TSG 12/03

Tax Strategy Group

Economic Framework for Budget 2013

Summary: A modest expansion of economic activity is expected this year, and progress is being made in reducing the budgetary deficit. At this stage it appears that the deficit target for this year will probably be met, although there will be little, if any, headroom.

Strong programme implementation, and in particular the achievement of various budgetary targets, has boosted market sentiment towards Ireland, and partial market-access has been achieved. The June euro area summit has also been an important factor in this regard, offering the possibly of removing some bank-related debt from the sovereign balance sheet.

It is crucial that momentum is maintained and that budgetary targets in Ireland continue to be achieved. Unfortunately, however, the outlook for next year is clouded by uncertainty. The Department's projection of 2.2 per cent GDP growth next year was published last April. The intensification of the euro area debt crisis since then and the (related) weakening of external demand mean that downside risks to this forecast are not insignificant. On the other hand, the prospect of the ECB providing an effective financial backstop in the euro area may have a positive effect on confidence and growth, although it will take some time to assess whether or not this is a game-changer for the monetary union.

I. Introduction

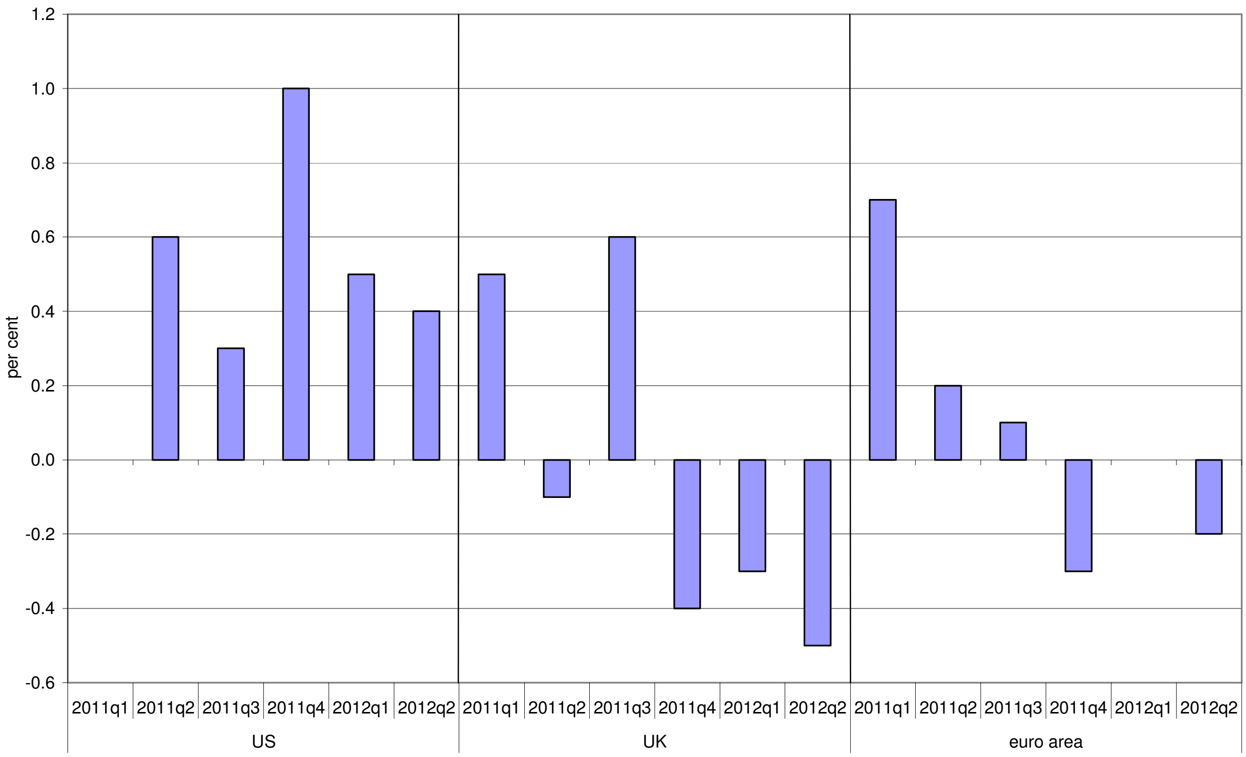
The primary objective of this paper is to update the Group on the current economic situation and the emerging macroeconomic and fiscal outlook. Recent developments in the external environment are briefly summarised in section II, while section III outlines the latest trends in the domestic economy. Prospects for the Irish economy over the period 2013–2015 are discussed in section IV while some of the key risks are identified in section V. Finally, section VI sets out the views of the Department of Finance in relation to the forthcoming Budget.

