

Budget 2011 Commentary

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Budget 2011 - The Painful Reality of a €6bn Adjustment

Introduction

The release of the Government's National Recovery Plan (NRP) almost two weeks ago meant that the broad contents of today's Budget had been widely disseminated long before its presentation to the country today by the Minister for Finance. Outlining as it did in a relatively detailed way the Government's fiscal intentions, the NRP had given a pretty clear steer on what to expect from Budget 2011 – the current Minister's fourth formal budget round since taking office in 2008.

The expected €6 billion adjustment was made up of a tax/PRSI package of €1.4bn, spending cuts of €3.9 bn and 'other measures' totalling €660million. The as-expected nature of the overall package offers little comfort however, as the wide-ranging cutbacks and tax hikes will permeate far and wide across society as is regrettably inevitable when pursuing a consolidation amounting to as much as 3.8% of GDP.

Tax package dominated by €1.35bn of income tax and PRSI hikes, but welcome reduction in Air Travel Tax and Stamp Duty

The tax package is dominated by the €1.35 bn of income tax and PRSI hikes. This includes a 10% reduction in the value of income tax bands and credits, a measure which is partly justified on the basis of declines in income levels across the economy. The latest official numbers do point to an approximate drop of around 5% in wage levels, but the wider point is the pressing need to broaden the income tax base. The changes announced today reduce the percentage of income earners who are exempt from income tax to 38% from 44%, equivalent to bringing an additional 132,000 earners into the income tax system. However, those on the new reduced minimum wage (now at €7.65, down 11.5% from €8.65 previously) will not pay income tax.

PRSI changes include the removal of the employee PRSI contribution ceiling, a measure clearly aimed at increasing the take from upper income earners (whose contributions were previously calculated on the basis of a ceiling of some €75,000). The self-employed, higher earning public servants and office holders will now also pay PRSI at a higher rate.

The new Universal Social Charge (USC) is to replace the now abolished Income and Health levys the aim being to replace two charges with one which will apply on a broad base of income at rates of up to 7%, the latter applying to incomes levels in excess of €16,016.

While there are the inevitable discontinuities and anomalies along the income distribution, the general impact of these changes is to yield an outcome whereby the combined tax/PRSI/USC burden rises for all income earners, but rises by more as a percentage of net income for those at the top end. For example, taking the circumstance of a married couple with one private sector income and two children: those on a gross income of €25,000 lose 1% of net income, those on €45,000 lose 2% while those on €175,000 lose 4%. However, somewhat controversially, the progressivity is not on a straight line basis as those in this category on €55,000 face a loss of 3.7% of net income.

Other elements of the tax package include a 4 cent per litre increase in excise on petrol and a 2 cent increase in diesel. These hikes are expected to yield €106mn, though both smokers and drinkers were spared this time around as neither cigarettes nor alcohol face any increases this year. Elsewhere, Capital Acquisitions Tax thresholds are being reduced by 20%, a measure that is expected to yield €27mn and applies to gifts or inheritances taken from midnight tonight

(December 7th). Finally, Deposit Interest Retention Tax (DIRT) is to be raised by 2% points, up to 27% for payments made annually or more frequently.

While clearly the overall objective was to increase the tax take, the Minister did produce a couple of initiatives designed to offer support to targeted areas. Notably, he has introduced a single revised rate of the Air Travel Tax of €3 to take effect from March 1st. This is a considerable reduction from the €10 which applies to journeys of over 300km, but an increase from the €2 rate that applies on shorter journeys. In making this change the Minister has laid down a challenge to the air carriers by introducing the measure on a temporary basis and promising to increase it again unless there is evidence of “an appropriate response from the airlines”; in other words, he wants to see the reduction translate into higher visitor numbers, not higher profits for airlines. The Dublin Airport Authority is to row in behind the move by introducing an incentive scheme for a rebate of airport charges for any incremental traffic over current levels.

