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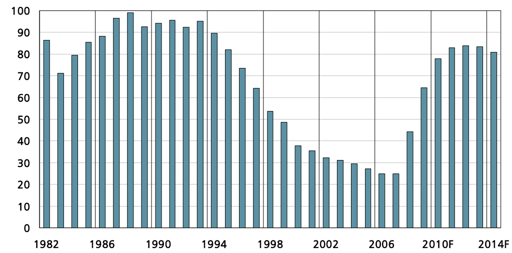
General government debt (% of GDP)



Source: Department of Finance; Datstream

December 10, 2009

Research Report: Irish economy

Irish Budget 2010

Strong Budget tackles public spending and limits structural deficit

Irish government takes decisive action to cut public spending; deficit set to fall in 2010

- The Irish government introduced a €4bn fiscal consolidation for 2010. It will reduce the deficit from 13.5% of GDP, if no action had been taken, to 11.6% in 2010, based on the government's estimates. We expect the deficit to come in lower than that ultimately as the economy stabilises. The estimated deficit for 2009 is 11.7% of GDP.
- The plan consists of difficult spending cuts of €4bn; taxes were not raised. Expenditure reductions focused on the public pay bill, social welfare and other non-pay cost reductions in government programmes. Excluding the tax loss from spending cuts, the net consolidation is €3.2bn or 2% of GDP.
- Capital spending was also reduced by almost €1bn, or 0.6% of GDP, but that had been flagged in April 2009. Falling tender prices mean that government investment will not drop in real terms and Ireland's spending on infrastructure remains above the European average.

No tax hikes will help consumer spending and safeguard investment in Ireland

- Net tax increases amount to €17m, or as close to zero as makes no difference. Crucially, income tax was left unchanged. That is vital, as rising marginal rates of tax in previous Budgets threatened investment in Ireland.
- Moreover, the government reiterated its commitment to retaining the 12.5% corporation tax rate indefinitely.
- Absent tax hikes, this may turn out to be an expansionary fiscal consolidation as consumer saving begins to ease (the Ricardian effects may override the initial deflationary impulse of spending cuts).

Unemployment forecast cut significantly

- The Department of Finance slashed its unemployment forecast to 13.2% on average for 2010 from 15.5% previously. It is now closer to our own forecast.

Strong Budget seriously tackles Irish deficit

The Irish Budget 2010 is hard to fault. It has seriously tackled the structural deficit by focusing solely on cutting expenditure. Tax increases are virtually zero, keeping Ireland's export competiveness in mind. Furthermore, it reaffirmed the government's commitment to retaining a 12.5% corporation tax rate indefinitely. Politically difficult decisions to cut public sector pay, social welfare payments and child benefit should not be underestimated. They highlight how much Ireland is doing to make its public finances sustainable, in stark contrast to countries like Greece.

The structural deficit will be at least 2% of GDP lower in 2010 than it would otherwise have been. The gross consolidation totals €4.068bn, which consists of €4.051bn in expenditure reductions and just €17m in tax increases. The net consolidation will amount to almost €3.2bn when negative tax buoyancy from the expenditure reductions is accounted for (see Table 1).

Table 1: Summary of Budget 2010 measures (€m)

Current spending	3090
Capital spending	961
Taxation	17
Negative tax buoyancy as a result of spending cuts	-897
Net fiscal consolidation	3171

Source: Davy

The general government deficit will be limited to 11.7% of GDP this year and will drop to 11.6% of GDP next year. That is conservative, as we expect the outturn for GNP and tax revenue to be somewhat better than the government's forecasts (see Table 2). The primary structural deficit (i.e. the deficit that would exist even if the economy was operating at full capacity excluding interest repayments on government debt) is estimated to be 7.2% this year and this will drop to 6.5% in 2010. That balance would have reached at least 9% without this package. Keep in mind, too, that consolidation measures in October 2008 (Budget 2009), February 2009 (public sector pension levy) and April 2009 (emergency Budget) meant that the general government deficit was limited to 11.7% of GDP this year. Without those measures, it would have reached almost 17% of GDP.