II. External Environment

II.1 Growth in our major trading partners…

Following tentative signs of stabilisation in the early part of this year (partly due to the positive impact of the ECB's longer term refinancing operations), the intensification of the euro area sovereign debt crisis from the second quarter has adversely affected global confidence, and financial market uncertainty has increased once again. These developments are affecting the 'real' side of the economy in many of our trading partners, where the data-flow over the summer has disappointed (see figure 1). In the **euro area** – the epicentre of current financial market stress – GDP contracted by 0.2 per cent in the second quarter of 2012 following a flat first quarter. Indeed, the aggregate figures are flattered somewhat by the performance of the Germany economy; the position is far worse in many other Member States, with almost half of all countries now in technical recession. High frequency data – including 'soft' data – point to continued weakness in the third quarter. In the **UK** GDP contracted by 0.5 per cent in the second quarter, the third successive quarter of negative growth. In the **US** the figures were a little more encouraging, with GDP increasing by 0.4 per cent in the second quarter.

Figure 1: Growth rates in our major trading partners (q/q, s.a.)



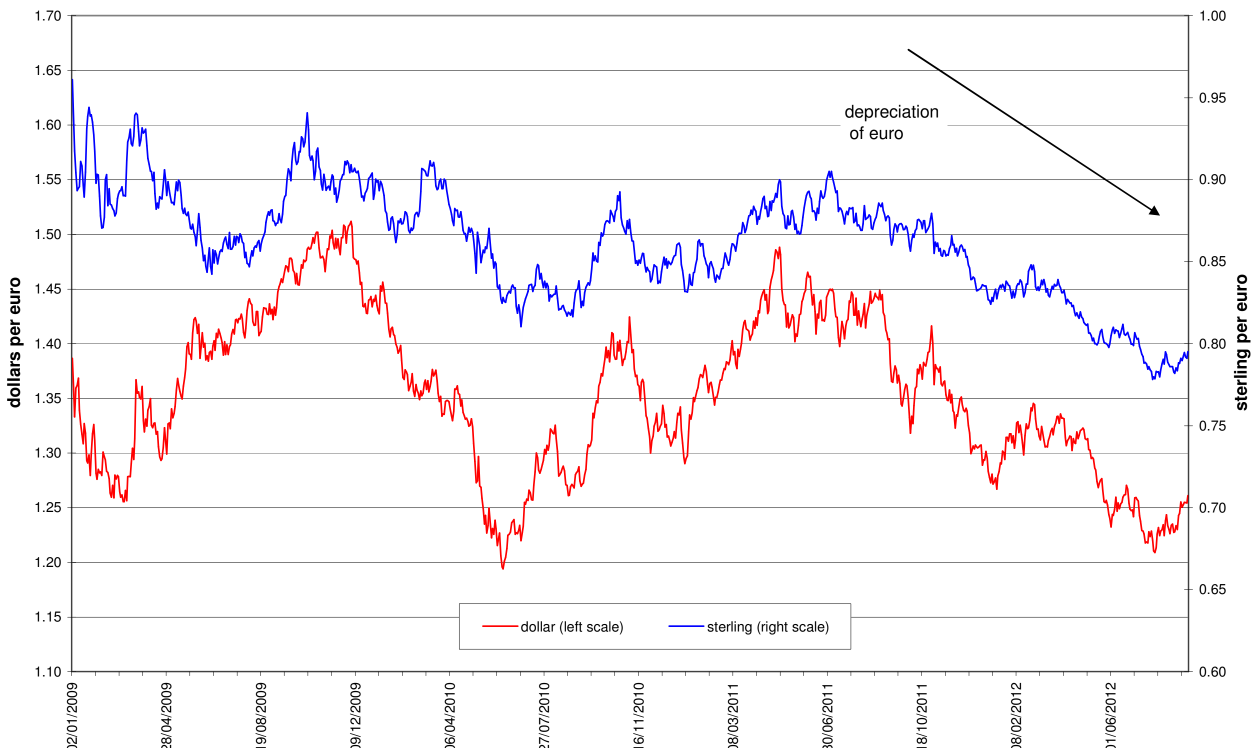
Source: Eurostat

II.2 Exchange Rate Developments…

Exchange rate developments from January 2009 are shown in figure 2 below. A gradual depreciation of the euro against both sterling and the dollar has been evident since mid-2011, as the crisis in the euro area has intensified. At end-August, the euro-dollar bilateral rate was $1.25, a 14 per cent depreciation over the last 12 months; the euro-sterling at end-August was £0.79, a 10 per cent depreciation compared with the same month a year earlier.

While the euro depreciation in part reflects concerns about the single currency, it is beneficial from an export perspective by reducing the price of Irish-produced goods and services in third country markets (particularly in the UK). In the past, depreciation against sterling would have been associated with upward pressure on import prices, with downstream effects on consumer prices; at the current juncture, however, the weakness of domestic demand is likely to contain the inflationary effects emerging through this channel.

Figure 2: Exchange rate developments, 2009 to present

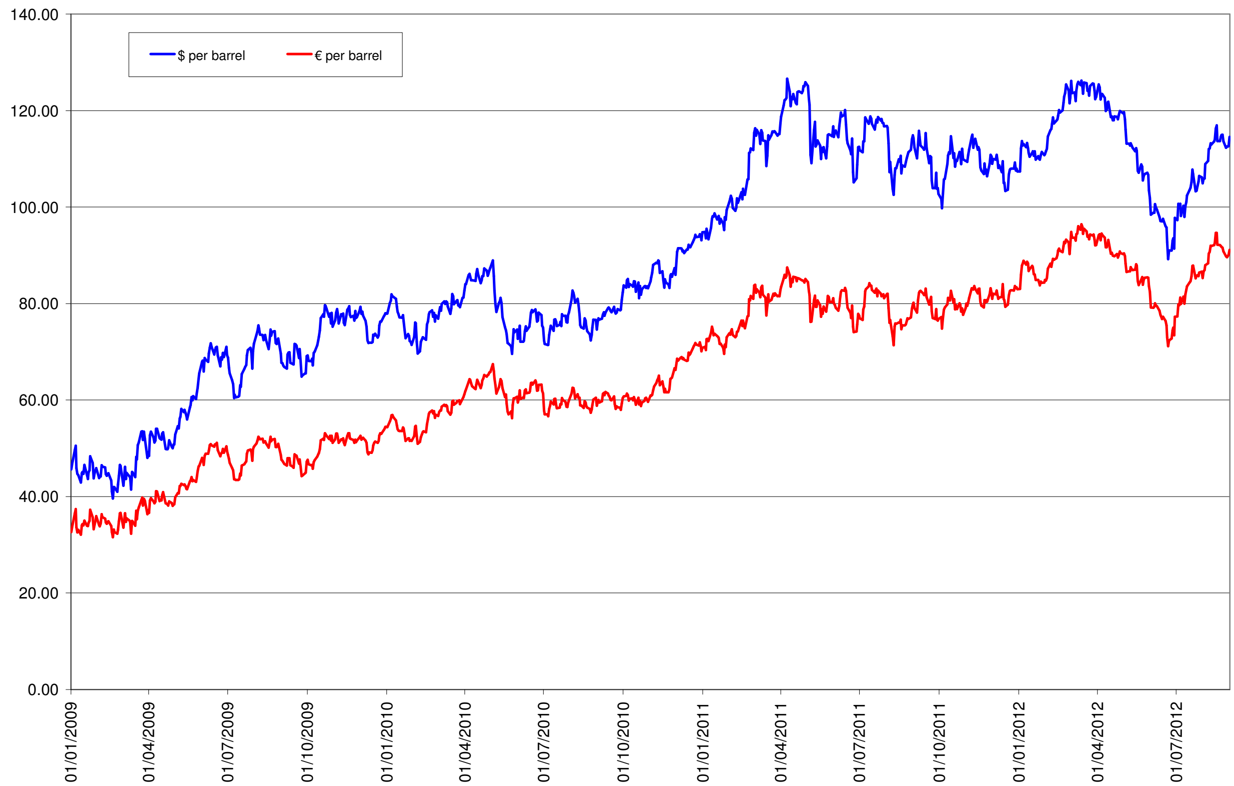


Source: Central Bank.