There was also a significant change in the Stamp Duty regime in relation to residential property. A 1% rate is to apply to properties up to €1mn, with a 2% rate applying to valuations over €1m, though all reliefs and exemptions are to be abolished. This represents a considerable reduction from prior rates of 7% and 9% which applied to valuations up to and beyond €1mn respectively, and is a welcome one from the point of view of stimulating activity in what is a depressed market. Reducing one impediment to transactions should facilitate a more liquid market, and allow the market to reach its lower equilibrium level at a faster pace. The intention is to use the resulting data on valuations to improve greater transparency of pricing in the market.

Finally, the Minister again took the opportunity to re-emphasise the commitment to the 12.5% corporation tax regime, stating unequivocally that “there will be no change to Ireland’s corporation tax rate”. Other business-friendly measures, with a job-creation focus, include a revamped and expanded Business Expansion Scheme, to be known as the Employment and Investment Incentive and an extension of the three year corporation tax exemption for start-up companies, with relief linked to the amount of PRSI paid by the company.

Spending adjustments of €3.9bn as guided in the National Recovery Plan

Turning to the spending side, the reductions were as signalled.

The pull-back in capital spending, if anything, was a touch higher than signalled in the NRP at €1.9bn. This leaves capital spending running at €4.7bn for next year, equivalent to 3.6% of GNP, and amounts to an annual decline of some 25% on 2010 levels.

A €2.1bn package of current spending cuts has an €873 million Social Welfare element as its largest element. While clearly extremely undesirable, not to mention extremely unpopular politically, the arithmetic of the required budgetary adjustment is such that cuts in welfare payments are unavoidable. Standard working-age rates of payment will fall by about 4%, taking them back to 2007 levels (though they are still 117% higher compared to 1997 according to the Minister, vs. cumulative inflation over the period of some 40%).

The Budget also aims to beef up activation measures to improve labour market outcomes of the unemployed. Initiatives here include an additional 15,000 activation places across three separate skills development / placement schemes.

Child benefit payments are also to be reduced, including reductions of €10 per month for the first and second child, with an additional €10 reduction for the third child. In total, lower child benefit outlays will result in savings of €150mn in a full year.

A host of initiatives in the arena of public sector pay and pensions yield expected savings of over €300mn. These include further cuts for senior political figures with the Taoiseach and Tanaiste taking further pay cuts of €14,000 and €11,000 respectively while Ministers face a reduction of €10,000 – as the Government seeks to display a top-down approach to lowering the bill of administering the country.

Elsewhere, outside of the main tax and spending headings, the Minister managed to find an additional €660mn of “other” savings. These are not well-specified but include €300mn of asset disposals (perhaps of some property holdings), €185mn of mobile telephony licenses and €175mn

of other items. While this category amounts to some 11% of the total adjustment achieved in this budget, these are low-quality measures in that they are one-off, non-recurring items which do not yield savings on a multi-annual basis.

Financial market issues: legislation coming next week on subordinated debt burden-sharing

From a financial markets perspective, there were a couple of noteworthy elements. First, on the issue of burden-sharing of the costs of bank losses, the Minister reiterated that senior bondholders will not play a role. He made it clear that in his view such a course of action was not an option given the banks' dependency on international investors. But perhaps more tellingly, he was explicit in stating that "unilaterally reneging on senior bondholders" as he put it was against the wishes of our European partners and the European institutions, underlining again that this particular issue was non-negotiable from the European point of view as part of the terms of Ireland's package of assistance. However, he said there would be further burden-sharing by subordinated bondholders (whose total exposure to Irish banks amounts to around €17bn), and that enabling legislation will be submitted to the Dail next week.

