

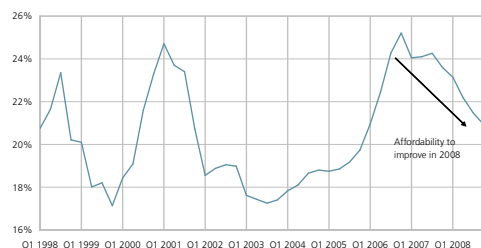


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Affordability index*



* % of disposable income required to meet net mortgage repayments for first-time buyer couple
Source: Davy

Research Report: Irish economy

Budget 2008

A reasonable balancing act; timely boost for the housing market

No change in taxes but spending set to increase significantly again

- Given the recently emerged shortfall in tax revenue for 2007, it was never likely that there would be any major reductions in tax rates in Budget 2008.
- Some had even feared that income tax bands and credits would not be indexed but, in the event, these fears proved unfounded and there was broad indexation.
- On the expenditure side, current spending is set to increase by more than 9% and capital spending by almost 13%.

But deficit limited to 0.9% of GDP with stable debt/GDP ratio

- The fact that this could be achieved after a year in which tax revenues came in well short of expectations, and still result in only a modest deficit, is testimony to the strength of the underlying fiscal position in Ireland.
- In general terms, the Budget will add to rather than subtract from economic growth in 2008.

Reform of stamp duty regime likely to boost housing market activity

- For second-hand buyers and buy-to-let investors, the changes amount to an effective price cut of up to 3.3%.
- In a weak market, we do not think the measure will be watered down by vendors increasing asking prices.
- Mortgage interest relief was increased, but it is a blunt measure. Affordability is set to improve anyway.

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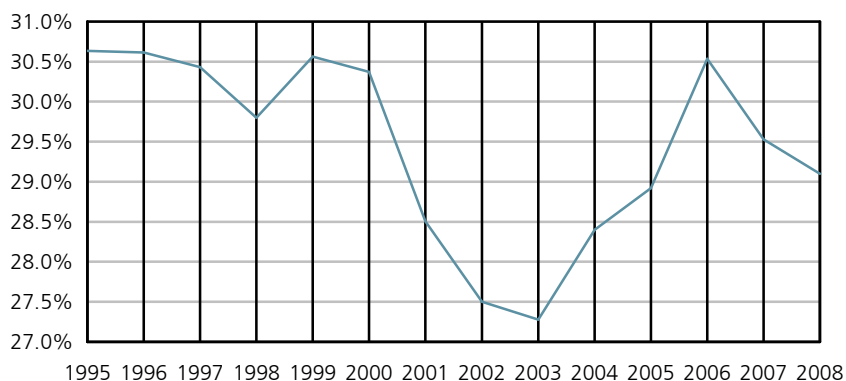
Revenue measures

Given the shortfall in tax revenue that emerged in the latter part of 2007, it was never likely that there would be any major tax relief announced for 2008. Indeed, many feared that the bands and credits in the income tax code would not even be indexed. In the event, credits and bands were increased by around 4% as was the ceiling for employee PRSI. That is broadly in line with the likely increase in incomes across the economy.

- Bands and credits indexed in line with income increases

Indeed in terms of the economy as a whole, the tax burden is set to fall in 2008. Total tax revenues are projected to rise by just 3.3% and taxes as a percentage of GNP will fall from 29.5% in 2007 to 29.1% in 2008.

Figure 1: Tax revenues as a percentage of GNP (%)



Source: Department of Finance; CSO

- Minister a late convert to stamp duty reform

The Minister also became a late convert to changing the stamp duty regime and kept his promise to raise interest relief for first-time buyers from €16,000 to €20,000 for a couple. We explore the implications of these changes for the housing market below.

- Very modest changes in indirect taxes

In terms of indirect taxation, there was an increase in excise duty of 30c per packet of 20 cigarettes and motor tax was increased by between 9.5% and 11% depending on the size of the car. Between them, the increases will generate revenues of around €150m in a full year and they will add less than 0.2% to the CPI.

- Social welfare package of just under €1bn

- Total current spending to increase by 9.4%.

- Capital spending to increase by almost 13%

- Projected deficit is less than 1% of GDP and the debt/GDP ratio remains unchanged

Expenditure measures

On Budget day itself, the biggest requirement for an increased expenditure allocation is to finance increases in social welfare rates. Pre-Budget calculations are always on the basis of 'no change' in these rates. Last year, social welfare rates were increased by between 8% and 10% and the overall cost of the package was €1.4bn.

This year, the increases were not quite as generous. Rates were increased by about 5.5% on average and the cost of the package comes to €980m in a full year.

There was provision for about €700m of extra current expenditure across a range of expenditure heads, the biggest of which was an extra allocation of €316m to the health budget.

As a result of all measures, current spending is forecast to increase by 9.4% in 2008. That is a sizeable increase in real terms and will result in current spending rising as a proportion of GNP.

On the capital side, €1bn of an unallocated National Development Plan (NDP) provision, which was already included in the arithmetic, was allocated across departments. As a result, the government kept its commitment to maintain the targets set in the NDP. Public capital spending will increase significantly in real terms again in 2008.

