to be of the order 60 – 70,000 units per annum.

Table 2: Leading Indicators of New Housing Output

	period	year-on-year, per cent
New house registrations	2007 M1-M7	- 34.8
New house commencements	2007 H1	- 22.5
Planning permissions	2007 Q1	- 8.8
Mortgage lending ^	2007 M6	+19.0

Source: Department of Environment, CSO, Central Bank and permanent tsb.
^ the 19.0 per cent annual growth rate was the slowest rate of increase since April 2002.

1.7 **Economic outlook 2008 – 2010:** Forecasts covering the period 2008 – 2010 are currently under review and will be published in October as part of the PBO. Since the last set of forecasts were published (at Budget time last December), a number of important economic developments – both domestic and internationally – have taken place, including:

- **Housing market** – the level of new housing output appears to be declining more rapidly than assumed last December;
- **Interest rates** – wholesale interest rates have risen by a cumulative 75 bps since December of last year, and notwithstanding recent developments in financial markets further increases cannot be ruled out, even if the timing may be somewhat delayed;
- **Oil prices** – the spot price of oil (Brent crude) reached $80 (€58) per barrel in mid-July, its highest level on record, and while prices have fallen back somewhat since then, further increases remain possible;
- **Exchange rates** – the euro-dollar bilateral exchange rate has been on an appreciating trend since the beginning of this year and in July reached €1 = $1.38, its highest level since the inception of the euro in 1999.

1.8 **Risks:** In overall terms, therefore, the short-term outlook for the Irish economy has deteriorated since Budget Day, with growth now likely to be in the region 3½ - 4 per cent per annum over the next few years (although this is still much higher than in other EU countries). Moreover, the balance of risk appears to be tilted towards the downside. The key identifiable downside risks include:

external risks

- The possibility of a sharp dollar depreciation, given the magnitude of the US current account deficit;

- The prospect of continued high and volatile oil prices is a significant risk to the global economy, and by extension to the Irish economy;
- The rise in household indebtedness[6] together with a relatively high concentration of mortgage debt at variable rates mean that the economy is exposed to further interest rate increases;
- The ongoing difficulties in the US housing sector – including difficulties in the sub-prime mortgage market – could spill-over to the rest of the US economy and, potentially, the wider global economy.

domestic risks

- New housing output could contract more rapidly than currently assumed;
- Deteriorating consumer confidence could have a 'self-reinforcing' impact on domestic demand;
- The economy remains exposed to a further deterioration in competitiveness, especially if the current relatively high rate of inflation becomes ingrained in the economy.

Part II: Views of External Commentators

2.1 The **IMF** (article IV report, August 2007) noted that the housing market and global economy present downside risks to Ireland's economic performance. In terms of budgetary policy, the Fund warns against discretionary measures that weaken the fiscal position. Over the medium term, improving value for money and 'modernising' property-related taxes are recommended. Longer term issues associated with the aging of the population are also highlighted.

2.2 The **OECD** (spring forecasts, June 2007), argued that the main risk facing the economy was the possibility of the slowing housing market having a more severe impact than anticipated. The strength of the euro against the dollar was also seen as a downside risk to which Ireland was particularly exposed.

[6] Household indebtedness in Ireland has risen from around 60 per cent of personal disposable income at the beginning of EMU to around 150 per cent last year.

2.3 The **European Commission** (spring forecasts, May 2007) identified the high reliance of the economy on the construction sector together with the high level of household indebtedness as risks to the economic outlook growth. The Commission views Ireland as exposed to a marked slowdown in the US economy.[7]

Part III: Macro-economic effects of tax initiatives

3.1 From an economic perspective, there are a number of factors that must be considered in order to ensure Ireland's continued economic development. These must be borne in mind when framing budgetary policy.

3.2 **Competitiveness:** As a small and very open economy, living standards in Ireland are largely determined by our ability to compete in the global market-place (i.e. to supply goods and services to the rest of the world and to secure inward investment). In this context, it is clear that our ability to compete internationally has been eroded in recent years, and this is having a detrimental impact on employment in the traded sector of the economy. In the manufacturing sector, for instance, total employment fell by 30,000 (9½ per cent) over the period 2001 – 2006, although from a macro-economic perspective, the unsustainably high level of employment in construction has concealed the resulting difficulties. Moreover, IMF research shows a lag between overall growth rates in Ireland and competitiveness developments. This suggests that the impact of past erosion of competitiveness may yet have a significant impact on overall economic activity. In these circumstances, it is imperative that budgetary policy (including taxation) does not further undermine the competitiveness position of the economy, especially in an era of increasingly globalised economic activity.

3.3 **Inflation:** On a harmonised basis, Irish inflation has exceeded the euro area average for some time now, with the result that the price level for consumer goods and services is now the highest in the euro area. On a CPI basis, the annual rate of CPI inflation has hovered around 5.0 per cent since the beginning of this year, and no significant moderation is expected in the second half. While some of the factors currently influencing inflation are

[7] Both the OECD and European Commission will produce revised forecasts for Ireland in the Autumn.

external in origin – such as higher oil prices and increases in interest rates – budgetary policy can also influence the inflationary environment. In this context:

- indirect tax measures – including those aimed at addressing key policy considerations such as those in the areas of health or the environment – need to be cognisant of the already very high inflation rate;
- increases in public expenditure must be consistent with the growth in available resources, otherwise additional revenue-raising measures will be necessary;
- overall budgetary policy should not add to demand in the economy.

3.4 **Infrastructural deficit:** A failure to invest adequately in infrastructure would be at the expense of economic growth and living standards in the future. Therefore, in spending decisions, the highest priority must be given to those measures which raise the productive capacity of our economy, particularly those aimed at reducing the significant infrastructural deficit.

3.5 **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 budgetary and economic outlook.

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