Budget 2012 Commentary

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Budget 2012

Introduction

Budget 2012 marked the seventh major policy initiative aimed at addressing the chronic imbalance between the State's revenues and its spending, a process that began as far back as July 2008. Up to this week, some €21 billion in corrective measures (equivalent to some 13% of GDP) had already been implemented via a series of four formal Budget rounds and two sets of expenditure-reducing measures.

The fiscal consolidation implemented by the previous Government has certainly done some heavy lifting in terms of the necessary correction in the public finances, and there are clear indications of improvement in the underlying position. The so-called primary budget balance (which strips out interest payments on debt) excluding exchequer-funded injections into the banks stood at €7.9bn in the year to November this year, down from €9.7bn and €13.8bn and in 2010 and 2009 respectively.

Nonetheless, the General Government Deficit – the measure used by the European authorities - for this year is still going to be in excess of 10% of GDP. Thus, the scale of the imbalances in the public finances requires that considerable further action is required to maintain the trajectory of improvement, with this week's announcements unveiling the implementation details of phase one of the new Government's medium-term fiscal plan.

One major difficulty facing Ministers Howlin and Noonan this week was that, following the €21 billion in corrective measures which have already been implemented over the past three and a half years, there were certainly no easy targets left on either the tax or spending sides at which to aim in order to reach the required consolidation amount of €3.8bn. In fact, this headline total is somewhat misleading as carry-over effects of previously implemented measures meant that Budget 2012 was aiming for *new* corrective measures of €3.2bn which in the event was exceeded slightly as the final tally of measures announced comes to €3.3bn. In keeping with the strategic approach since 2008, the bulk of the adjustment was felt on the spending side, with €1.1bn, or one third, of the new measures accounted for by revenue-raising initiatives.

Budget 2012 Package		€mn	% of total
Taxation/PRSI		**1,072**	33
VAT	559		
Excise Duty	178		
Household Charge	160		
Other	175		
Current Spending		**1,450**	44
Health	543		
Social Welfare	475		
Education	132		
Other	300		
Capital Spending		**755**	23
Total*		**3,277**	

* Total is 3.3bn, not the 3.8bn headline which includes carry-over effects of previous tax changes

Over half of the €1.1 bn of the Tax/PRSI Package comes from the pre-announced VAT hike

Some €560 million of the €1.1bn revenue package came from the pre-announced two-point increase in the top rate of VAT. The next biggest contributor was in the Excise category where a €178 million suite of measures included hikes on tobacco (duty on a packet of 20 cigarettes is to go up by 25 cents), a €5 per tonne rise in the carbon tax (equating to one and a half cents per litre extra on petrol and diesel) and large increases in motor tax (tax on Band B cars – about half of all private cars – is due to go up by a whopping 44%). The new Household Charge of €100 is also being introduced as planned and will raise an estimated €160 million.

It looks as if the measures announced in the Budget are going to dampen economic growth in the year ahead. While it is just over four weeks since the Department of Finance provided a comprehensive assessment of the economic outlook, today's Budget contained a downgrade to the Department's view on the economic outlook for next year. The economy is now projected to expand by 1.3% in real GDP terms, down from the estimated 1.6% in early November. Real GNP is now expected to expand by 0.7%, down from 1% a month ago.

While the Department's updated forecasts are certainly not unreasonable, even this lower growth outlook is subject to heightened downside risks, particularly those stemming from the ongoing debt crisis in Europe. Having said that, the latest readings of the Purchasing Manager Indices of activity in the Irish manufacturing and services sectors point to encouraging signs of resilience within the traded sectors of the economy. Not only is Ireland now clearly outperforming the other PIGS countries, but the Irish PMIs for both manufacturing and services are now running higher than the equivalent numbers in Germany. Indeed, activity in the Irish services sector has managed outright improvement for the past three months in a row bucking the general pattern of deterioration elsewhere in the zone, a result that perhaps reflects the combined effects of improved Irish competitiveness and the somewhat more positive trends which have emerged from the US economy lately.

In any case, the Department's forecasts incorporate a slightly weaker international economic outlook which results in softer Irish export growth, which is now seen at 3.6% next year, down from 3.8%. However, the biggest changes in the forecast come in consumer spending which is expected to post a fifth consecutive annual decline. In particular, the indirect tax changes, including the two-point hike in the top rate of VAT, will push up consumer prices and costs. The department's inflation forecast has been raised from 1.2% to 1.9% for next year, meaning households will be suffering a corresponding hit to their incomes in real terms, thereby suppressing spending volumes. The forecast drop is now put at 1.3% for next year, down from a fall of 1% pencilled in last month.