II.3 Oil price developments…

Notwithstanding the weakening of global economic activity, the price of crude oil has remained elevated this year, peaking at $126 per barrel in March, the highest level since mid-2008 (see figure 3). A key factor underlying recent trends is heightened geopolitical tensions in important oil-producing countries, which is affecting supply. In addition, given that oil is traded in dollars, the depreciation of the euro against the dollar has put upward pressure on the euro price of oil. At end-August, the price of a barrel of Brent crude stood at $112 (around €90 per barrel).

Figure 3: Oil price developments, 2009 to present



Source: Ecowin.

III. Latest Domestic Developments

III.1 Economic activity in the first half of 2012…

The latest (preliminary) data show that real GDP declined at a quarterly rate of 1.1 per cent in the first quarter of this year (GNP fell by 1.3 per cent). When compared with the same period last year, the level of activity increased by 1.2 per cent, with the composition of demand broadly in line with developments over the last year or so, i.e. weak domestic demand together with relatively strong export growth.

The data-flow over the summer points to a continuation of this broad trend. Personal consumer spending remains weak, although there are some tentative indications of a stabilisation of 'core' spending, albeit at low levels. On the external side, industrial production data have been fairly positive, which dovetails nicely with the performance of manufacturing Purchasing Managers Indices.

III.2 Labour market developments…

Conditions in the labour market remain poor. Employment fell at a quarterly rate of 0.4 per cent in the first quarter of this year (a fall of 1.0 per cent when compared with the same period a year earlier), with the largest declines recorded in sectors largely associated with the public sector.[1] Unemployment reached 14.8 per cent in the first quarter, and live register trends point to unemployment remaining high in the intervening period. Of particular concern is the fact that the long term unemployment rate (those unemployed for one year or over) is now almost 9.0 per cent, or nearly two-thirds of those out of work.

Over the past couple of years, labour supply in Ireland has fallen in response to the deterioration in labour demand, with increased outward migration and falling participation rates. This, in turn, has mitigated the increase in unemployment. However, there is increasing evidence that the fall in labour supply is bottoming out; so in other words, there is the very real possibility that even if employment does pick up, it will not lead to commensurate reduction in unemployment. This has important implications for policy.

III.3 Inflationary developments…

As measured by the Harmonised Index of Consumer Prices (HICP) – the comparable measure of inflation across Europe – prices in Ireland rose at an annual rate of 2.6 per cent in August. While price pressures across most components of consumer expenditure are relatively muted, upward pressure has come from oil price developments, both directly (e.g. pushing up petrol, home-heating oil prices) and indirectly (e.g. pushing up the price of consumer goods and services that rely on oil as an input, such as electricity). Upward pressure is also emanating from indirect tax increases and administered prices changes, with adverse implications for our price and cost competitiveness.

