TSG 10/02

Tax Strategy Group

Economic Framework for Budget 2011

Summary: While economic recovery is underway in Ireland, the pace is sluggish and risks to the outlook remain considerable. On the labour market front, unemployment has remained stubbornly high and is not expected to recede to any great extent any time soon.

The fiscal challenge remains paramount. Turbulence in financial markets brings additional urgency to the consolidation programme. Ireland is now very much on the radar of financial markets, and there is heightened concern regarding the build-up of public debt (including Anglo-related debt) in Ireland. Investor sentiment towards Ireland has diminished in recent weeks with the result that funding the deficit is proceeding at a very high cost. As a result, some commentary has questioned the pace of fiscal consolidation, suggesting that a more ambitious timeframe for restoring order to the public finances is necessary.

On foot of these developments, the Department of Finance view is that, at a very minimum, strict adherence to the fiscal consolidation programme is absolutely crucial; and deviation from the path would jeopardise the capacity of the State to provide services to the population at large.

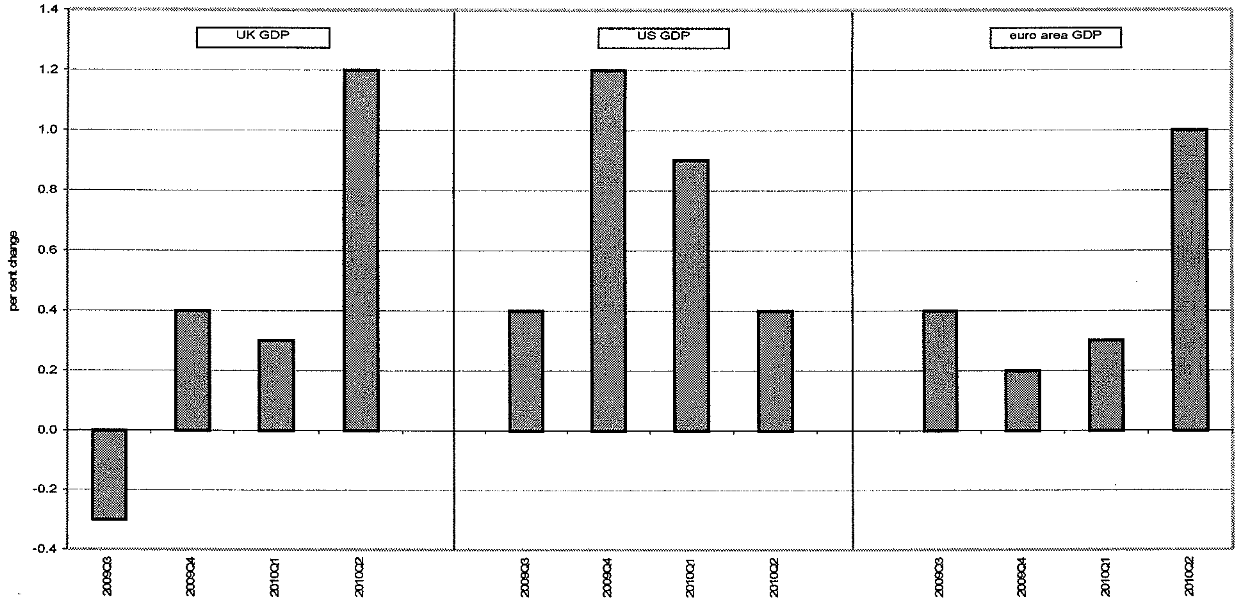
I. Introduction

The primary objectives of this paper are to update the Group on the current economic situation and to set out the medium term macroeconomic outlook as currently envisaged. 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 – 2014 is assessed in section IV. Finally, section V highlights the Department of Finance view regarding the importance of adopting appropriate fiscal measures to restore long term sustainability to the public finances and, thereby, to reassure financial markets that Ireland can continue to meet its liabilities.

II. External Environment

Globally, a multispeed recovery is underway. Emerging economies, especially in Asia, are once again experiencing strong, if somewhat unbalanced, growth. Unfortunately from an Irish perspective, the pace of recovery in advanced economies – the destination for the bulk of Irish exports – is much more tepid. For many of these countries, excesses built up prior to the crisis have not yet been worked off, with the result that key weaknesses remain. Four-fifths of Irish exports are destined for the UK, US and euro area, and recent data paint a somewhat mixed picture (see figure 1) for these economies. Growth surprised on the upside in euro area, driven by a very strong performance in Germany; on the other hand, second quarter growth in the US was weaker than expected and this has triggered some concerns regarding a 'double-dip' recession in the US.

