

Budget 2014 delivers €2.5bn adjustment, as expected

Conall Mac Coille

conall.maccoille@davy.ie / +353 1 6148770

David McNamara

david.mcnamara@davy.ie / +353 1 6148819

Economics Team

Conall Mac Coille, David McNamara

research@davy.ie

DAVY VIEW

Budget 2014 implemented €2.5bn of cuts as expected, split between €0.9bn of tax rises and €1.6bn of spending cuts. The deficit is expected to be 4.8% of GDP in 2013 and 2.9% in 2015. Debt is expected to fall from 124% of GDP in 2013 to 120% in 2014. The clear winner from the budget was the tourism industry, which maintained its 9% VAT rate at a cost of €350m per annum. Tax rises were concentrated on the 'old reliables': excise duties and deposit interest tax. On spending, the health sector is expected to make a large €666m saving in 2014, but with an over-run of up to €200m expected in 2013, doubts will persist on whether the desired savings can be achieved.

Tax rises €0.9bn, expenditure cuts €1.6bn

Budget 2014 delivered a €2.5bn (1.5% of GDP) adjustment, as expected. Tax rises were €0.9bn (€200m less than planned in April) and expenditure cuts €1.6bn (€400m lower). The government expects to run a deficit worth 4.8% of nominal GDP in 2014, falling to 2.9% in 2015. This should be sufficient to reduce the debt-to-GDP ratio from 124% in 2013 to 120% in 2014, coupled with a €11bn reduction in cash balances.

Extra tax measures to fund 9% tourism VAT rate

The tax rises were concentrated on the 'old reliables', such as DIRT (€105m) and excise duties (€160m), together with a new raid on private pension pots (€135m) and a new bank levy (€150m). The stamp duty rate on pension funds will be raised to 0.75% from 0.6%. The deposit interest tax rate will increase to 41%. The clear winner in the Budget was the tourism industry, which retained its 9% VAT rate at a cost of €350m in the full year, or €290m in 2014, effectively receiving the entire €200m cut in planned revenue adjustments in 2014. There were no changes to income tax rates, the universal social charge (USC) or the corporation tax rate.

Spending cuts eased to €1.6bn; concerns on health spending overshoot persist

Over and above the €1.6bn spending adjustment, government departments are expected to make €300m of additional cuts to stay within expenditure ceilings. On the spending side, the cuts were concentrated in the Departments of Health (€666m) and Social Protection (€290m). However, with Health expected to be close to €200m over budget at the end of 2013 – for a second year running – doubts will persist on whether it can achieve the desired savings in 2014. The cuts in social spending were broadly based, but the headline levels of unemployment benefit were left unchanged, albeit with job-seekers' allowances for the under-25s reduced to €144 per week.

See the end of this report for important disclosures and analyst certification

Tax measures stronger than expected, comprising 50% of the adjustment.

Deficit to fall to 2.9% of GDP in 2015. Debt to fall from 124% in 2013 to 120% in 2014 as state erodes cash balances.

Spending cuts of €2.5bn, as expected

Budget 2014 delivered a €2.5bn (1.5% of GDP) adjustment as expected. Tax rises were €0.9bn (€200m less than planned in April) and expenditure cuts €1.6bn (€400m lower). The government expects to run a deficit worth 4.8% of nominal GDP in 2014, falling to 2.9% in 2015. This should be sufficient to reduce the debt-to-GDP ratio from 124% in 2013 to 120% in 2014, coupled with a €10bn reduction in cash balances.

The tax rises were concentrated on the 'old reliables', such as DIRT (€105m) and excise duties (€160m), together with a new raid on private pension pots (€135m) and a new bank levy (€150m). The clear winner in the Budget was the tourism industry, which retained its 9% VAT rate at a cost of €350m in the full year, or €290m in 2014, effectively receiving the entire €200m cut in planned revenue adjustment in 2014.

On the spending side, the cuts were concentrated in the Departments of Health (€666m) and Social Protection (€290m). However, with the Department of Health expected to be close to €200m over budget at the end of 2013 – for a second year running – doubts will persist on whether it can achieve the desired savings in 2014. Over and above the €1.6bn spending adjustment, government departments are expected to make €300m of additional adjustments to stay within expenditure ceilings.

Table 1: Budget 2014 fiscal consolidation measures (€bn)

	2013	2014
Fiscal consolidation measures	3.5	2.5
Spending cuts	1.9	1.6
- Current	1.4	1.4
- Capital	0.5	0.1
Tax increases	1.4	0.9

Source: Department of Finance, Budget 2014

The government's projections for the deficit and debt are based on 0.2% GDP growth in 2013 and 2.0% in 2014. These forecasts are below Davy projections for 1% growth in 2013 and 2.5% in 2014. Hence, our forecast is for a government deficit of 4.4% in 2014.