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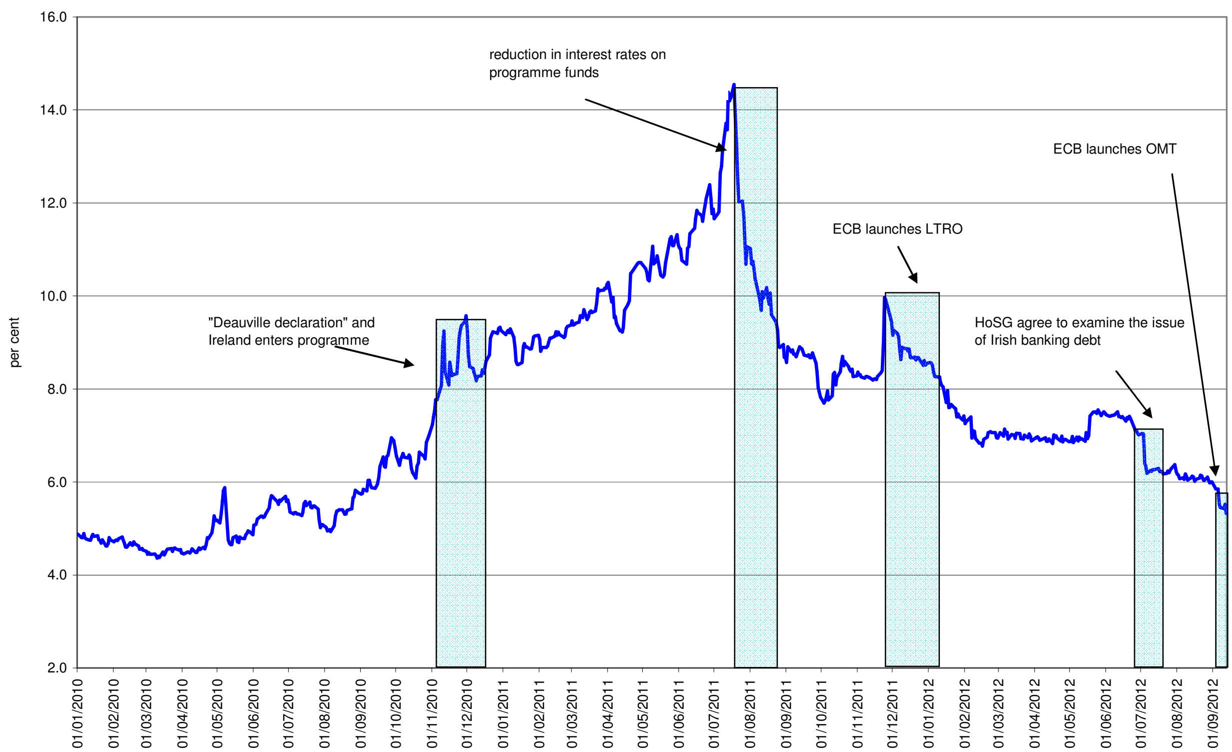
[1] The quarterly national household survey does not distinguish employees between public and private sectors. Instead, employees are characterised into fourteen sectors; our assumption is that sectors such as education, health and public administration are populated by (mainly) public sector employees.

III.4 Public finances…

Strong programme implementation, and in particular the achievement of various budgetary targets, has boosted market sentiment towards Ireland (see figure 4). Partial market-access has been achieved, albeit at prices above the cost of programme funds. The partial return to capital markets is an important first step, and has also succeeded in reducing considerably financing needs that would have arisen in early-2014 because of a large redemption which, at one stage, stood at almost €12 billion.

Figure 4: Yields on long-dated Irish Government paper[2]



Source: Department of Finance.

In terms of developments this year, the latest data show cumulative tax receipts in the period to end-August 1.7 per cent ahead of expectations. However, data also suggest some weakening in more recent months with income tax receipts falling short of targets in both July and August and excise receipts recording a large shortfall in August. September is a key month for tax receipts (for VAT and stamp duties in particular) and the outturn will provide a clearer indication of the likely end-year position.

[2] Up to late-2011 the chart shows the yields on 10-year Irish government paper; thereafter the figures refer to the yield on the 9-year note as there is no 10-year note outstanding.

In addition, it is important to note that the taxation surplus (relative to target) is effectively offset by higher voted expenditure, notably in the Social Protection and Health areas which has been evident for much of the year. This is a serious cause for concern in the context of firstly, achieving budgetary targets and secondly, restoring confidence in the management of the Irish public finances.

In General Government terms, the April Stability Programme Update (SPU) projected a deficit of 8.3 per cent of GDP for this year. This is within the 8.6 per cent limit set by the ECOFIN Council in December 2010. This was based on two crucial assumptions. Firstly, both tax revenues and voted spending were assumed to end the year in line with profile. Secondly, achieving an 8.3 per cent deficit assumed that the auctioning of the Spectrum mobile telephony licence proceeded as planned this year. If these revenues are not realised in 2012, the deficit estimate would *ceteris paribus* be right at the 8.6 per cent of GDP deficit limit permissible.