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

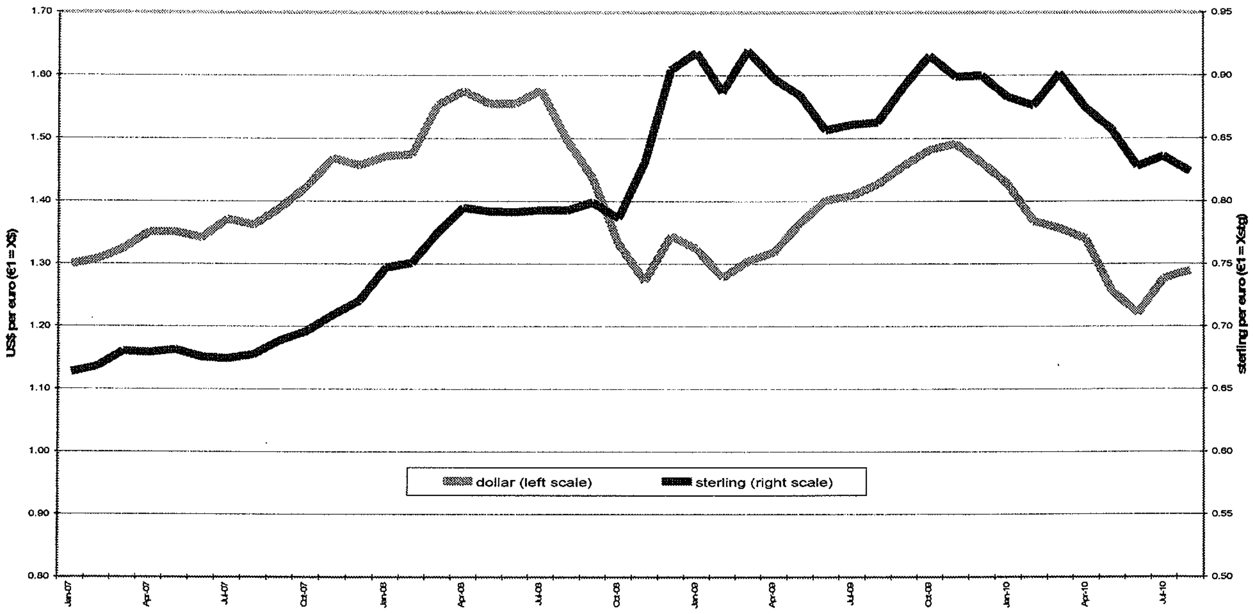


Source: Eurostat.

From a competitiveness perspective, exchange rate trends have been relatively favourable over the past year or so, with the euro depreciating against both the dollar and sterling (see figure 2). At end-August, the euro-dollar bilateral rate was €1 = \$1.27 while the euro-sterling rate was €1 = stg£0.84; both rates are significantly lower than in the same month last year, and this is providing some support to the exporting sector. In trade-weighted terms, the effective exchange rate in July (latest data) was at its lowest level since the first quarter of 2007.

