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Davy Research

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Research Report: Irish economy

Budget 2012: Tax measures

€1.6bn of revenue measures announced

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Budget tax measures (€m)

	Yield, €m	%
Value-added taxes	559	55%
Excise duty (motor and carbon tax)	178	18%
Household charge	160	16%
Capital gains tax	81	8%
Capital acquisitions tax	51	5%
Deposit interest retention tax	35	3%
Stamp duty	-64	-6%
Corporation tax	-5	0%
Other	20	2%
Total	**1084**	**100**

Source: Department of Finance; Davy calculations

Adjustment of €1.6bn in revenues in 2012

- €600m is to come from the full-year impact of measures introduced last year, with €1.0bn of new measures announced today.
- The burden is borne by higher value-added taxes (€559m), excise duties (€178), a new household charge (€160m) and capital taxes and deposit interest (€167m).
- The total budget adjustment is €3.8bn following the €2.2bn of spending cuts announced on December 5th.

Broadly similar profile for expected deficits and debt

- The target for the deficit is still 8.6% of GDP in 2012, narrowing to 2.9% by 2015.
- Interest costs are now expected to peak at 5.8% of GDP in 2014, a little below the 6.0% previously.
- The debt-to-GDP ratio is to peak at 119% in 2014.

Projections for GDP growth revised down marginally

- GDP growth in 2012 is now expected to be 1.3%, marginally lower than the 1.6% expected previously.
- Unemployment is to remain above 14% until 2013.

Welcome emphasis of tax measures away from incomes

- The decision to raise indirect taxes rather than income taxes is positive, given the already high marginal income tax rates in Ireland.
- Higher taxes on interest and capital may reduce the incentive to save, and a high level of household saving has clearly held back Irish domestic demand.
- Overall, the composition of today's tax measures seems better balanced than the expenditure cuts announced yesterday, which were overly skewed towards capital spending.

Quantum of revenue measures as expected and appropriately skewed towards indirect taxation

- **Overall €3.8bn adjustment, split expenditure €2.2bn and taxation €1.6bn as expected.**

Today (December 6th), the Minister for Finance set out €1.6bn of tax-raising measures following yesterday's announcements of expenditure cuts worth €2.2bn (for further detail, see our research report issued December 5th). So, the overall adjustment in Budget 2012 is €3.8bn.

Table 1: Budget measures (€bn)

	2012	*2013*	*2014*	*2015*
Revenue measures	1.6	1.2	1.1	0.7
o/w new measures	1.0	0.95	0.9	0.4
carry forward	0.6	0.3	0.2	0.3
Current expenditure	1.45	1.7	1.9	1.3
Capital expenditure	0.75	0.55	0.1	0
Expenditure measures	2.2	2.3	2.0	1.3
Budget adjustment	3.8	3.5	3.1	2.0

Source: Department of Finance

- **Of the €1.6bn of revenue measures announced today, higher VAT rates and a new household charge were among the key measures.**

A key change announced today was a 2 percentage point increase in the rate of value-added tax to 23%. This is expected to yield €559m, accounting for more half of the total €1.0bn of new measures. The bulk of the remainder of the tax increases is borne by excise duties (€178m), the household charge (€160m) and capital taxes and deposit interest retention tax (€167m).

The emphasis on indirect taxation, rather than income taxes, is welcome. As discussed in the Minister's Budget speech, marginal income tax rates are high in Ireland, and further increases would pose a threat to employment.

No significant changes to fiscal targets and GDP projections

- **The government is still targeting a deficit of 8.6% of GDP in 2012. Debt-to-GDP is expected to peak at 119% in 2014.**

As anticipated, there were few significant changes to the expected profile for the public finances. The government is still targeting a deficit of 8.6% of GDP in 2012. Debt-to-GDP is expected to peak at 119% in 2014. Interest costs meanwhile are expected to peak at 5.8% of nominal GDP in 2014, with the primary deficit moving to a surplus of 2.8% in 2015.