On its own, a VAT hike will tend to encourage households to save rather than spend. But with the Minister very conscious of the already-high savings rate in the household sector, he introduced a countervailing measure in the form of a three point increase in DIRT tax, to 30%. While this is part of the overall revenue-raising strategy of course, it is also aimed at dis-incentivising high savings levels, though trying to offset the negative impact of one tax by imposing even greater increases in another is far from ideal.

Whilst a key aim of today's Budget was to introduce revenue raising measures to complement yesterday's spending cuts and thus to help the economy to meet its deficit target of 8.6% of GDP for next year, there was also some level of targeted support for selected areas.

The largest measure on this front in terms of revenue foregone (€64 million) was the abolition of multiple Stamp Duty rates for non-residential properties, including the top rate of 6%, to be replaced with a single rate of 2%. In addition, the minister indicated that the Government would not now be proceeding with retrospective legislation to abolish upward only rent reviews (it hasn't proved possible to develop a targeted scheme that would not be vulnerable to legal challenge or require compensation to landlords, according to the minister). While this will certainly be a disappointment to business struggling with high rent burdens, it does remove one significant source of uncertainty which has been adversely affecting the commercial property market. This,

taken together with the reduction in transaction costs as per the cut in stamp duty, should combine to provide important support to market conditions and activity generally, and capital values in particular.

The next-largest support measure was the increase in the rate of mortgage interest relief to 30% for first time buyers who took out their first mortgage in the period 2004 to 2008. He also confirmed that mortgage interest relief will no longer be available to purchasers who purchase after next year, and indicated that both first-time and other buyers would benefit from lower rates than had been previously proposed – measures which are all designed to spur potential home buyers into action in an attempt at engineering some stabilisation in the residential market.

In keeping with the Government's stated desire to be guided by the principle of fairness, there was some relief for low-income workers by virtue of the increase in the lower exemption threshold of the Universal Social Charge (from €4,004 to €10,036). Such workers are the only category of workers to see any outright reductions in income tax from today's announcement: those with a gross income of €10,000 will benefit to the tune of €200 per year, with the measure set to cost €34 million next year.

Finally, there were some measures, albeit very modest in size, aimed at supporting the enterprise sector. One of the measures is focused on helping and incentivising companies to expand into emerging market economies, whereby the government has introduced a Foreign Earnings Deduction scheme applicable to individuals that spend 60 days a year developing markets for Ireland in the so called BRICS (Brazil, Russia, India, China, South Africa). Given the importance that external trade will play in the economic outlook for Ireland, targeted measures such as these, while limited by fiscal constraints, are nonetheless helpful at the margin in supporting Ireland's trade prospects. The minister also extended the scheme which provides three-year relief from corporation tax for start-up companies which commence a new trade between now and 2014.

Health budget bears the brunt of the cuts in day-to-day spending

Having already announced €0.755 bn in capital spending reductions, Minister Howlin this week faced the hugely unenviable task of cutting €1.45 billion out of the budget for day-to-day government spending. On their own, the measures announced on Monday will make the single biggest contribution to the 2012 budgetary adjustment, as the suite of current spending measures represents some 45% of the total €3.3bn package of new budgetary measures for 2012.

The minister was keen to emphasise the importance which the government places on protecting the most vulnerable in society, and in fairness his Social Protection spending allocations for 2012 do reflect this priority. Education has also been prioritised, while the Health budget is facing proportionately larger cuts next year.

That is certainly not to say that spending on Social Protection was immune from his scalpel; the €475 million in cutbacks contains a host of painful cuts including the widely-touted phasing out of higher rates of child benefit for the third and subsequent child, reductions in the Back to School Clothing and Footwear Allowance, and reductions in the One Parent Family Payment and the Rent and Mortgage Interest Supplement schemes.

However, if the cut in the Social Protection budget for 2012 had been implemented in proportion to that department's 40% share of overall current spending, then the cuts would have been of the order of €600 million, i.e. over €100 million more than actually proposed. Indeed, the Minister pointed out in his speech that his proposed cuts are also lower than what had been pencilled in by the previous Government in its National Recovery Plan. That will be cold comfort of course to those affected by the scaling back of the various welfare supports, but it does indicate an attempt on the part of the current Government to both prioritise support for the less-well off in society and to differentiate itself politically from its predecessor.

The Education budget also looks to have received some prioritisation, as the proposed cuts here of €132 million for next year are over €100 million lower than would have been the case if spending had been cut in line with its 17% share in overall day-to-day expenditure. However, again, there is no getting away from the fact that in absolute terms resources are being cut, particularly in higher

and third level education where the proposed measures include the expected hike (of €250) in the third-level student contribution, a 2% reduction in core funding for higher education and changes to fee and maintenance supports for new post-graduate students.