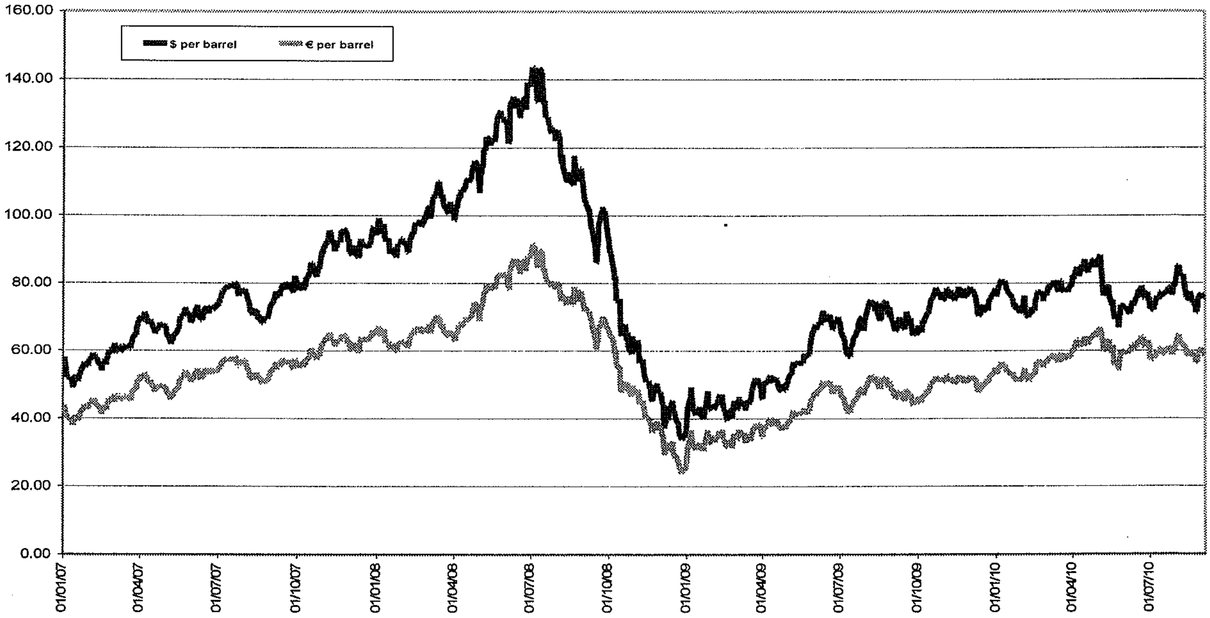
Turning to commodity prices, figure 3 shows that oil prices have been fairly stable over the past year or so, averaging around \$76 (€55) per barrel. Futures markets are pricing in modest price increases during 2011 and beyond as global demand improves.

Figure 2: Exchange rate developments, 2007 to present



Source: Central Bank of Ireland. Data are monthly averages.

Figure 3: Oil Price Developments, 2007 to present



Source: Ecowin. Data are daily.

III. Latest Domestic Developments

III.1 Economic developments in 2010…

National accounts data show that GDP rose at a quarterly rate of 2.7 per cent in the first quarter of the year, thus signaling a resumption of GDP growth a couple of quarters ahead of what the Department had previously anticipated. GNP continued to contract in the first quarter, reflecting the export-led nature of activity. On foot of these data, the Department revised upwards its forecast for GDP growth this year to 1.0 per cent, but with the expectation that GNP would decline by ¾ per cent. These figures are suggestive of a modest recovery, and would certainly not be sufficient to stop the upward movement in unemployment (in addition, even when more robust growth is achieved, it will take some time for unemployment to fall, given inherent lags in the process). For comparison purposes, the end-August consensus forecast is for GDP growth of 0.7 per cent this year (a GNP decline of 1 per cent).

Second quarter GDP figures will be published at end-September; monthly data relating to industrial production, retail sales, etc. suggest that the Departments forecast for this year remains on track. However, while limited at this stage, some indicators (purchasing managers indices, core retail sales) suggest a soft patch over the summer. The Department will provide updated macroeconomic and fiscal forecasts in the *Pre-Budget Outlook*, due for publication in mid-October.

The correction in residential investment continues to weigh on overall economic activity. Available data point towards house completions of around 14,000 units this year; this would amount to a decline of 50 per cent and exert a drag of 1½ percentage points on the overall level of GDP. Commercial property investment also remains weak. The over-hang of both commercial and residential property is likely to restrain investment in this sector for some time. It should be noted that the size of the construction sector (and hence its influence on overall economic activity) has diminished greatly in recent years. Moreover, residential construction will never return to the levels experience at the peak in 2006 (when 90,000 units were produced); the Department's forecasts assume a bottoming out of house completions next year and only slowly returning to 30,000 units per annum by the end of the forecast horizon in 2014.

III.2 Labour market 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 annual rate of 108,000 (5.5 per cent). Job losses in the construction and retail sectors were particularly severe over the period, accounting for around four-fifths of all employment losses. The unemployment rate rose to

12.9 per cent in the first quarter, and live register trends suggest that unemployment has picked-up since then, with provisional data putting the unemployment rate at 13.8 per cent in August. A significant number of those on the live register were previously employed in the construction sector, although in recent months the occupational distribution of those on the live register has become more widespread.