Second, the Minister announced that the Government will be proceeding with a proposal put to it by the Irish Association of Pension Funds and the Society of Actuaries. The idea is that Irish pension funds can invest in longer-term Irish bonds (which offer higher yields than currently available elsewhere), and price their liabilities to pensioners on the basis of those higher yields. For pension fund managers who may opt for such investments, this would have the effect of reducing the present value of such liabilities, albeit with some degree of additional market risk, while for the Government it offers a potentially helpful source of additional domestic demand for new debt issuance at a time when many foreign investors have turned "Ireland-shy".

Overall, this Budget intensifies the headwinds facing the economy, but it should be seen more as a growth limiter rather than a growth killer

Overall, this Budget builds on the considerable effort which has been underway since mid-2008 as the Government seeks to get the public finances back onto a sustainable trajectory. Prior to today, on a cumulative basis, measures implemented over the past two and a half years amount to almost €15bn, or some 9% of GDP. As drastic as the deterioration in the public finances has been, this represents a decisive fiscal policy response by any standard.

Furthermore, incoming Exchequer Returns data for the year to November confirm that the measures are delivering results. Tax receipts are 6.6% higher than year-ago levels in the three months to November and are on track to come in close to €500mn, or 1.5%, ahead of expectations, while assertive spending restraint is delivering larger than anticipated savings on discretionary expenditure.

This track record of delivering on ambitious consolidation targets should help foster confidence in Ireland's ability to make further significant progress at its fiscal adjustment enters a new phase of intensity. The front-loading of the 2011-14 correction with 40% of the four-year adjustment taking place in year one is designed to reinforce the credibility of the plan by making further rapid progress in the near term. The targets set out in the Budget envisage the underlying general government deficit falling from an estimated 11.6% in 2010 to 9.4% next year. Moreover, the broad approach being pursued is following guidelines on best practice with the four-year programme weighted 2:1 in the direction of spending cuts rather than tax increases, in line with evidence from previous successful fiscal stabilisations internationally.

Nevertheless, a fiscal correction of this magnitude will certainly negatively affect the economy. The Department of Finance's own estimates point to an estimated loss in tax revenue arising from the Budget of around €1.2billion as the cuts and tax hikes themselves negatively impact income, spending and activity levels across the economy. The Department also tentatively estimate that the fiscal tightening being implemented will reduce GDP growth by some 1.5 to 2% percentage points in 2011.

However, it is important to point out that even a budgetary adjustment of this magnitude is more a growth limiter rather than a growth killer.

Ireland is a very small, flexible and extremely open economy with exports amounting to some 90% of Irish GDP.

Indeed, with exports continuing to perform very strongly we expect that next week's GDP report for the third quarter will signal a return to positive quarterly economic growth. While quarterly Irish growth figures are notoriously volatile and difficult to predict, we expect to see quarterly expansion in excess of 1% in GDP terms. While some of this performance is certainly attributable to a buoyant multi-national sector, we wouldn't be surprised to see a marginally positive reading on GNP also, which would mark the first positive quarter since early 2008.

Such an outcome would serve as a timely reminder that a return to positive economic growth in a small, open economy such as Ireland has much more to do with the supportive impulses of global recovery than domestic fiscal policy.

(Please see below a table summarising the key features of Budget 2011).

Budget 2011 - Key Features

7th December 2010



Exchequer and General Government Balances

- The **Exchequer deficit** in 2011 is forecast at €17,670m (11% of GDP). This compares with a deficit of €18,755m in 2010 (11.9% of GDP). The 2012 forecast is for a deficit of €15,105m (9.0 % of GDP).
- For the **General Government Balance (GGB)**, deficits of 9.4% and 7.3% are forecast for 2011 and 2012 respectively, compared with an underlying deficit of 11.6% in 2010 and total GGB of 31.9%. (The

corresponding figure in 2009 was -11.9%.) The deficit is expected to fall to 2.8% by 2014, just below the Stability and Growth Pact limit of 3%.

- The General Government Debt is forecast at 98.6% of GDP in 2011, up from 94.2% in 2010 and 66% in 2009. The debt ratio is expected to peak at 102.5% in 2013.

