Tax Strategy Group

Economic Framework for Budget 2012

Summary: While GDP is growing once again in real terms, with a further pick-up expected next year and a return to more robust growth foreseen over the medium term, uncertainty and risks to the economic outlook are considerable. The export-led nature of economic growth points to a relatively jobless recovery, at least in the short-term, with the unemployment rate set to stay well above its pre-crisis level for some time to come.

On the budgetary front, the deficit remains extremely large and there are pressures emerging, particularly on the spending side. Despite an apparent improvement in sentiment towards Ireland and a narrowing of bond spreads in recent weeks, Ireland is still at high risk of contagion from the euro-area debt crisis. To convince market participants of the sustainability of the debt position, some commentators are suggesting that the consolidation process be accelerated.

The General Government deficit of 8.6 per cent of GDP is the absolute outer limit to be targeted next year; while targeting a lower deficit would provide a potentially valuable buffer. The importance of adhering to the deficit targets for 2012 and later years, and clearly laying out the way in which the required consolidation will be implemented, cannot be underestimated. Potential investors want to see that a clear, credible and achievable fiscal consolidation strategy is in place, with as much detail as possible set out. This should be done in the Pre-Budget Outlook, in line with the commitment in the revised MOU. It is also important to stress that the composition of consolidation matters and 'clever consolidation' - which minimises the impact on the economy - takes place.

I. Introduction

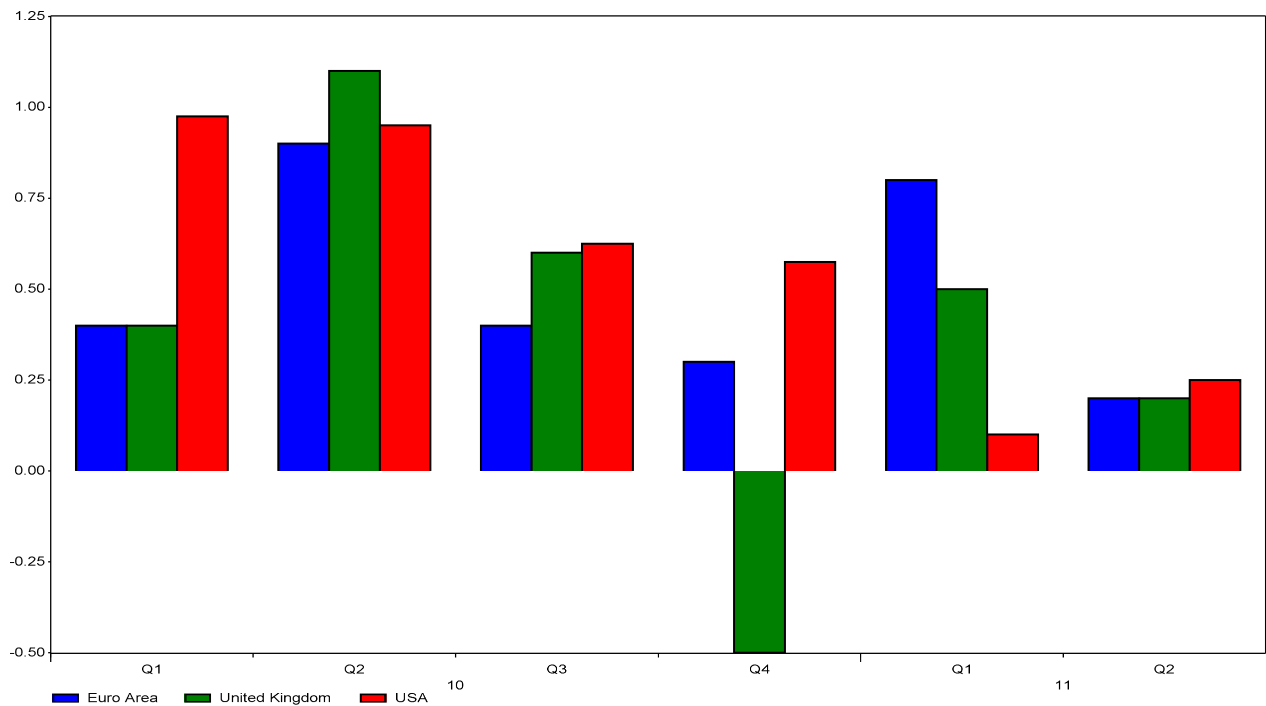
The primary objectives of this paper are to update the Group on the current economic situation and the emerging macroeconomic outlook. Recent developments in the external environment are briefly summarised in section II, while section III outlines the main trends in the domestic economy. Growth prospects over the period 2012–2015 are discussed in section IV, with Section V considering the risks to the economic outlook. Finally, Section VI sets out the views of the Department of Finance vis-à-vis the framing of the forthcoming Budget.