Table 2: Budget forecasts 2011-2015 (€m)

	2011	*2012*	*2013*	*2014*	*2015*
Tax revenue, €m	34175	35825	38350	41020	43175
Current expenditure, €m	53070	51880	50,590	48,715	47355
Capital expenditure, €m	4635	3935	3375	3255	3255
General government deficit	-15615	-13650	-12385	-8505	-5215
% of GDP	-10.1%	-8.6%	-7.5%	-5.0%	-2.9%
Interest cost, % of GDP	3.3%	4.2%	5.6%	5.8%	5.7%
Primary balance, % of GDP	-6.7%	-4.4%	-1.9%	0.8%	2.8%
General government debt, % GDP	107	115	119	118	115
GDP growth, %	1.0	1.3	2.4	3.0	3.0

Source: Department of Finance

The projection for GDP growth in 2012 was revised down marginally to 1.3%, from 1.6% in the *Medium-term fiscal statement,* issued November 4th. Overall, this revision is small and pales in comparison with broader uncertainties about economic prospects. GDP is still expected to grow by 2.4% in 2013, and 3.0% in 2014 and 2015.

Focus on indirect taxation appropriate

Of the €1.6bn revenue adjustment in 2012, €600m is expected from the full-year impact of measures adopted in Budget 2011. This left Minister for Finance, Michael Noonan, with €1.0bn of additional revenues to raise in Budget 2012.

As had been well flagged, the rate of value-added tax was increased by 2 percentage points to 23%. This single measure is expected to raise around half of the €1.0bn adjustment (Table 3). Elsewhere, the focus remained on indirect taxation with increases in capital gains and acquisitions taxes and on deposit interest retention tax (DIRT).

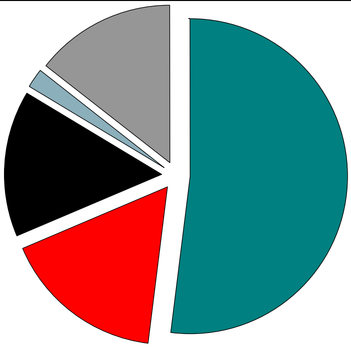
- **The decision to focus the revenue measures on indirect taxes is positive.**

The decision to focus the revenue measures on indirect taxes is positive. High marginal income tax rates — in excess of 50% in Ireland — are a clear disincentive to employment. So, the move away from income taxes as a source of revenue in Budget 2012 is welcome.

- **High household savings rates in Ireland have been a key factor behind the weakness of the domestic economy.**

High household savings rates in Ireland have been a key factor behind the weakness of the domestic economy. Clearly, many Irish households have maintained high savings to pay down debt. But other households, with less debt, have maintained high savings because of the prevailing mood of uncertainty. Higher taxes on deposit interest and capital may reduce the incentive to save in the near term.

Figure 1: Distribution of tax raising measures



Source: Department of Finance

Table 3: Budget tax measures (€m)

	Yield, €m	%
Value-added taxes	559	55%
Excise duty (motor and carbon tax)	178	18%
Household charge	160	16%
Capital gains tax	81	8%
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Stamp duty	-64	-6%
Corporation tax	-5	0%
Other	20	2%
Total	**1084**	**100**

Source: Department of Finance; Davy calculations

So overall, the composition of today's tax measures seems better balanced than the expenditure cuts announced yesterday, which were highly skewed towards capital spending. That said, there may still have been scope to rebalance the overall adjustment more towards spending rather than taxation.

Measures to revive the property market

- **The Budget also included some interesting measures to assist the property market.**

The Budget also included some interesting measures to assist the property market, including increases in mortgage interest relief for purchases in 2012. Similarly, there was a reduction in the rate of stamp duty on commercial property, from 6% to 2%, and a reduction in capital gains tax for property purchased before the end of 2013 and held for a minimum of seven years. While a resurgent property boom is neither likely nor desirable, the measures announced today could help activity in the property sector at the margin towards more 'normal' levels.

Macroeconomic assumptions

- **The projection for GDP growth in 2012 was revised down marginally to 1.3% in the Budget 2012 projections from 1.6% in the *Medium-term fiscal statement.***

The projection for GDP growth in 2012 was revised down marginally to 1.3% in the Budget 2012 projections from 1.6% in the *Medium-term fiscal statement*. The Budget documents indicate that the deteriorating global environment was the principal reason for the downward revisions to the 2012 projection.

The downward revisions neatly place the official Department of Finance projections for 2012 close to the average of other forecasters, for example the Central Bank (1.8%), Davy (1.5%), IMF (1.5%), Reuters consensus (1.5%), OECD (1.0%), European Commission (1.1%) and ESRI (0.9%).

Overall, the size of the revision is small and it pales in comparison with the broader risks and uncertainties emanating from the euro area debt crisis. Further out, the projections have not been revised. GDP is still expected to grow by 2.4% in 2013, and 3.0% per annum thereafter.