Table 2: General government deficit (% of GDP)

	2009	*2010*	*2011*	*2012*	*2013*	*2014*
General Government balance	-11.7	-11.6	-10.0	-7.2	-4.9	-2.9
of which:						
Cyclical component	-2.8	-2.8	-1.5	-0.4	0.3	0.6
Temporary measures	0.4	0.6	0.0	0.0	0.0	0.0
Structural balance	-9.3	-9.4	-8.5	-6.8	-5.2	-3.5
less:						
Interest expenditure	2.1	2.9	3.4	3.8	3.9	3.9
Structural primary balance	-7.2	-6.5	-5.1	-3.0	-1.3	0.4

Source: Department of Finance

Spending measures split evenly enough between public pay, social welfare and day-to-day costs

Last week, the government decided unilaterally to cut public sector pay when it could not reach agreement with public sector unions. This was more than justified, given that public pay inflation ran far ahead of increases in the CPI in the period 2002-2008. Moreover, there is a huge public pay premium over the private sector, even more so when implicit benefits like job security and defined benefit pensions are accounted for. Pay was cut on a graduated scale of 5-8% for most public servants. Added to carryover full-year savings from earlier 2009 changes, this will reduce the pay and pensions bill by about €1.4bn year-on-year (there will however be an offsetting reduction of about €300m in the pensions levy yield as salary levels are lowered).

Elsewhere, social welfare payments were cut by 4.1% and child benefit by about 10%. That generates a saving of €780m. The levelling off in numbers claiming unemployment benefit provided an extra €243m that had not been included in the arithmetic until the white paper last weekend. The final element of the current expenditure package was €1bn in savings to programmes: this included a €400m saving in the health sector through non-labour cost savings and payments to drug suppliers.

Taxes virtually unchanged overall; carbon tax introduced, but VAT and excise duty cut and no change in tax rates

The overall tax increase amounts to just €17m, as close to zero as makes no difference. The huge positive was that there was no increase in marginal tax rates. But there was some change in the mix. A carbon tax will raise €250m, or 0.15% of GDP in 2010. It will apply at a rate of €15 per tonne on fossil fuels. These changes were broadly offset by a half-percentage-point reduction in the standard rate of VAT from 21.5% to 21%, reversing the ludicrous increase of October 2008. This is judged to cost €167m in a full year; it is more likely to prove revenue-neutral. Excise duty on alcohol has been cut. The other tax measures include a car scrappage scheme for vehicles older than ten years and the restriction of tax reliefs for very high earners.

Capital spending cut again, but volume may not be greatly affected

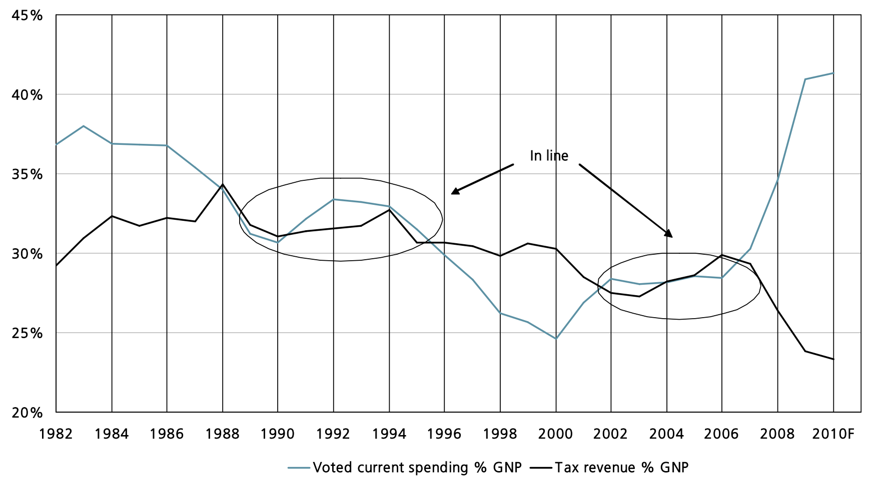
We already knew that capital spending was set to fall in 2010, as this was flagged in the April 2009 Budget. Capital spending was reduced a little further for next year and by €500m for each of 2012 and 2013. It is expected to total €6.45bn in 2010, down less than €200m from the figure projected in April. But it is almost €1.9bn lower than the original 2010 estimate pencilled into the Budget of October 2008.

The government now plans to spend €5.5bn a year out to 2016. That is some way below the run-rate of €8bn planned as of 18 months ago. However, keep in mind that the level of spending is still relatively high in a European context, at about 4% of GNP in 2011 for example. The reduced programme can be justified in part by lower tender prices (down 23% from peak according to the SCS index) and by the spare capacity that has opened up in the economy. But on the first point, the government must successfully renegotiate advance contracts. On the second, there are still bottlenecks in certain areas and Ireland lags well behind on telecommunications infrastructure, especially broadband. At least this capital spending forecast does not include investment by semi-state companies, which remains quite healthy.