II. External Environment

Globally, uncertainty surrounding growth prospects has increased over the course of the summer. In advanced economies, the data-flow in recent weeks has been weaker than expected. As a result, short-term macroeconomic projections for many regions are in the process of being revised down. The downgrading of the US sovereign debt rating has added to uncertainty, while the intensification of the euro-area debt crisis necessitated further ECB intervention in sovereign debt markets. Emerging and developing economies are performing broadly as forecast, though signs of overheating are increasingly evident.

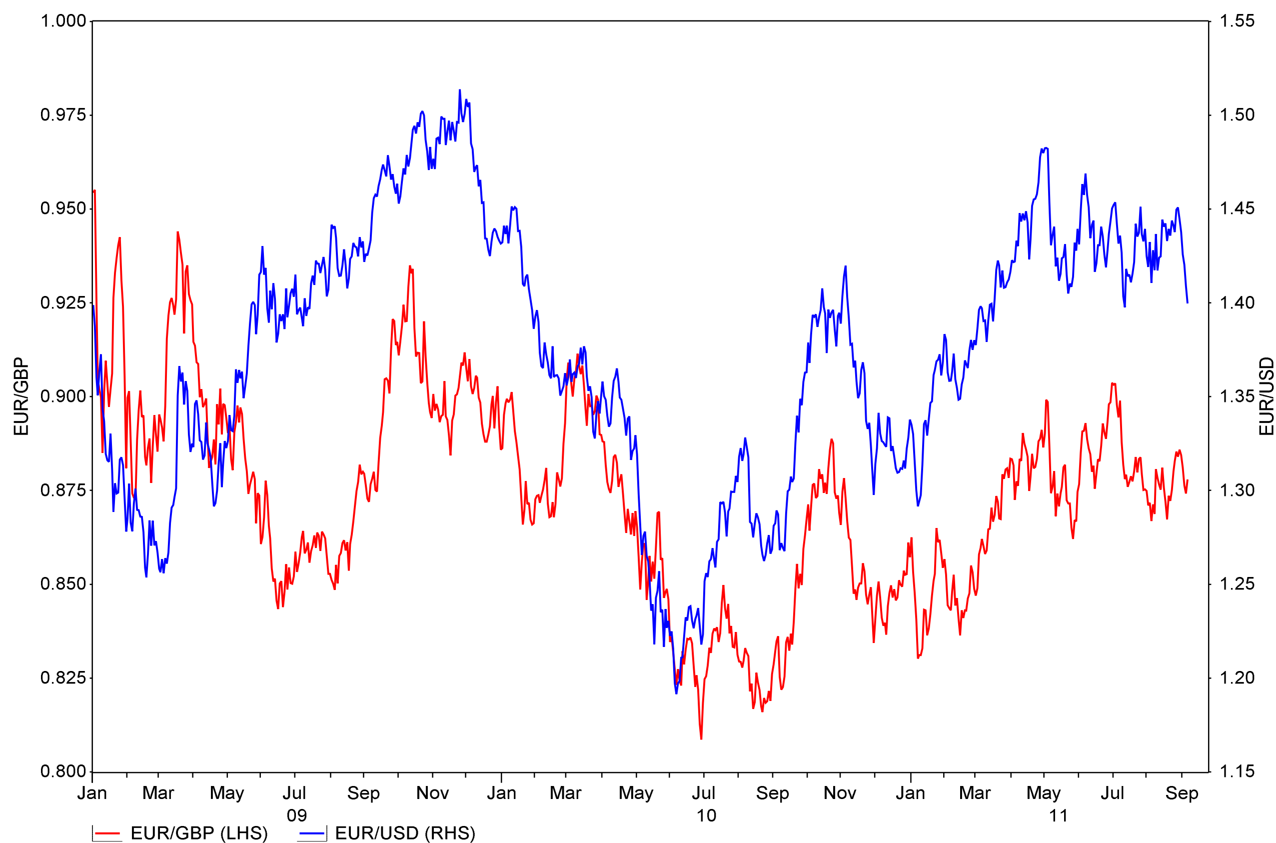
Advanced economies form the bulk of our main trading partners, with four-fifths of Irish exports going to the UK, US and euro area. The latest data for these economies has disappointed (see figure 1). Growth in the UK softened in the second quarter and has been weaker than expected in the US throughout the first half of the year, triggering talk of a 'double-dip' recession. Following an exceptionally strong performance in the first quarter, the euro-area economy slowed considerably in the second, as activity moderated in Germany and stalled in France.