The revised set of macro-projections published in July assumes an average decline in employment of 4 per cent this year – this would mean that in excess of a quarter of a million people will have lost their jobs since employment peaked in 2007. An alternative way of putting it is that one out of every eight people in employment prior to the crisis will have lost their job by the end of this year.

III.3 Inflationary developments...

The latest data show that consumer prices continue to decline, although, as expected, the rate at which prices are falling has slowed. On an internationally comparable basis, the harmonised index of consumer prices (which excludes mortgage interest costs) fell by 1.2 per cent in August, compared with an annual rate of decline of 2.4 per cent in the first quarter. On this harmonised basis, consumer prices are projected to fall by 1.5 per cent this year, compared with a rise of around 1.5 per cent in the euro area as a whole. And while this implies an improvement in competitiveness, it must be borne in mind that the level of consumer prices in Ireland remains about 20 per cent higher than the euro area average.

On a CPI basis, the annual rate of inflation turned positive in August for the first time since end-2008. In the coming months, the annual rate of price increase will become more positive (rising retail interest rates will contribute in no small part to this). An annual average decline of -1 per cent for this year as a whole is projected, while for next year consumer prices will – in all likelihood – record a full-year increase.

A wider measure of price developments in the economy is the GDP deflator – this takes into account not just consumer prices, but prices for investment goods and services, export prices, etc. This was significantly negative in the first quarter, and while it will become less negative as the year progresses, a full year decline in the GDP deflator is likely. Thus, notwithstanding the increase in the volume of GDP, the overall level of nominal GDP is likely to fall this year. In fact, between 2007 and 2010, nominal GDP will have fallen by 17 per cent (from €189 bn. to around €157 bn.) and this has implications for various ratios, such as the deficit expressed as a percentage of GDP.

III.4 Public finances…

The Irish public finances, in particular tax receipts, have been very severely impacted upon by the sharp deterioration in economic activity. Tax revenue in 2010 is currently forecast at €31 billion, a 6 per cent decline on the 2009 outturn. As a result, the level of tax revenue this year will be 35 per cent below its peak in 2007. In effect, tax revenue is now back at 2003 levels, while, in contrast, gross voted current expenditure has grown by around 65 per cent over the same period.

The Exchequer returns for the year-to-date show tax revenue in line with expectations. On the expenditure side, there are some minor pressures on the current side, but capital spending is below profile. Notwithstanding the fiscal measures already implemented, an underlying General Government deficit of the order 11¾ - 12 per cent of GDP is in prospect for this year, by far the highest in the euro area. Moreover, this does not allow for the effect of any banking-related measures which could further significantly negatively impact upon the General Government deficit headline figure for 2010. Last year's deficit was impacted by certain banking measures and it is certain that this year's headline figure will be significantly affected by the fiscal treatment of various banking supports (relating mostly to Anlgo). While this statistical treatment does not impact on the fiscal consolidation path, it will impact on the perception of our public finances, and this increases the need for fiscal restraint.

III.5 Projections for this year…

The Department's latest forecasts for this year, published in July, are shown in table 1. The data which have become available in the intervening period are, for the most part, consistent with these numbers. As is the normal practice, 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.[1]

Table 1: Macroeconomic forecasts for 2010, per cent change

	D/Finance, July	Consensus, end-August
GDP	1.0	0.7
GNP	-¾	-1.0
CPI	-1.0	-1.0
Unemployment (per cent of labour force)*	13.5	13.6

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

IV. Economic outlook 2011 – 2014

There is little scope for any significant improvement in domestic demand conditions (see section IV.2) over the short- and medium-term. In these circumstances, exports must provide the main impetus to growth for the foreseeable future. The external environment will therefore have a major bearing on medium term prospects in Ireland.

IV.I The external environment…

Forecasts for our main export markets recently produced by the OECD are presented in Table 2 below. The key point is that, notwithstanding the modest recovery currently underway, economic conditions in our main export markets are likely to remain fragile. The need for public and private balance sheet repair in many of our trading partners means that growth is likely to be modest. As a result, notwithstanding the significant improvements in competitiveness that have taken place, relatively weak external demand will act as a restraining force on the pace of export growth.