Table 1: Growth in government spending (% change in real terms)

	2002	2003	2004	2005	2006	2007E	2008F
Current spending	7.4%	2.7%	-0.7%	4.8%	6.9%	7.9%	5.2%
Capital spending	8.4%	-7.7%	-8.3%	1.6%	6.7%	17.2%	10.6%
Total spending	7.6%	1.1%	-1.8%	4.4%	6.8%	9.1%	5.9%

Source: Department of Finance

Capital spending is set to increase by 13% in nominal terms—an increase of well over 10% in real terms—and this follows a 17% increase in real terms in 2007. For the building industry, it provides a welcome offset to the significant reduction in activity in the housing market that is now underway.

After making these adjustments for both spending and revenue, the Minister ended up targeting an overall deficit of €1.8bn, the equivalent of 0.9% of GDP. This will be only the second year since 1996 in which the overall government balance will be in deficit and it is well within the Maastricht limit of 3% of GDP.

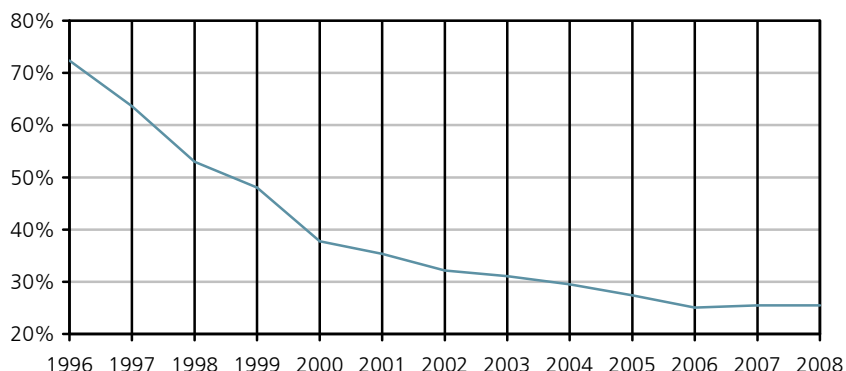
Table 2: General Government Balance as % of GDP

2002	2003	2004	2005	2006	2007	2008F
-0.5%	0.5%	1.6%	1.2%	3.4%	0.5%	--0.9%

Source: Department of Finance

At this level, the debt/GDP ratio will remain more or less unchanged at the very low level of not much more than 25%.

Figure 2: Government debt as % of GDP



Source: Department of Finance

Economic forecasts

- Broadly expansionary Budget
- Testimony to the strength of the underlying fiscal position in Ireland

In summary, the Budget provided for a 9%+ increase in current spending, a near 13% increase in capital spending, and was broadly neutral on tax policy.

The fact that the Minister could do this after a year in which tax revenues came in well short of expectations and still incur only a modest deficit is testimony to the strength of the underlying fiscal position in Ireland. In general terms, it will add to rather than subtract from economic growth in 2008.

Table 3: Comparison of economic forecasts

	Dept of Finance		ESRI		Central Bank		Davy	
	2007	2008	2007	2008	2007	2008	2007	2008
Consumer spending	6.6	3.8	7.5	4.0	7.0	3.8	5.7	3.0
Government spending	4.8	3.6	5.5	3.5	4.0	3.5	5.0	4.5
Investment spending	1.5	-1.6	1.6	-1.2	1.0	-0.5	0.1	-3.4
Exports	6.8	5.6	5.8	5.1	6.5	6.0	7.0	6.0
Imports	5.9	4.5	4.7	2.7	5.8	4.8	5.5	4.1
GDP	4.8	3.0	4.7	2.7	4.8	3.5	4.6	3.2
GNP	4.2	2.8	4.4	2.9	4.8	3.3	4.0	2.7

Source: Department of Finance; ESRI; Central Bank; Davy

- Official growth forecast revised down to 2.8% for 2008
- Growth accelerating again to 3.3% in 2009

The Department of Finance updated its economic forecasts in the documents accompanying the Budget. It has reduced its GNP forecast for 2008 to 2.8% from 3.0% last October. That is pretty much in line with the last published Davy forecast. We will update that forecast in our forthcoming end-year review. We suspect that we will be downgrading again but it should still be in the 2% to 3% range.

Interestingly, the Department is one of the few agencies which produces forecasts for years beyond 2008. It expects GNP growth to bounce back to 3.3% in 2009 and 3.9% in 2010.

In our forthcoming end-year review, we will also extend our forecast horizon to 2009 and we suspect that we will be somewhat more optimistic than the Department.

Reform of stamp duty regime likely to boost housing market activity

- Measures to reform stamp duty regime
- Changes clearly positive for market sentiment
- We think that vendors will not increase their asking prices to take advantage of the fact that buyers have to pay a lower transaction tax

The Minister announced measures to reform the stamp duty regime on housing transactions for buyers other than first-time buyers and buy-to-let investors. Note that first-time buyers already did not pay any stamp duty—and neither did owner-occupiers buying new houses.