Figure 1: Growth rates in our major trading partners (quarter-on-quarter growth, seasonally adjusted)



Exchange rate trends in the year to date have been broadly as expected, with the euro strengthening against the dollar and sterling (see figure 2). At end-August, the euro-dollar bilateral rate was €1 = $1.44, while the euro-sterling rate was €1 = stg£0.88. Both rates are above those in the same month of 2010, though the appreciation of the euro against the dollar over the course of the year has been more marked.

Figure 2: Exchange rate developments, 2009 to present



Turning to commodity prices, figure 3 shows that oil prices have been on an upward trend for some time now, averaging around $113 (€80) per barrel in the year so far. This primarily reflects supply side issues, and the geopolitical crisis in the Middle East in particular. Futures markets are currently pricing in an oil price of $109 at end-2012 and $105 at end-2013. Prices of other commodities, such as food and metals, have also increased.

Figure 3: Oil price developments, 2009 to present

III. Latest Domestic Developments

III.1 Economic developments in 2011…

Domestically, GDP is growing once again in real terms. National accounts data show that GDP rose by 1.3 per cent on a quarterly basis in the first quarter of the year, though GNP slipped back into negative territory. The dichotomy that has characterised the recovery so far – a buoyant exporting sector but depressed domestic demand – was also a feature of the first quarter data. As expected, export growth was strong and relatively broad-based, whereas domestic activity in general and household spending in particular remained weak.

The flow of economic data over the summer has been mixed. Notably, high-frequency indicators such as retail sales and consumer sentiment continued to disappoint. Disposable income is being affected by, inter alia, fiscal consolidation and recent interest rate rises, with the latter also impacting on the cost of capital and investment activity. At the same time, concerns about the situation in Greece and the wider euro area, along with general

uncertainty, are weighing on household and business confidence. On the housing front, recent data are consistent with a further fall in output this year. More positively, the latest trade data show that goods exports performed reasonably well in the second quarter, though 'soft' data released over the summer months points to a weakening in new export orders.

While second quarter National Accounts data will not be published until later in September and both the domestic and international situations remain fluid, the general expectation at this point is that GDP will return to growth this year, for the first time since 2007. The Department of Finance's latest forecast (as set out in April's Stability Programme Update) is for GDP to increase by 0.8 per cent, driven by a strong contribution from the traded sector. Uncertainty and risks at the current juncture are considerable however (see section V).

III.2 Labour market developments…

The labour market situation remains weak, although there are tentative signs that conditions are stabilising. Employment continued to decline in the first quarter of the year but did so at its slowest pace for three years (-0.5% from the previous quarter). Against the backdrop of a further decline in the labour force, the unadjusted unemployment rate (on a Quarterly National Household Survey basis) has increased only marginally since the third quarter of 2010, from 13.9% to 14.1%. On the other hand, Live Register trends suggest unemployment has picked-up lately, with provisional data putting the unemployment rate at 14.4 per cent in August. While the September data will give a clearer picture, the Live Register average for this year is set to be much higher than initially forecast, with significant implications for the 2012 average and also for the public finances.