Table 2: GDP forecasts for our major trading partners

	2010	2011
UK	1.3	2.5
US	3.2	3.2
euro area	1.2	1.8

Source: OECD, September 2010.

[1] 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.

Moreover, international forecasting organisations such as the OECD / IMF put the risks to global growth firmly on the downside. In particular, the possibility of a 'double-dip' recession in the US cannot be ruled out, while in recent weeks financial markets have once again become increasingly concerned about fiscal developments in peripheral euro area economies.

IV.2 Developments in the domestic economy…

While some improvement is possible, domestic economic conditions are likely to remain fairly subdued at least in the short term. Housing investment is likely to remain at low levels until excess supply is worked off, while general uncertainty is likely to restrain other forms of investment. Modest real income growth and the need for Irish households to repair their balance sheets will restrain personal consumption growth for some time.

Thus, while activity is expected to increase next year, growth is likely to be relatively modest. In the Budget last December, GDP in 2011 was projected to expand by 3¼ per cent. While the Department will revisit this projection in the *Pre-Budget Outlook* next month, it is of interest to note that the consensus forecast at end-August was for GDP growth of 2¾ per cent next year.

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.[2] Therefore, it is possible that growth of around 4 per cent per annum will be achieved over the 2011 – 2014 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 than factored in. Such a more pessimistic view would have significant implications for the scale of our fiscal consolidation.

Finally, the outlook for the labour market remains poor. On the basis of historical trends, unemployment will not fall unless GDP growth in the region 4½ – 5 per cent is attained.

[2] 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.

While there are some differences in the structure of the labour market now (such as the large presence of non-Irish nationals with a relatively weak attachment to the country) which means that the historical estimates may be on the high-side, it is nonetheless becoming increasingly evident that, without significant additional policy initiatives, unemployment will only recede at a modest pace in the coming years.

V Budgetary policy

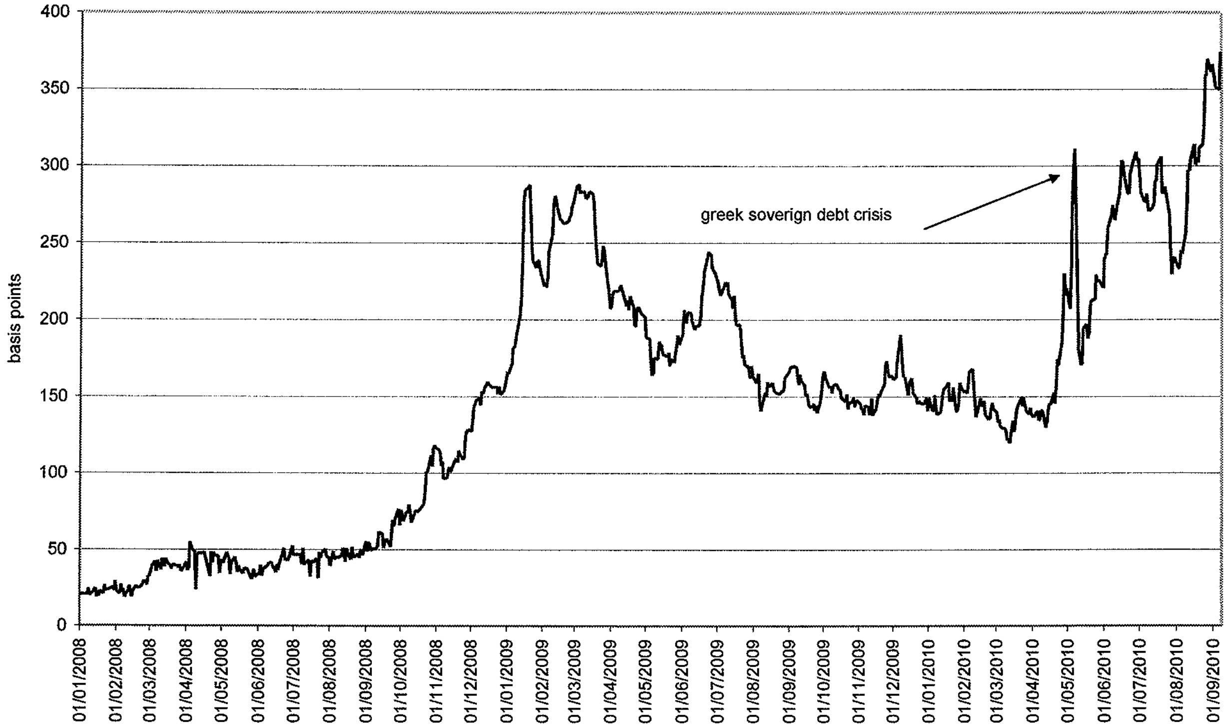
In terms of framing budgetary policy, the Department of Finance strongly held view is that the single most important requirement is to send a clear, decisive signal that Ireland is determined to continue to adopt feasible, sustainable budgetary measures to underpin the public finances over the long-term. In this regard, it is absolutely imperative that the fiscal consolidation programme, which envisages adjustments amounting to at least €3 billion for next year, is strictly adhered to.