The changes simplify the system and will probably amount to an effective house price cut for buyers, while causing no loss to vendors. They are clearly positive for market sentiment and activity in the 'trader-up' and buy-to-let categories is likely to pick up in 2008.

Effective price cut may help pull second-hand market to clearing level

In the current weak market, we think that vendors will not increase their asking prices to take advantage of the fact that buyers have to pay a lower transaction tax to the Exchequer. In effect, if the market price (stamp exclusive) stays unchanged, prospective buyers will pay up to 3.3% less all in. Note that second-hand market prices are actually falling—they fell 2.3% month-on-month in October and 2.2% in September—so this measure will help bring supply to the clearing price much quicker.

The changes are as follows:

- Stamp duty will not be charged on the first €125,000 of the house price.
- It will be levied at 7% above €125,000 up to €1,000,000.
- The rate increases to 9% for the portion above that threshold.

Note that the average existing mix-adjusted house price is €289,000. The savings for buyers at different house prices are outlined in Table 4.

Table 4: Stamp duty savings after Budget 2008 changes* (€)

House price	Previous stamp	New stamp	Saving	Saving % price
200,000	8,000	5,250	2,750	1.4%
250,000	10,000	8,750	1,250	0.5%
300,000	15,000	12,250	2,750	0.9%
350,000	21,000	15,750	5,250	1.5%
400,000	30,000	19,250	10,750	2.7%
450,000	33,750	22,750	11,000	2.4%
500,000	37,500	26,250	11,250	2.3%
600,000	45,000	33,250	11,750	2.0%
700,000	63,000	40,250	22,750	3.3%
800,000	72,000	47,250	24,750	3.1%
900,000	81,000	54,250	26,750	3.0%
1,000,000	90,000	61,250	28,750	2.9%
1,500,000	135,000	106,250	28,750	1.9%

*First-time buyers do not pay stamp duty; owner-occupiers buying a new house do not pay any either; This measure benefits any non-first-time buyer purchasing an existing house and buy-to-let investors buying a new or existing house
Source: Davy

- 'Lock-in' period reduced to two years

The Minister introduced another minor measure that will increase mobility in the housing market. As noted above, first-time buyers and owner-occupiers buying new houses are exempt from stamp duty. But stamp duty was clawed back by the government if those exempt persons rented out the property within five years. That 'lock-in' period has been reduced to two years.

Mortgage interest relief increased by 25% as flagged, but this will not have much effect; affordability set to improve anyway

Mortgage interest relief was increased, as flagged by the government after the election last summer. But relief is so high now that the changes actually will not affect the marginal buying couple, based on our affordability model.

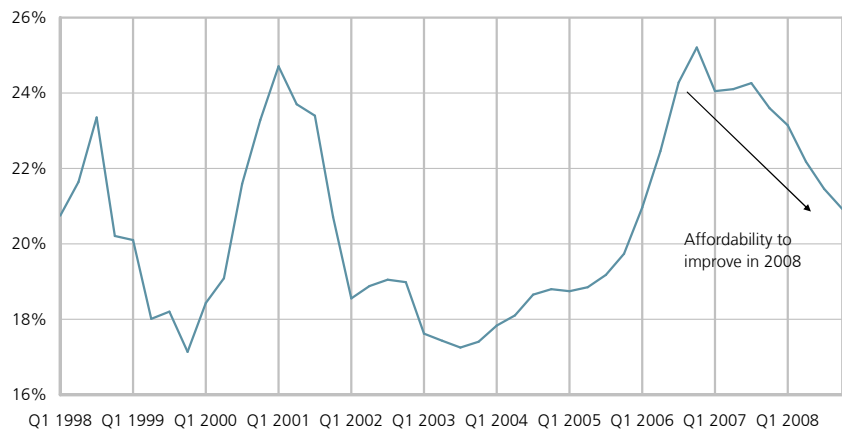
Interest relief for a couple was limited to €16,000, available at the marginal 20% tax rate (i.e. it was worth €3,200). That limit has been raised to €20,000. But the average new house price is now €290,000 and the average mortgage rate is 5.5%. Based on the typical 92% loan-to-value for a first-time buyer, the annual interest charge for a new buying couple does not exceed €16,000. Joint-buyers would need to be purchasing a house closer to €400,000 for it to have an effect.

The increase in mortgage relief will not help single buyers either. If we assume that the maximum price-to-income ratio is six times, a single buyer can avail of a mortgage of almost €250,000 (at 100% loan-to-value). His or her interest charge well exceeds the new threshold of €10,000. It will actually only help single buyers who purchase a house below €200,000 on 90% loan-to-value.

- Affordability is set to improve next year

Either way, affordability is set to improve next year (see Figure 3). The European Central Bank refi rate has peaked, even if banks may have to pass on higher money market rates in the short term. Income tax changes help, but the key reason for the improvement in affordability is further cuts in new house prices in H1 2008.

Figure 3: Affordability index*



* % of disposable income required to meet net mortgage repayments for first-time buyer couple
Source: Davy

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