III.5 Projections for this year…

The Department of Finance's latest economic forecasts for 2012, published last April in the SPU, are shown in table 1. The data to hand suggest that these projections remain broadly valid. For instance, the April projections for most variables (GDP, GNP, etc.) are in line with the consensus forecasts which were published at end-August. [3]

Table 1: Macroeconomic forecasts for 2012, per cent change

	DoF, April	**Central Bank July**	**Commission August**	**ESRI June**	**Consensus end-August**
GDP	0.7	0.7	0.4	0.6	0.7
GNP	-0.2	-0.3	n.a.	0.0	-0.4
HICP	1.8	1.4	1.4	1.7^	1.7
Unemployment	14.3	14.7	14.8	14.9	14.6*

Source: Department of Finance and institutions cited.
^ CPI.
* end-year.

[3] 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.

The Department will update its forecasts in the coming weeks, taking account of macro and fiscal data that will shortly become available, including the second quarter national accounts and end-September public finance data (both Exchequer and EDP returns). These revised forecasts will be published in October.

IV. Economic outlook 2013–2015

The April SPU forecast was for GDP growth of 2.2 per cent in real terms next year and 3.0 per cent in both 2014 and 2015. This was based on the assumption of a stabilisation in domestic demand, albeit at relatively low levels, as well as a fully-functioning credit market over the forecast horizon. In addition, the assumption of a recovery in the external environment underpinned the April projection.

At this stage, the outlook for next year is clouded by considerable uncertainty. While there are signs that the rate of contraction in domestic demand is easing, the external environment – central to any meaningful recovery in Ireland – appears increasingly fragile. Ongoing balance sheet repair – in both public and private sectors – in many of our trading partners is clearly taking its toll on external demand, while uncertainty regarding the policy response to the euro area debt crisis is weighing on the confidence of households and firms.

Table 2: GDP forecasts for our major trading partners, per cent change

	2011	2012	2013 - SPU	2013 – now
UK	0.7	0.2	2.0	1.4
US	1.7	2.0	2.0	2.3
euro area	1.5	-0.3	0.9	0.7

Source: IMF WEO Update, July 2012

Against this backdrop, the outlook for external demand is weaker than previously assumed. Table 2 shows IMF projections for GDP growth in our main export markets next year, and compares these with the forecasts that underpinned the SPU last April. It is evident that output growth in both the UK and euro area will be weaker than assumed, although this is partly offset by stronger than assumed activity in the US. All-in-all, the less benign external situation could have negative implications for the performance of Irish exports and the wider Irish economy next year.

In the absence of updated, publically-available forecasts, the Department's April forecasts are compared with those of other institutions in table 3 below. While in line with the prevailing consensus at the time, the Department's April forecasts are now at the upper-end of the spectrum, given developments in the intervening period. In summary, therefore, the earlier projection of 2.2 per cent real output growth for next year is looking increasingly at the optimistic end. Revised projections for next year (and for 2014 and 2015) will be published in October.

Table 3: Macroeconomic forecasts for 2013, per cent change

	DoF, April	**Central Bank July**	**Commission August**	**ESRI June**	**Consensus end-August**
GDP	2.2	1.9	1.4	2.2	1.8
GNP	1.4	0.9	n.a.	0.5	0.8
HICP	1.3	0.7	1.0	1.5^	1.5
Unemployment	13.6	14.4	14.4	14.7	14.0*

Source: Department of Finance and institutions cited.
^ CPI.
* end-year.

V. Risks to the forecasts

The macroeconomic outlook is highly uncertain, and downside risks loom large. The most immediate risk relates to the situation in the euro area, which has adversely affected global confidence and is the root-cause of financial market stress. Having said that, the ECB recently announced that it stands ready to support euro area Member States experiencing financial difficulties, subject to appropriate conditionality, by purchasing (potentially) unlimited quantities of short-dated public debt in the secondary market. At this stage it is too early to assess whether this would be a game-changer, but it could potentially have a positive effect on confidence in the euro area, leading to a more rapid recovery than currently expected.