Table 2: Budget 2014 deficit, debt and macroeconomic projections

	2013	2014	2015
Fiscal aggregates			
General Government Balance (% GDP)	7.3	4.8	2.9
Of which:			
Primary balance	-2.7	0.0%	2.0%
Interest vots	4.6%	4.8%	4.9%
General government debt, % GDP	124.1%	120.0%	118.4%
Macroeconomic assumptions			
Nominal GDP	165.9	170.6	176.9
Nominal GDP growth	1.2	2.9	3.7
Real GDP growth	0.2	2.0	2.3

Source: Department of Finance, Budget 2014

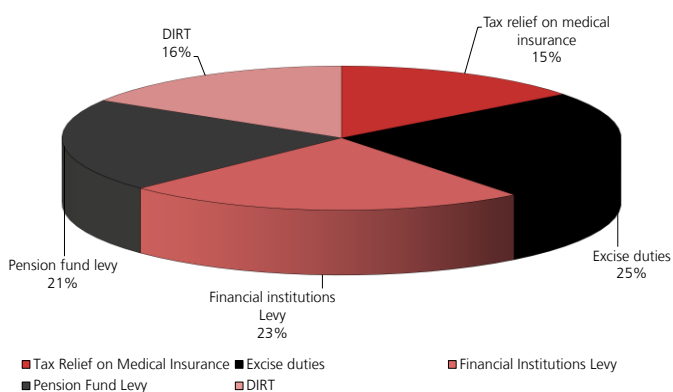
Tax measures focused on the 'old reliables' such as DIRT and excise duties, together with a new raid on pension funds and a €150m bank levy.

€300m of extra tax measures to fund 9% tourism VAT rate

Tax revenue measures were larger than expected, at €1.2bn, in order to maintain the 9% tourism services VAT rate at a cost of €290m in 2014. Overall, the tax adjustment was €900m, €200m lower than planned in the April Stability Update and well flagged ahead of the Budget's announcements.

Of the €1.2bn of tax rises, €500m reflected a carry-over from 2013 – the full-year impact of the property tax and the new ceiling on pension reliefs. Amongst the other main measures was a hike in excise duties on alcohol and tobacco (€160m), a new levy on banks (€150m) and an increase in the levy on pension funds (€135m). The stamp duty rate on pension fund assets is being increased from 0.6% to 0.75%. A hike in the deposit interest retention tax (DIRT) rate to 41% is expected to yield another €105m. As such, the Budget relied strongly on hitting the 'old reliables'.

Figure 1: Distribution of tax-raising measures



Source: Department of Finance, Budget 2014:

Table 3: Budget 2014 tax measures (€m)

	2014 yield	FY impact
Tax relief for medical insurance	94	127
Excise on alcohol and tobacco	160	160
Financial institutions levy	150	150
Pension fund levy	135	135
Deposit interest retention tax	105	140
Other	54	
Carry-over from Budget 2013	500	500
Total	1200	

Source: Department of Finance, Budget 2014

The Budget also included several measures to help jobs growth.

The Minister for Finance announced several initiatives to help jobs growth and investment. The 9% VAT rate for tourism services will be retained, while air travel tax is being reduced to zero. Tourism was the clear winner in Budget 2014 but there were also several initiatives aimed at construction. A new home renovation tax incentive will encourage spending on repair and maintenance on principal private residences by offering relief on works costing €5,000-35,000. This is expected to cost €62m from 2015. The relief from capital gains for properties will be extended to purchases up to the end of 2014.

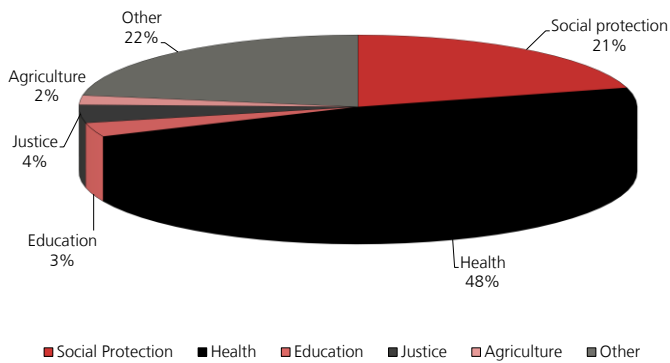
The Minister also closed the loophole allowing Irish registered companies to be 'stateless' in terms of their place of tax residency. The Department of Finance did not indicate if it expected this to have any impact on corporation tax revenues in 2014.