Obviously, not all areas can be prioritised and one of the casualties is the Health budget which is facing a reduction of €543 million. This stands in contrast to a hypothetical alternative scenario where it might have faced cuts of €400 million if it had borne a proportionate share of the total reductions in line with its 27% share in total spending.

Overall, the Big-Three spending departments of Social Protection, Health and Education contributed €1.1 billion, or 79%, of the €1.45 billion total package in current spending measures announced on Monday.

Another guiding principle flagged by the Minister was jobs. Minister Howlin reiterated the Government's commitment to the recently-announced multi-annual Action Plan for Jobs which will include quarterly performance targets as well as a monitoring group to oversee implementation. Putting employment at the heart of Government policy is a welcome and absolutely necessary step, and the implementation of the action plan will be key. However, there were no game-changers on the jobs front announced as part of his package.

A policy statement on labour market activation is due to be published 'shortly', with the aim of addressing the growing scourge that is the problem of long-term unemployment and he did provide €20 million for a Labour Market Activation Fund, specifically targeted at the long-term unemployed. However, at 6,500, the number of places on this scheme is dwarfed by the scale of the problem, with the latest figures showing that the numbers who have been unemployed for a year or more rose by 37,200 in the past year alone, with the total now standing at over 164,000.

Summary

So overall, as pre-announced, Mr. Noonan achieved over half of his package of new tax measures via a two-point hike in the top rate of VAT, while Mr Howlin provided some protection, in a relative sense at least, to the social welfare budget, partly at the expense of a disproportionate reduction in health spending. In each case, these measures represented a departure from the previous administration's published plans, entitling both ministers to rightly claim that the new Government was exercising its political mandate to follow its own policy priorities.

However, it would be wrong to overstate the extent to which what we witnessed this week was a material shift in Irish fiscal policy. Budget 2012 was the first instalment in a planned total correction of €10.4bn over the 2012-14 period, a bit more than, but very close to, the €9.8bn outlined in last year's National Recovery Plan (NRP). Moreover, the spending:taxation split of the new administration's plan over this period is exactly the same as the NRP at 62:38. This highlights that, while there has been a change of government since the last Budget, there is a clear continuity and consistency in Irish fiscal policy formulation and implementation, thus boosting the credibility of the consolidation effort.

(Please see below a table summarising the key features of Budget 2012).

Budget 2012 - Key Features

5th/6th December 2011

Exchequer and General Government Balances

- The **Exchequer deficit** in 2012 is forecast at €18.860m (11.9% of GDP). This compares with a deficit of €25,205m in 2011 (16.2% of GDP). The 2013 forecast is for a deficit of €14,085m (8.6 % of GDP).
- For the **General Government Balance (GGB)**, deficits of 8.6% and 7.5% are forecast for 2012 and 2013 respectively, compared with a deficit of 10.1% in 2010.

Government Spending

The budget provides for overall savings of €1.45 billion in Current Spending and €750 million in Capital Spending. **Total saving of €2.2 billion.**

Health – savings of €543 million

- Increased generation and collection of private income through measures such as further increases in the charges for private beds in public hospitals and new legislation to allow hospitals to raise charges in respect of all private patients. To yield €143 million in 2012 and €268 million in a full year.
- Reduction in health service employment levels and in volume of expenditure on agency staff, overtime and premium payments. To yield € 145 million in 2012 and €219 million in a full year
- Savings in drug costs and professional fees, reference pricing for interchangeable medicines and increasing the Drug Payment Scheme threshold by €12 to €132 p/m in 2012. To yield €124 million in 2012 and €219 million in a full year

Social Protection – savings of €475 million

- Reduction of employer rebate from 60% to 15%, to yield €81 million in 2012 and €104 million in a full year.
- Changes to One Parent Family entitlements to yield €20.7 million in 2012 and €112 million in a full year.
- Savings in child benefit through the phasing out of entitlements for the 3rd and subsequent child and the discontinuation of the one-off grants in respect of multiple births. To yield €44.7 million in 2012 and 70.7 million in a full year

Education and Skills – savings of €132 million

- Savings achieved through amendments to Student Support and Access, including changing the post graduate grants system by paying fees only (no maintenance grant) for special rate students and a 3% reduction in the student maintenance grant. To yield €15.4 million in 2012 and €77.6 million in a full year.
- In terms of teacher numbers, post primary schools to manage career guidance provision within their existing Pupil Teacher Ratio, and raising the minimum number of pupils required for allocation of teaching posts. To yield €19.4 million in 2012 and €75.9 million in a full year.
- A 2% reduction in core funding for higher education bodies in 2012 & 2013, followed by further 1% reduction in 2014 and 2015, along with termination of Technological Sector research programme. To yield €24.6 million in 2012 and €70 million in a full year

Other savings of €300 million

- Dept of Agriculture. Total savings of €105 million in 2012/full year with savings targeted in areas such as REPs expenditure
- Dept of Justice. Total savings of €100 million in 2012/full year, with €79 million in savings/cost containment measures in relation to An Garda Siochana
- Dept of Foreign Affairs & Trade. Total savings of €55m in 2012, with the bulk of the savings coming from a reduction in the Development Cooperation budget(i.e. overseas development aid)

Taxation

Tax measures to save total of €1.1 billion in 2011

VAT – yield of €560 million

- Increase in the standard rate of VAT from 21% to 23%.