V.1 Financial markets increasingly nervous…

Risk aversion is currently the dominant force in capital markets, with a large rise in the flow of investable funds into the safest of asset classes in recent weeks. In the euro area, this has resulted in yields on German government paper reaching an all-time low over the summer. Conversely, investor appetite for peripheral euro area government bonds – notably Irish government paper – has diminished in recent weeks. Rapidly rising public indebtedness (including public debt associated with supporting Anglo) has added to nervousness, with the result that investors are demanding a significant premium in order to lend to Ireland. The spread vis-à-vis Irish and German government bond yields has widened to levels in excess of those which prevailed in advance of the Greek sovereign debt crisis last May (figure 4). In other words, the cost of funding the deficit has risen significantly.

While the deficit for this year is now fully funded, the NTMA must raise around €20 billion per annum over the period to 2014 (to fund the annual deficit as well as re-finance existing debt). Thus, even if Ireland is able to continue to access capital markets, the huge financing needs of large advanced economies in the months and years ahead means that the cost of funds is likely to remain relatively elevated for the foreseeable future.

Figure 4: Difference on yield between Irish and German (10-yr) Government paper, bps



Source: Ecowin

V.2 Need to contain debt service cost …

The rising unit cost of debt together with the larger volume of debt means that an increasing proportion of available resources will be used to service the national debt – very soon, debt service costs will absorb one-fifth of taxation revenue. Servicing the national debt has first call on State resources with the result that, if not curtailed, rising debt service costs will (quite rapidly) constrain the capacity of the State to provide services to the population at large. Moreover, public debt is approaching 100 per cent of GDP, thus sending out worrying signals regarding long-term sustainability.

V.3 Additional fiscal consolidation is absolutely imperative…

The credibility built up through front-loading our consolidation efforts risks being lost as a result of (i) the very changed international circumstances (ii) the costs associated with Anglo and banking measures generally, and (iii) actions taken by other EU Member States to consolidate their public finances. In these circumstances, it is absolutely imperative that the fiscal consolidation path be strictly adhered to. In terms of the forthcoming Budget, apart from securing the next phase of consolidation through a mix of tax and expenditure measures, it would also be important to send a strong message that targets for later years will also be strictly adhered to. In this regard, the need to implement structural reform and take decisions that improve the sustainability of the tax system are vital.

V.4 Well designed consolidation measures will limit the economic impact…

Implementing fiscal consolidation measures at a time of weak activity will restrain the pace of economic growth. Nevertheless, without sufficient consolidation, sovereign debt market developments present a major risk to any recovery, i.e. in a nutshell, the need for fiscal consolidation supersedes the need to support demand in the economy.

With this in mind, there is considerable evidence to show that well-designed consolidation measures can limit the impact on private demand in the short term, as well as enhance the economy's capacity to grow over the medium term. While it is beyond the scope of this paper to provide an exhaustive list of suggestive measures, a number of principles should be adhered to in order to minimise the short- and medium-term economic impact.

Firstly, tax rates on capital and labour should be applied to a wide base, thus reducing the need for high rates while still supporting revenue. This would also help promote investment and labour supply, thus supporting growth over the medium term. Taxing immobile (and unproductive) factors of production – in particular property – would ensure a more stable income stream, while the introduction of user charges for publically-provided goods and services (e.g. water charges) would generate significant efficiency gains.

On the spending side, structural reforms which have a favourable impact on labour supply and promote medium term growth (for example curbing entitlement spending) would be preferable.

The Group may wish to discuss the emerging economic outlook.

September 2010