Spending cuts eased to just €1.6bn; concerns on overshoot in health spending persist

Budget 2014 implemented a €1.6bn adjustment in spending. This is smaller than the 2.0bn adjustment foreseen in the April Stability Update. As in previous years, the onus is on the Departments of Health (€666m) and Social Protection (€290m) to deliver the bulk of the adjustment. In last year's Budget, an additional €700m of health cuts was required to keep the Health Service Executive (HSE) within budget. Reports suggests that another over-run is likely in 2013.

The spending adjustment in 2014 was revised down substantially.

Figure 2: Planned expenditure savings



Source: Department of Finance, Budget 2014

Table 4: Planned expenditure cuts in 2014 (€m)

Department	€m
Health	666
Social protection	290
Education	44
Transport	75
Justice	56.5
Other	314
Total departmental cuts	1.4
Carry-over from 2013	0.1
Total current expenditure cuts	1.5
Capital expenditure cuts	0.1
Total expenditure cuts	1.6

Source: Department of Finance, Budget 2014

Over-runs in the Department of Health raise concerns about the government's ability to hit targets in 2014.

Given the Department of Health's record to date, a degree of scepticism must surround the aggressive cuts planned for 2014. Savings are expected to come from substitution of generic drugs (€50m), pay (€268m), a review to remove ineligible or redundant medical cards (€113m) and private bed charges (€30m).

In Social Protection, the cuts were broadly-based. Spending on the household benefits package is being reduced by €49m and jobseekers allowance for under-25s by €32m, with fraud and control measures expected to yield €30m. A reduction in illness benefit from three to six days is expected to yield €22m and maternity and adoptive benefit €30m. However, there were no changes in headline levels of unemployment benefit.

The Budget raises fresh concerns on the ability of the government to deliver the requisite savings. For the second year running, planned expenditure in the Department of Health has been raised (by €187m), with an over-run close to €200m expected in 2013. So the concern is that the Department of Health may struggle to reach the planned cuts of €666m set out for 2014. The government has also been slow to achieve savings in the Department of Social Protection. The IMF's recommendations that universal social benefits should be better targeted towards the most vulnerable groups have not been adopted. In the IMF's February 2012 review of Ireland's programme, the government was scheduled to complete a review of child and working age benefits, but there has been little progress towards means-testing or taxing universal social benefits. Inevitably this lack of progress in addressing structural expenditure problems has necessitated the adoption of alternative measures like additional public sector wage cuts and taxation.

Important Disclosures

Analyst certification

Each research analyst primarily responsible for the content of this research report certifies that : (1) the views expressed in this research report accurately reflect his or her personal views about any or all of the subject securities or issuers referred to in this report and (2) no part of his or her compensation was, is or will be, directly or indirectly, related to the specific recommendations or views expressed in this report.

Investment ratings

A summary of existing and previous ratings for each company under coverage, together with an indication of which of these companies Davy has provided investment banking services to, is available at www.davy.ie/ratings.

Investment ratings definitions

Davy ratings are indicators of the expected performance of the stock relative to its sector index (FTSE E300) over the next 12 months. At times, the performance might fall outside the general ranges stated below due to near-term events, market conditions, stock volatility or – in some cases – company-specific issues. Research reports and ratings should not be relied upon as individual investment advice. As always, an investor's decision to buy or sell a security must depend on individual circumstances, including existing holdings, time horizons and risk tolerance.

Our ratings are based on the following parameters:

Outperform: Outperforms the relevant E300 sector by 10% or more over the next 12 months.

Neutral: Performs in-line with the relevant E300 sector (+/-10%) over the next 12 months.

Underperform: Underperforms the relevant E300 sector by 10% or more over the next 12 months.

Under Review: Rating is actively under review.

Suspended: Rating is suspended until further notice.

Restricted: The rating has been removed in accordance with Davy policy and/or applicable law and regulations where Davy is engaged in an investment banking transaction and in certain other circumstances.

Distribution of ratings/investment banking relationships

Rating	Count	Investment banking services/Past 12 months		
		Percent	Count	Percent
Outperform	60	55	23	69
Neutral	27	25	6	18
Underperform	11	10	0	0
Under Review	3	2	2	6
Suspended	5	4	0	0
Restricted	2	1	2	6

This is a summary of Davy ratings for all companies under research coverage, including those companies under coverage to which Davy has provided material investment banking services in the previous 12 months. This summary is updated on a quarterly basis. The term 'material investment banking services' includes Davy acting as broker as well as the provision of corporate finance services, such as underwriting and managing or advising on a public offer.