The export-led nature of economic growth points to a relatively jobless recovery, at least in the short-term. This is borne out by recent data, and indeed, employment is projected to fall again this year, albeit by less than in the past couple of years. The growing numbers in long-term unemployment is also of concern, with more than half of those out of work in the first quarter having been unemployed for more than a year.

III.3 Inflationary developments…

The latest data show that consumer prices have rebound. The harmonised index of consumer prices (HICP) – the international comparison measure - rose by 1.0 per cent in August; compared with an annual rate of decline of 1.2 per cent in the same month of last year. Annual HICP inflation is forecast at around 1.0 per cent for this year as a whole. As consumer prices elsewhere are projected to rise at a faster pace, this will support a continued improvement in Ireland's competitiveness position. In CPI terms, annual inflation in the region of 2½ per cent is forecast for this year. Unlike the HICP, this measure takes account of interest rates and thus, the increases in both retail and ECB policy rates in recent months.

A wider measure of price developments in the economy is the GDP deflator, which reflects not just consumer prices, but prices for investment goods and services, export prices, etc. This was negative in the first quarter, but is expected to pick-up as the year progresses.

III.4 Public finances…

The end-August Exchequer Returns show taxes above target and voted spending less than planned. On a cumulative basis, tax revenues were 1 per cent better than expected, though this was largely due to favourable timing factors related to income tax and stamp duties. The Exchequer deficit remains large however, and there are a number of pressures emerging, particularly on the spending side.

In General Government terms, a deficit in the order of 10 per cent of GDP is in prospect for this year. Crucially, this is within the 10.6 per cent target set by the ECOFIN Council in December 2010. However, it is based on the assumption that none of the banking recapitalisation payments funded from the Exchequer in July are classified as capital transfers and, therefore, counted as part of the General Government deficit. This will become clearer in the coming weeks in the context of the end-September Maastricht statistical returns to Eurostat.

In addition, this General Government deficit estimate assumes that tax revenues meet the overall Budget 2011 target, that spending pressures are managed from within existing resources and that the once-off/other measures factored into the Budget 2011 forecasts are fully realised. It is vital that these assumptions these hold.

III.5 Projections for this year…

The Department of Finance's latest economic forecasts, published in April's Stability Programme Update (SPU), are shown in table 1. While there is much uncertainty, the information that has come to hand since then suggests that the GDP growth forecast for this year is still broadly on track; though the composition may alter and the risks are now firmly to the downside (see section V). The Department will update its forecasts in the coming weeks, taking account of international and domestic data (such as second quarter National Accounts figures) available up to end-September. As is the normal practice, these revised forecasts will be published in October's Pre-Budget Outlook. In the meantime, the latest private sector consensus forecasts (i.e. those published at end-August) are shown for illustrative purposes.[1]

Table 1: Macroeconomic forecasts for 2011, per cent change

	Dept. of Finance, April's SPU	**Consensus, end-August**
GDP	0.8	0.5
GNP	0.3	-0.4
HICP	1.0	1.3
Unemployment (per cent of labour force)*	14.4	14.2

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

IV. Economic outlook 2012–2015

As domestic demand is set to remain lacklustre for some time yet (see section IV.2), the main impetus to growth will necessarily have to come from exports. The external environment will thus have a major bearing on short to medium-term growth prospects.

[1] Each month, Reuters surveys around ten private sector forecasters (mostly in the financial sector) and publish the median projections for the key macroeconomic variables.

IV.I The external environment…

As noted above, economic growth in our main trading partners was weaker than expected in the first half of the year. Furthermore, with the legacies of the crisis taking longer than expected to unwind and ongoing tensions in financial and sovereign-debt markets, the OECD has revised down its growth projections for US, UK and the euro area for the second half of the year. However, it still foresees a modest expansion in all three economies. These developments will hold back Irish export growth somewhat, though the significant improvements in competitiveness that have taken place in recent years will continue to provide support in the period ahead.