Government Spending

The budget provides for overall savings of €2.07 billion in Current Spending and €1.86 billion in Capital Spending. **Total saving of €3.93 billion.**

Social Welfare – savings of €73 million

- People of working-age savings of €397 million or about 4% to include:
Maximum personal rate for all on weekly welfare benefits (excluding those aged 66+) to decrease by €8 per week from Jan 2011.
Jobseeker's allowance and Supplementary Welfare Allowance for persons aged 22-24 reduced by €6 per week, no change to those aged 18-21.
- Child Benefit rates to be reduced by €10 a month from Jan 2011 for the first and second child, taking the rate to €140. Additional €10 decrease for the third child, to €167, no additional decrease to fourth and subsequent children - rate at €177. To yield €149 million in 2011/full year.
- More intensive labour activation strategy to reduce numbers on the Live Register, yield of €100 million in 2011/full year.

Health and Children – savings of €746 million

- Savings in drug costs and professional fees in demand led schemes, to yield €380 million in 2011 and €390 million in a full year.
- Other procurement and non-core pay cost savings to yield €200 million in 2011/full year.
- Payroll saving from voluntary exit package in the HSE, to yield €123 million in 2011/full year.

Education and Skills – savings of €170 million

- Measures include replacing the Student Services Charge with a flat

higher education student contribution of €2k (representing a €500 increase, for the first child only) and a €200 charge for PLC students, a 5% reduction in all capitation grants and a 4% reduction in Student Support Scheme grants.

- Other pay and administrative efficiencies to yield €64 million and €160 million in a full year.

Public Service Pay and Pensions – savings of €309 million

- New employees to entry grades of the public service to start at 10% lower pay than the existing pay scale and at the first point of that scale.
- Salary of the Taoiseach to be reduced by €14k, the Tanaiste by €11k and Ministers by €10k.
- Maximum salary of €250k to apply in the public sector, but contractual issues remain for incumbent post holders in State Agencies. €250k cap to also apply to the President and members of the judiciary, with pay in all future appointments in the latter to be reduced by at least 10%.
- Reduction of €100 million or 4% in cost of public service pensions in 2011, to apply to existing beneficiaries also. The first €12k will be exempt; thereafter pensions between €12-24k will be reduced by 6%, €24-60k by 9% and €60k+ by 12%.

Capital Expenditure – savings of €1.86 billion

Savings in the large Transport and Environment, Heritage and Local Government Departments combined make up some €1.14 billion of the total.

Taxation

Tax measures to save total of €1.1 billion in 2011

Income Tax – saving of €1.05 billion

- 10% reduction in tax credits, to €1,650 from €1,830 for a single person and to €3,300 from €3,660 for married, to yield €435 million in 2011 and €585 million in full year.
- 10% reduction in standard rate bands, to €32,800 from €36,400 for a single person, €41,800 from €45,400 for married one income and to €65,600 from €72,800 for married two incomes. Changes here to yield €395 million in 2011 and €530 million in a full year.
- Health levy and income levy to be abolished and replaced with a Universal Social Charge (USC) on a revenue-neutral basis in 2011, rates range from 0-7% depending on income.

PRSI – saving of €296 million

- Abolition of PRSI ceiling of €75,036, to yield €100 million in 2011 and €145 million in a full year.
- Class S Self-Employed PRSI rate increased from 3% to 4%, to yield €53 million in 2011 and €80 million in a full year.
- Employee pension contributions to be subject to PRSI and the USC from January 1st 2011, to yield €40 million in 2011 and €60 million in a full year.
- Employer PRSI exemption for employee contributions to pension schemes reduced to 50% from January 1st 2011, yield of €40million in 2011 and €90 million in a full year.

Excise Duties – saving of €33 million

Mineral Oil

- From midnight on Dec 7th tax on petrol to increase by 4 cent per litre and on diesel by 2 cent. Yield of €106 million in 2011/full year.