Government starts to tackle huge spending problem

The salient problem with the Irish public finances is that spending got out of control from 2002 onwards. That is highlighted by the structural deficit which the government estimates accounts for 9.3 percentage points of the overall 11.7% of GDP deficit in 2009 (see Table 2). It is also evidenced in Figure 1, which documents current spending and tax as a percentage of national income.

Figure 1: Current spending and tax revenue as % of GNP

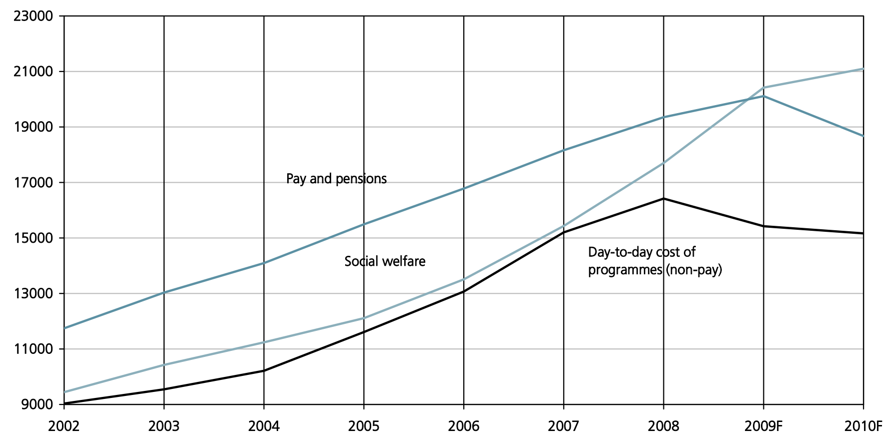


Source: Davy; Department of Finance

The loss of control over spending during the construction bubble is highlighted in Figure 2. Between 2002 and 2008, the public pay and pensions bill surged by 65%. That compared with a 12% increase in the population and a 45% increase in GNP over the same period. About half of the growth was accounted for by rising state employment and the rest by unjustified pay increases financed by property-bubble-related tax revenue that has since evaporated. By 2007, the public sector pay premium was 19%, when individual and employment characteristics were controlled for, according to the CSO, not taking into account superior job security and much more generous pension arrangements.

In 2002-2007, social welfare jumped by 63% in a period of full employment. Social welfare rose much faster than the HICP (+15%) in those years. Incredibly, the rate of social welfare was increased by about 3% on average in October 2008, heading into a 12-month period when the CPI would drop by 6.6% and the HICP by 2.8%. A recent ESRI study showed that the cost of living for the lowest income deciles that are reliant on welfare has slipped 4%. That excessive increase exacerbated the pressure on the state that had been applied as automatic stabilisers kicked in.

Figure 2: Breakdown of current public spending (€m)



Source: Davy; Department of Finance

Crucially, the government has taken stern action to tackle the expenditure problem. So far during the consolidation, it had focused more on the day-to-day running of the public service, i.e. volume rather than price. This Budget finally cuts the price of public services, making the fiscal arithmetic less challenging longer-term and helping to reduce the cost of business for the economy.

The budgetary projections suggest that the ratio of current expenditure to GNP will stabilise next year at just over 41% (using Davy forecasts for GNP). The pay and pensions bill will fall back towards the 2007 level, all the more so if the pensions levy, which is counted as government revenue, is included. Social welfare is likely to rise slightly, as unemployment may not peak until the summer of 2010. But the day-to-day non-pay or social welfare cost of public services may fall from a peak of €16.4bn in 2008 to €15.2bn in 2010 (i.e. back to the 2007 level).

Pension reform will help long-term fiscal sustainability

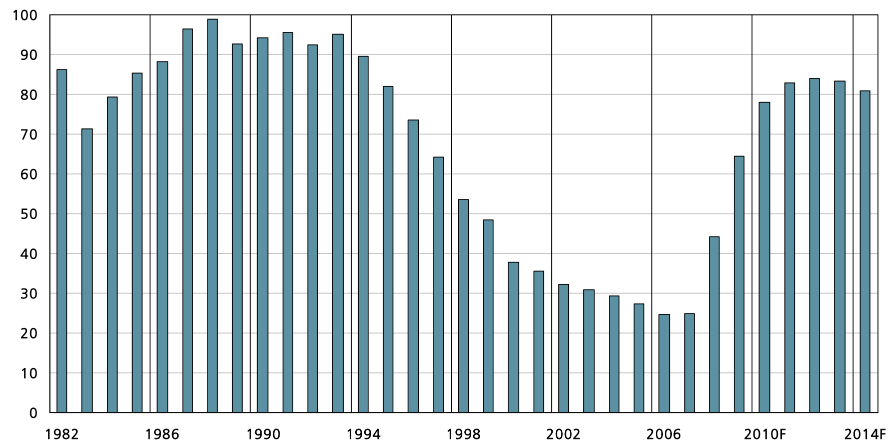
Ireland's pension time-bomb is much further away than it is for the rest of Europe: this country has the lowest old-age dependency ratio in the EU-27. But there need not be a time bomb at all. It is very encouraging to see that the government is thinking about the issue now: it plans to present a new 'national pensions framework' imminently. And it highlighted two changes in the Budget that could greatly ease the future burden for the state in meeting pension costs. These changes should also make Ireland's debt picture look more sustainable, making holding Irish long-term debt more attractive. The changes are:

- There will be a new single pensions scheme for all new entrants to the Irish public service. This will be a defined-contribution scheme closer to norms in the private sector, rather than the defined-benefit, final salary scheme in place for current serving and retired public servants.
- For those already in working in the public service and existing retirees, the minister may index pensions in future to the CPI rather than to wage inflation in the public sector. One of the problems of recent years is that wage inflation in the public sector far outstripped the CPI or HICP. Based on estimates by the Comptroller and Auditor General, a switch to CPI indexation would reduce the present actuarial cost of public sector pensions by almost 20%, from €108bn to €87bn.

Debt-to-GDP ratio set to stabilise at 80-84%

Those state pension changes will help with longer-term sustainability, but in the short term, this week's consolidation plan will help stabilise the debt-to-GDP ratio. The government expects the ratio to rise to 78% next year from this year's 64.5%. It may reach 84% by 2010 before falling back to 81% by 2014 when the deficit is also expected to be below the Maastricht limit of 3% of GDP.

Figure 3: General government debt (% of GDP)



Source: Datastream; Department of Finance

Department of Finance forecasts cautious in short term, sanguine longer-term

The Department of Finance has revised up its economic forecasts slightly since the April 2009 Budget (see Table 3). It now sees GNP declining by 1.7% next year, from a drop of 2.9% previously. It does expect price deflation next year (in terms of the GNP deflator), so nominal GNP is expected to drop 3%. We do not disagree too much in terms of nominal GNP, as we expect better volume growth but deeper deflation than the department. Looking further ahead, the department expects real GNP growth to average 3.7% in 2011-2014.

The other key metric is unemployment, where the government has moved much closer to our own forecasts. It now expects an average unemployment rate of 13.2% in 2010 from its previous forecast of 15.5%. Consensus forecasts for unemployment (see Table 4) remain far too high. The Department's downward revision to unemployment reflects the ongoing shakeout in the labour force (through emigration and declining participation rates) and the fact that the pace of layoffs has slowed. Its average employment decline of 3.4% implies that job growth may re-emerge on a quarter-on-quarter basis at the back-end of 2010 (we think it will be Q3), taking into account the significant negative carryover into 2010.

Table 3: Department of Finance macro forecasts (by date of Budget)

		2009			*2010*	
	Apr 2009	*Dec 2009*	*chg pp*	*Apr 2009*	*Dec 2009*	*chg pp*
Consumer spending	-7.8	-7.2	0.6	-3.7	-3.0	0.7
Government	-0.4	-0.6	-0.2	0.0	-3.0	-3.0
Investment	-27.0	-33.9	-6.9	-16.0	-19.2	-3.2
Exports	-6.1	-2.7	3.4	-3.1	0.4	3.5
Imports	-10.1	-9.0	1.1	-6.1	-2.8	3.3
GDP	-7.7	-7.5	0.2	-2.8	-1.3	1.5
GNP	-8.0	-10.4	-2.4	-2.9	-1.7	1.2
HICP	-1.4	-1.7	-0.3	0.5	-1.2	-1.7
Unemployment rate (annual average)	12.6	11.8	-0.8	15.5	13.2	-2.3

Source: Department of Finance

Table 4: Summary of consensus forecasts (% change yoy, unless stated)

	GNP		*HICP*		*Unemployment rate*	
	2010	*2011*	*2010*	*2011*	*2010*	*2011*
Department of Finance	-1.7	3.0	-1.2	1.0	13.2	12.6
Davy	0.5	3.9	-1.6	0.5	13.3	12.1
Central Bank	-3.1	N/A	-0.5	N/A	14.0	N/A
ESRI	-1.7	N/A	-0.7	N/A	14.8	N/A
Consensus	-1.5	2.8	-0.5	1.5	13.5*	N/A

*end-year
Source: Davy; Department of Finance; Reuters

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