IV.2 Developments in the domestic economy…

With households, firms and the government still working through past imbalances, domestic demand conditions are likely to remain subdued for some time to come. Housing investment is set to remain at low levels until excess supply is eliminated, whereas general uncertainty is likely to dampen other investment activity. Modest real income growth, the need for households to repair their balance sheets and fiscal consolidation will restrain personal consumption growth.

Compared to this year, the drag from these factors is not expected to be as pronounced in 2012. As such, a further pick-up in economic activity is expected next year. At the time of the SPU, GDP was projected to expand by 2.5 per cent in 2012. While the Department will revisit this projection in next month's Pre-Budget Outlook, the changed external environment would suggest that the balance of risks is now to the downside (see section V). Should growth next year turn out to be softer than expected, it would make it difficult to achieve the General Government deficit target for 2012 without additional consolidation. It would also imply a more sluggish recovery in employment. For illustrative purposes, the Consensus forecast for GDP growth next year was 1.9 per cent at end-August, while the IMF has just revised down its forecast for next year from 1.9 per cent to 1.5 per cent.

Looking to 2013 and beyond, a gradual firming in economic activity is foreseen as the recovery broadens out and spills over to the labour market. With external headwinds

adding to those on the domestic front however, it may be that the economy's return to robust growth is pushed slightly further out the medium-term horizon.

Finally, a gradual improvement in labour market conditions is expected over the forecast timeframe. As the recovery gains ground, the pace of hiring should strengthen and the numbers out of work should start to come down. Even so, the unemployment rate is expected to remain well above its pre-crisis level and still in double-digits by 2015.

V. Risks to the economic outlook

Uncertainty at the current juncture is high and risks to the macroeconomic outlook are considerable. To begin with, there are what might be described as 'perennial' risks, those to which economic forecasts, particularly for an open economy, are generally subject. These include growth in Ireland's main trading partners which could be weaker or stronger than assumed, and the possibility of adverse commodity price, exchange rate and interest rate movements.

But there are also risks specific to the circumstances in which the economy currently finds itself. The most important of these relate to the speed of balance sheet repair on the part of households and the corporate sector, the unprecedented scale of fiscal adjustment and its effect on confidence and private consumption / economic activity, and the availability of credit. The balance of risks in respect of these issues is largely to the downside. Moreover, the situation in Greece and the wider euro area remains volatile and negative spill-over effects to Ireland cannot be ruled out. On the upside, the structural reform measures set out in the Programme for Government and the Joint EU/IMF Programme could boost competitiveness, and thus exports, by more than expected.

As already mentioned, the forecasts set out in April's Stability Programme Update will be revisited in next month's Pre-Budget Outlook. While international and domestic data available over the coming weeks will need to be taken into account, developments in the year to date suggest that private consumption is likely to be somewhat weaker this year and next than anticipated at the time of the SPU. With external headwinds gaining momentum

of late, export growth is also likely to be softer. On the other hand, risks to the unemployment forecast for this year (on a Quarterly National Household Survey basis) appear to have marginally lessened, on foot of downward revisions by the CSO to the standardised unemployment rate in the early months of the year. In terms of prices, developments so far this year suggest that there may be a slight upside risk to the 2011 HICP inflation forecast, but downside risk to the forecast for the GDP deflator. The latter would imply a lower level of GDP, and thus impact on the various fiscal ratios as well as revenue generation.