Regulatory and other important information

J&E Davy, trading as Davy, is regulated by the Central Bank of Ireland. Davy is a member of the Irish Stock Exchange, the London Stock Exchange and Euronext. In the UK, Davy is authorised by the Central Bank of Ireland and authorised and subject to limited regulation by the Financial Conduct Authority. Details about the extent of our authorisation and regulation by the Financial Conduct Authority are available from us on request. No part of this document is to be reproduced without our written permission. This publication is solely for information purposes and does not constitute an offer or solicitation to buy or sell securities. This document does not constitute investment advice and has been prepared without regard to the individual financial circumstances and objectives of persons who receive it. The securities/strategy discussed in this report may not be suitable or appropriate for all investors. The value of investments can fall as well as rise and there is no guarantee that investors will receive back their capital invested. Past performance and simulated performance is not a reliable guide to future performance. Projected returns are estimates only and are not a reliable guide to the future performance of this investment. Forecasted returns depend on assumptions that involve subjective judgment and on analysis that may or may not be correct. Any information related to the tax status of the securities discussed herein is not intended to provide tax advice or to be used as tax advice. You should consult your tax adviser about the rules that apply in your individual circumstances.

This document has been prepared and issued by Davy on the basis of publicly available information, internally developed data and other sources believed to be reliable. While all reasonable care has been taken in the preparation of this document, we do not guarantee the accuracy or completeness of the information contained herein. Any opinion expressed (including estimates and forecasts) may be subject to change without notice. We or any of our connected or affiliated companies or their employees may have a position in any of the securities or may have provided, within the last twelve months, significant advice or investment services in relation to any of the securities or related investments referred to in this document.

While reasonable care has been taken in the preparation of the information contained in this document, no warranty or representation, express or implied, is or will be provided by Davy or any of its shareholders, subsidiaries or affiliated entities or any person, firm or body corporate under its control or under common control or by any of their respective directors, officers, employees, agents, advisers and representatives, all of whom expressly disclaim any and all liability for the contents of, or omissions from, this document, the information or opinions on which it is based and/or whether it is a reasonable summary of the securities in this document and for any other written or oral communication transmitted or made available to the recipient or any of its officers, employees, agents or representatives.

Neither Davy nor any of its shareholders, subsidiaries, affiliated entities or any person, firm or body corporate under its control or under common control or their respective directors, officers, agents, employees, advisors, representatives or any associated entities (each an "Indemnified Party") will be responsible or liable for any costs, losses or expenses incurred by investors in connection with the information contained in this document. The investor indemnifies and holds harmless Davy and each Indemnified Party for any losses, liabilities or claims, joint or several, howsoever arising, except upon such Indemnified Party's bad faith or gross negligence.

Share ownership policy

Davy allows analysts to own shares in companies they issue recommendations on, subject to strict compliance with our internal rules governing own-account trading by staff members.

We are satisfied that our internal policy on share ownership does not compromise the objectivity of analysts in issuing recommendations.

Conflicts of interest

Our conflicts of interest management policy is available at www.davy.ie/ConflictsOfInterest.

Other important disclosures

A description of this company is available at www.davy.ie/RegulatoryDisclosures. A summary of our standard valuation methods is available at www.davy.ie/ValuationMethodologies. All prices used in this report are as of close on the previous trading day unless otherwise indicated. A summary of existing and previous ratings for each company under coverage, together with an indication of which of these companies Davy has provided investment banking services to, is available at www.davy.ie/ratings.

The data contained in this research note have been compiled by our independent analysts, based on a combination of publicly-available information and the analysts' assumptions and modelling. Further information is available upon request.

This document does not constitute or form part of any offer, solicitation or invitation to subscribe or purchase any securities, nor shall it or any part of it form the basis of, or be relied upon in connection with, any contract or commitment whatsoever. Any decision to purchase or subscribe for securities in any offering must be made solely on the basis of the information contained in the prospectus or other offering circular issued by the company concerned in connection with such an offering.

This document has been prepared by its authors independently of the company or companies covered. Davy has no authority whatsoever to give any information, or make any representation or warranty on behalf of the company or companies. In particular, the opinions, estimates and projections expressed in it are entirely those of the analysts and are not given as an agent or financial adviser of the company or companies.

US Securities Exchange Act, 1934

This report is only distributed in the US to major institutional investors as defined by S15a-6 of the Securities Exchange Act, 1934 as amended. By accepting this report, a US recipient warrants that it is a major institutional investor as defined and shall not distribute or provide this report, or any part thereof, to any other person.

Distribution of research to clients of Davy Securities in the US

Davy Securities distributes third-party research produced by its affiliate, J&E Davy.

Davy Securities is a member of FINRA and SIPC and is regulated by the Central Bank of Ireland.

Confidentiality and copyright statement

Davy, Research Department, Davy House, 49 Dawson St., Dublin 2, Ireland. Confidential © Davy 2013.