Other key external risks relate to commodity prices, and in particular oil prices. Notwithstanding the softening of global activity prices remain at elevated levels, and a further supply-side shock cannot be ruled out.

On the domestic front, confidence remains fragile and could deteriorate rapidly in the event of external developments. Earlier forecasts were underpinned by the assumption of a fully functioning credit market; if this was not to materialise then domestic demand would *ceteris paribus* be lower than envisaged over the forecast horizon. In addition, the labour market situation presents a risk to the attainment of the economic forecasts. Unemployment is becoming progressively more structural in nature, with an emerging skills mis-match between the new jobs being created and those seeking work. This raises the very real possibility that unemployment will not fall as rapidly as currently envisaged over the forecast horizon, with implications for both domestic demand and the public finances.

VI. Budgetary policy

In the context of framing budgetary policy, it is first and foremost crucially important that fiscal targets – both the annual General Government deficit targets set by the ECOFIN Council in December 2010 as well as the EU/IMF Programme cumulative end-quarter Exchequer primary balance targets – continue to be adhered to. Progress in reducing the deficit is being made and with this Ireland's credibility and standing in the markets have improved.

It is vital that momentum be maintained. Firstly, notwithstanding recent progress, the deficit remains excessively large with, for instance, a primary surplus, i.e. the budgetary position excluding interest payments, not expected until 2014. Secondly, further consolidation is also necessary to stem the increase in public debt (expected to peak at around 120 per cent of GDP next year on the basis of the April SPU forecasts) and curtail the rapid increase in debt servicing costs which has absorbed a substantially increased amount of revenue in recent years. While discussions regarding the possible removal of (some) banking debt from the sovereign balance sheet are ongoing, the fact is there remains a very large gap between day-to-day spending and revenues that is contributing to increased public debt and this needs to be closed.

V.1 Adherence to the 2013 GGD limit of 7.5 per cent of GDP is a must…

A General Government deficit for 2013 of 7.5 per cent of GDP is the absolute outer limit permissible under the terms of ECOFIN Council decision of December 2010. A budgetary consolidation package of €3.5 billion was identified in last November's Medium Term Fiscal Statement (MTFS) as being required in 2013 in order to meet this deficit target and this amount is also committed to in the EU/IMF Programme Memorandum of Understanding (MoU).

The April SPU forecast next year's deficit at 7.5 per cent on the basis of real GDP growth of 2.2 per cent. As outlined above, the external outlook has deteriorated since then and so there are downside risks to the SPU budgetary forecast, including from a continuation of the spending pressures evident so far this year. Revised macroeconomic and fiscal projections will be published in October, which will also set out what is required in order to continue meeting fiscal targets. At this stage, however, it is clear that consolidation of €3.5 billion is the minimum required to meet next year's target, and there remains the possibility that more will be needed.

V.2 Minimising the economic impact…

In order to minimise the short- and medium-term impact of fiscal consolidation on aggregate demand, a number of guiding principles should be adhered to. 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, as would the re-prioritisation of public expenditure towards more growth-enhancing areas.

On the taxation side, measures adopted should be of high quality and of a permanent nature in order to foster confidence. Secondly, the emphasis should be on base broadening as opposed to increasing rates, as the latter could damage the supply side of the economy. In this regard, taxing immobile (and unproductive) resources would ensure a more stable income stream, while the introduction of user charges for publically-provided goods and services would generate significant efficiency gains.

VI.3 Further enhancing transparency will boost certainty and credibility…

Setting out a clear, credible and achievable fiscal consolidation strategy, with as much detail as possible on future budgetary measures, is also of great importance. Providing greater certainty regarding future fiscal measures can assist households and businesses in planning their spending and investment decisions and help limit the negative economic impact of consolidation. It would also be favourably viewed by our external funding partners and further improve sentiment towards Ireland in the eyes of the international financial markets. Last year's MTFS was broadly welcomed and provided a reasonable amount of detail on the medium term consolidation strategy; however, there was a lack of detail around some of the measures to be implemented in the later years of the forecast period. This is something that should be addressed in this year's update.

The Group may wish to discuss the emerging economic outlook.

September 2012