Air Travel Tax

- A single revised rate of €3 from March 1st 2011, on a trial basis for 12 months. This represents an increase on the €2 rate that currently applies to journeys 300kms and less from Dublin airport and a reduction from €10 on longer distances. Cost of €56 million in 2011.

Vehicle Registration Tax (VRT)

- Extension of car scrappage scheme to June 30th 2011, extension of VRT relief for Hybrid Vehicles and Flexible Fuel Vehicles and increase in the VRT rate for Commercial Category C vehicles to €200 from €50 from May 1st 2011. Combined these measures are revenue neutral in a full year.

Capital Acquisitions Tax – saving of €27 million

- Current group tax free thresholds reduced by 20% from midnight December 7th, with reduction applying to gifts or inheritances. Yield of €27 million in 2011 and €40 million in full year.

DIRT – saving of €22.5 million

- From Jan 1st 2011 rate of retention applying to deposit interest to be increased by 2% to 27% for payments made more frequently than annually and to 30% for payments made less frequently than annually. Yield of €22.5 million in 2011 and €30 million in full year.

Stamp Duties – cost of €36 million

- Reduction to 1% on properties valued up to €1 million (previously 7% from €125k+) and to 2% on amounts over €1 million (previously 9%) from Dec 8th 2010. Abolition of various other reliefs and exemptions, including first time buyer relief.

Other Measures

- **Remaining €660 million** of €6 billion 2011 package to come from asset disposals (€300 million), mobile phone licences (€185 million), debt servicing savings (€120 million) and increased dividends (€55 million).
- **Tax treatment of pensions** – reduction of the annual earnings cap for tax-relievable pension contributions whereby lump sums above €200k will be subject to tax and the maximum allowable tax-relieved pension fund will be reduced. Effective tax rate on Approved Retirement Funds to be increased by the deemed annual distribution of assets from 3% to 5% per annum with that distribution subject to full income tax each year.
- Business Expansion Scheme to be revamped and renamed the **Employment and Investment Programme**. Under this, the limit that can be raised by companies will be increased from €2 million to €10 million, with the amount that can be raised in any 12-month period will be increased from €1.5 million to €2.5 million. The incentive will expire in December 2013.
- Extension of the 3-year **corporation tax** exemption for start-up companies who commence a new trade in 2011.
- Government to proceed with a proposal from the Irish Association of Pension Funds and the Society of Actuaries, whereby Irish **pension funds** can invest in longer-term Irish bonds (which offer higher yields than currently available elsewhere), and price their liabilities to pensioners on the basis of those higher yields.

Economic Forecasts

- Following an estimated 0.3% fall in **GDP** in 2010, a rise of 1.7% is forecast in 2011 (GNP basis –2.0% in 2010 and +1.0% in 2011). From 2012-14 GDP is expected to rise by an average of 2.5%.
- **Consumer spending** is forecast to remain flat in 2011, following an estimated decline of 1.3% this year. Modest growth of the order of 0.9% is forecast for 2012.
- Irish **Exports** have continued to demonstrate impressive resilience in 2010, with a rise of 6.2% expected. Increases of the order of 5% are forecast for 2011 and 2012.
- The **HICP** measure of inflation, the more appropriate measure for UK/ euro area comparisons, is forecast to rise by 0.7% next year following an estimated 1.5% fall in 2010.
- Following an estimated 4.0% fall in 2010, **employment** is expected to decline at a much slower rate of 0.2% in 2011. Looking forward to 2012, a resumption of employment growth of the order of 1.3% is forecast, with an average increase of 1.6% over the period 2012-14 expected.
- From an expected average of 13.4% in 2010, the **unemployment** rate is expected to be slightly lower at 13.2% next year. Thereafter more notable declines are expected as the economy shows greater signs of recovery, with the rate expected to fall to 9.8% by 2014.