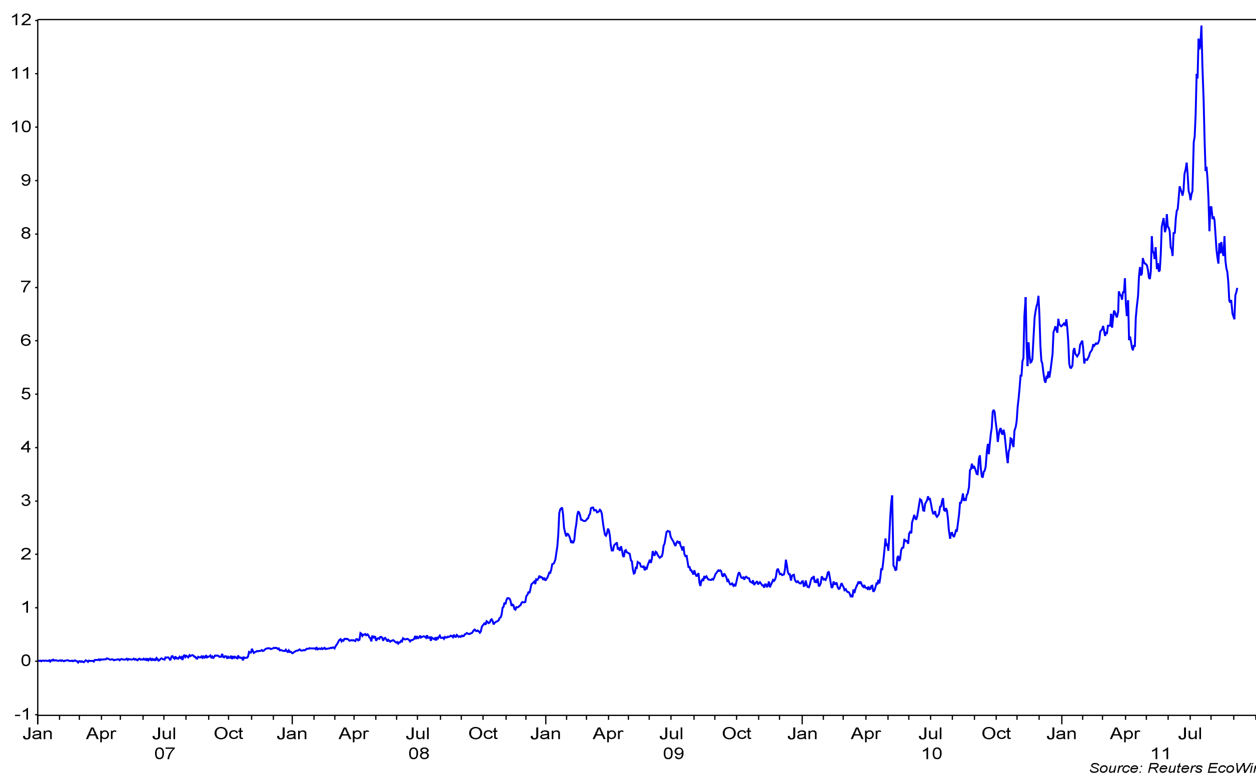
VI. Budgetary policy

In terms of framing budgetary policy it is extremely important to adhere to the General Government deficit targets for 2012 and later years – which have been agreed at ECOFIN - particularly in the context of returning to sovereign debt markets. Potential investors (long term foreign direct investors and financial market investors) want to see that a clear, credible and achievable fiscal consolidation strategy is in place, with as much detail as is practically possible set out.

VI.1 Ireland remains at high risk of contagion…

Ireland's standing in financial markets has improved on foot of the announcements made at the July 21 Heads of State/Government of the euro area meeting, with sovereign debt yields indicating a clear decoupling from other programme countries in recent weeks. While still high, rates have come down significantly from their peak reflecting factors such as savings on the banking side and strong programme implementation. In recent days, the yield on the benchmark 10-year bond has fallen below 9 per cent in the secondary market for the first time since February. Notwithstanding this improvement in sentiment, it remains the case that Ireland is at high risk of contagion from the euro-area debt crisis. Given this, there can be no deviation from the commitment to restore sustainability to the public finances.

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



In terms of the forthcoming Budget, apart from securing the next phase of the fiscal correction through a combination of tax and expenditure measures, it would be important to send a strong message that General Government deficit targets for later years will also be strictly adhered to. Implementing structural reforms and taking decisions that improve the sustainability of the tax system are essential in this respect.