Excise Duties – yield of €177.5 million

Carbon Tax

- Carbon tax to be increased by €5 to €20 per tonne on fossil fuels. The increase will apply to petrol and auto diesel. To yield €80million in 2012 and €109 million in a full year

Motor Tax

- Tax to increase across all categories, effective from 1 January 2012. To yield €46.5 million in 2012/full year

Tobacco

- From midnight on Dec 6th excise duty on a packet of 20 cigarettes is being increased by 25 cents (including VAT) with a pro rata increase on other tobacco products. To yield €41 million in 2012/full year.

Betting Duty

- Extension of the betting duty of 1% to remote betting and the introduction of a betting intermediaries duty to cover betting exchanges. Expected to be effective from Q2 2012. To yield €10 million in 2012 and €20 million in a full year.

Household Charge

- A household charge of €100 to fund local services is being introduced in 2012 as an intern measure pending the design and implementation of a full property tax, which will apply in 2014. Charge will yield €160 million in 2012/full year

Capital Acquisitions Tax

- The current rate of CAT is being increased from 25% to 30%. The current Group A Tax free threshold is being reduced from €332,084 to €250,000. To yield €51 million in 2012 and €76 million in a full year

Pensions – total yield of €57million

Employer PRSI on pension contributions

- Current relief of 50% of employer PRSI for employee contributions to occupational pension schemes and other pension arrangements is being removed from 1 January 2012. To yield €57 million in 2012 and €90 million in a full year.

DIRT/Exit Taxes – yield of €35 million

- The DIRT that applies to deposit accounts, along with the rates of exit tax that apply to life assurance polices/investment funds is being increased by 3% to 30% for payments made annually/more frequently and increased to 33% for payments made less frequently than annually, effective from 1 January 2012

Other Measures

- **Stamp Duty –** Abolition of multiple Stamp Duty rates for non residential properties, replaced with a single rate of 2% in respect of instruments executed after 6 December 2011.

- **Mortgage Interest Relief –** Increase in the rate of mortgage interest relief to 30% for first time buyers who took out their first mortgage in the period 2004 to 2008. Mortgage interest relief will no longer be available on house purchases after the end of 2012 and will be fully abolished from 2018.

- **Universal Social Charge –** increase of lower exemption threshold from €4,004 to €10,036, effective from 1 January 2012. The measure will enable workers to earn up to that level without incurring the USC and will benefit ca. 330,000 people.

- **Promoting International Trade** – Introduction of a Special Assignee Relief Programme to allow multinationals and indigenous companies to attract key people to Ireland with the aim being to create jobs and help companies to develop and expand. The introduction of a Foreign Earnings Deduction scheme which will apply to individuals that spend 60 days a year developing markets for Ireland in Brazil, Russia, India, China and South Africa.

Reform of Public Services

- 2012 department staffing ceilings represent a reduction of roughly 6,000 in total, over the 2011 end year estimate of 300,000 public sector workers.

Economic Forecasts

- Following an estimated 1% rise in **GDP** in 2011, a rise of 1.3% is forecast in 2012 (GNP basis +0.4% in 2011 and +0.7% in 2012). From 2013-15, GDP is expected to rise by an average of 2.8%.
- **Consumer spending** is forecast to decline by 1.3% in 2012, following an estimated decline of 2.5% this year. Consumer spending is expected to be flat in 2013.
- **Exports** have continued to perform well this year and provided the driver of economic growth. For 2011, a rise of 4.6% is expected, with a slowdown in export growth to 3.6% forecast for 2012, before reaccelerating to 4.5% in 2013.
- The **HICP** measure of inflation, the more appropriate measure for UK/ Eurozone comparisons, is forecast to rise by 1.9% in 2012, following an estimated 1.2% rise this year.
- Following an estimated 1.9% fall in 2011**, employment** is expected to decline at a much slower rate of 0.2% in 2012. Looking forward to 2013, a resumption of employment growth of the order of 0.8% is forecast, with an average increase of 1.2% expected over the period 2013-15.
- The **unemployment** rate is expected to average 14.1% in 2012, slightly lower than the 14.3% rate estimated for this year. Thereafter more notable declines are expected as the economy shows greater signs of recovery, with the rate expected to fall to 11.6% by 2015.

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