Table 4: Budget forecasts (%)

	2011	*2012*	*2013*	*2014*	*2015*
Consumer spending	-2.5	-1.3	0.0	1.0	1.2
Government spending	-3.0	-2.2	-2.2	-2.3	-2.1
Investment	-11.0	-1.0	3.2	4.6	4.8
Change in inventories	0.2	0.3	0.3	0.3	0.2
Exports	4.6	3.6	4.5	4.8	4.8
Imports	1.6	1.6	2.8	3.4	3.5
GDP	1.0	1.3	2.4	3.0	3.0

Source: Department of Finance

- **Growth is expected to continue to be export-led with consumer spending and investment contracting in 2012.**

As shown in Table 4, growth is expected to continue to be export-led with consumer spending and investment contracting in 2012. Consumer spending does not begin to contribute positively to growth until 2014. So, given the weak outlook for domestic demand, the dependence on export-led growth accentuates the risks to Ireland from the global economy.

Debt dynamics remain challenging

The medium-term projections for the government deficit and debt incorporate a lower assumed interest rate: 5.1% rather than the 5.6% assumed in Budget 2011. In part, this reduction reflects the approximately €1.1bn of savings per annum — once funds are fully drawn — from the July agreement with the EU to lower the interest rate on Ireland's borrowing from official sources under the EU/IMF deal.

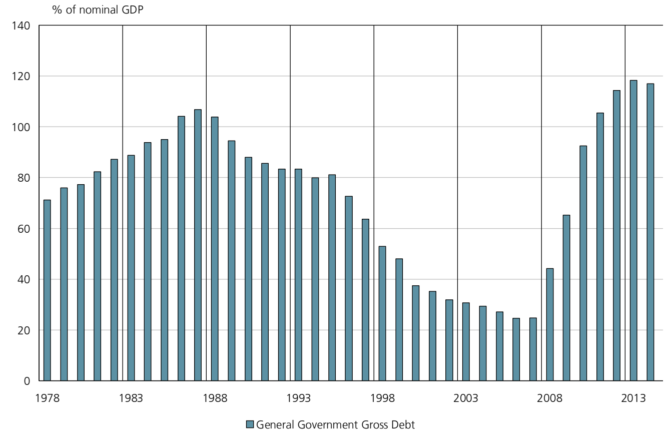
- **The debt-to-GDP ratio is expected to peak at 119% in 2013 and interest payments at 5.8% of GDP in 2014.**

The debt-to-GDP ratio is expected to peak at 119% in 2013 and interest payments at 5.8% of GDP in 2014. Figure 2 shows that the debt-to-GDP ratio fell precipitously from levels exceeding 100% in the early 1980s. But such rapid growth in GDP as Ireland experienced in the 1990s is unlikely to be repeated. However, as a proportion of tax revenue, the interest burden is not unprecedented. The interest burden peaked at close to 35% of tax revenue in the mid-1980s and is expected to peak at close to 20% in 2014.

In part, the ability of both households and governments to bear higher debt levels is dependent on the trend decline in nominal interest rates between the 1980s and 2000s (Figure 3). However, the projections for interest costs through 2012-2015 are conditional on the average interest rate remaining at 5.2%.

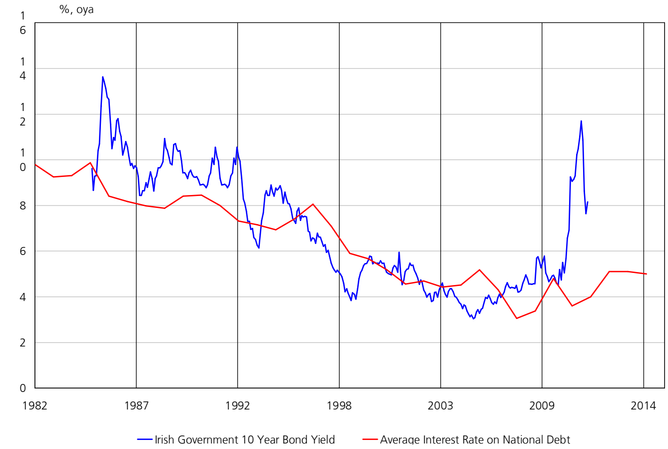
The 5.2% rate is clearly well below current yields in markets, with funding from the current EU/IMF deal set to end in 2013. Clearly, if conditions in private funding markets remain challenging, further official funding of the Irish sovereign may be required.

Figure 2: General government gross debt



Source: Department of Finance

Figure 3: Interest rates



Source: Department of Finance; Thomson Reuters; Datastream

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