VI.2 Targeting a GGD of 8.6 per cent of GDP is the absolute outer limit for 2012…

A General Government deficit (GGD) for 2012 of 8.6 per cent of GDP is the absolute outer limit to be targeted. Following the meeting of the Heads of State/Government of the Euro Area on 21 July it was announced that Ireland, along with other programme countries, would benefit from lower interest rates and extended maturities on loans from the European Financial Stability Facility (EFSF). As there are aspects of the interest rate change that have yet to be finalised, it is difficult to be precise about the impact, though potential savings are in the region of €600 million on the basis of certain assumptions[2]. All

[2] As a technical exercise, the NTMA has estimated that on the basis of a 2% reduction in the interest margin for all EFSF, EFSM and bilateral loans drawn down as part of the Joint EU/IMF Programme,

other things being equal, this would reduce the General Government deficit. However, there are other factors emerging which are likely to push the deficit back up. As such, a budgetary consolidation package of at least €3.6 billion, and probably more, will be required in 2012 if the 8.6 per cent of GDP General Government deficit target is to be achieved. Targeting a General Government deficit below the 8.6% of GDP would provide a buffer in the event that factors beyond Ireland's control – such as the external environment, financial-market reactions and potential policy mistakes at US and EU level – dominate. It would also ensure that Ireland stayed 'ahead of the curve' in financial markets.

VI.3 Targeting a GGD of 8.6 per cent of GDP is the absolute outer limit for 2012…

In order to minimise the short and medium-term economic impact of the consolidation needed to achieve the 8.6 per cent of GDP, or a lower General Government deficit target, a number principles should be adhered to. In the first instance, tax rates on capital and labour should be applied to a wide base, thus reducing the need for high rates but at the same time supporting revenue. By benefitting investment and labour supply, this would also support growth over the medium term. Second, taxing immobile (and unproductive) factors of production would ensure a more stable income stream, while the introduction of user charges for publically-provided goods and services 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. A carefully targeted reduction in infrastructure investment could also be envisaged. Given the prevailing circumstances in Ireland, it is unlikely that this would have the usual effect of reducing the growth potential of the economy.

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cash savings would be of the order of €600 million in 2012. Savings of this magnitude are calculated on the basis of the benefit from the rate reduction applying to the full amount of the funding available to be drawn down in 2012, and to future interest payments on funds already disbursed. It is also based on the 2% cut applying to the average rates which were used to calculate the original interest estimates. The State will of course only be able to draw down all of the funding available under the Programme if the targets set under the Programme continue to be met.

It is also important that specific measures are chosen in order to minimise the damage to the economy. In other words, we need 'clever consolidation' – the composition of consolidation matters.

VI.4 Greater transparency will boost certainty and credibility…

At present, there is a lot of uncertainty as to the nature of the consolidation measures to be implemented as part of Budget 2012 and subsequent budgets. Outlining in the Pre-Budget Outlook what is to be done may prove beneficial in providing clarity and credibility; thus allowing households and businesses to plan their spending and make investment decisions. Such a step would also be in line with the MOU. It is also likely to be viewed favourably by our external funding partners and international financial markets. During discussions with officials of the EU, IMF and ECB in the course of the July Review, they expressed the strong view that the earlier decisions are made with regard to the nature of the consolidation measures to be introduced in 2012, and also in 2013-2015, the better. This should be done as part of October's Pre-Budget Outlook. Indeed, the revised MOU (following the July Review of the Joint EU/IMF Programme) contains a commitment to present by end-October a PBO *"setting out a medium-term fiscal consolidation plan for the period 2012-2015 outlining the overall composition of revenue and expenditure adjustments for each year, consistent with the targets set out in the Council Recommendation in the context of the excessive deficit procedure. Moreover by 2012 Budget day in early December 2011 Government will anchor this consolidation plan in binding medium-term expenditure cash ceilings and will set out revenue and expenditure measures to deliver the needed adjustment"*.

The Group may wish to discuss the emerging economic outlook.

September 2011