

Pre-Budget Outlook

November 2009

BAILE ÁTHA CLIATH
ARNA FHOILSIÚ AG OIFIG AN tSOLÁTHAIR
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nó trí aon díoltóir leabhar.

DUBLIN
PUBLISHED BY THE STATIONERY OFFICE
To be purchased directly from the
GOVERNMENT PUBLICATIONS SALE OFFICE
SUN ALLIANCE HOUSE, MOLESWORTH STREET, DUBLIN 2,
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GOVERNMENT PUBLICATIONS, POSTAL TRADE SECTION,
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(Prn. A9/1539) €7.00

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Section 1 - Summary and Overview

The past eighteen months or so have been an exceptionally difficult period for the Irish economy. While a number of factors have been at work, two stand out – the global recession brought about by difficulties in world financial markets and domestically, the correction in the property market.

There is some evidence that while activity will remain at lower levels in the near-term, the worst of the decline may have passed. Externally, a global recovery appears to be underway, although there is a broad consensus among the main international forecasting institutions that this will be fairly modest. While Ireland will lag the global economic recovery, it is expected that economic growth will emerge during 2010, although it is expected that it will be 2011 before we experience positive growth for the year as a whole. However, there remain outstanding issues in the domestic economy – such as loss of international competitiveness, an over-supply of housing, high levels of public and private indebtedness – which will continue to weigh on activity in the short-term.

Why action is needed

Given the very substantial contraction in living standards that we are experiencing, the public finances will be under pressure for the foreseeable future. The normal cyclical improvement in the economy over the medium term will not be sufficient to eliminate the gap between revenue and expenditure because of the narrow tax base and the fact that the tax content of export-led growth is less than that of domestically-driven growth. In other words, a large part of the deficit is permanent, or structural, and will not be eliminated without action. This is why expenditure-reducing measures and revenue-raising measures have been necessary and why further adjustments are essential.

While there have been significant revenue-raising measures introduced in the last two Budgets, the scope for further extensive revenue measures is limited at this time. The Report from the Commission on Taxation recommended that the tax base should be made broader and less volatile and this will be an important factor in medium term taxation policy.

In seeking to stabilise the public finances for 2010, the Government is taking into account previous domestic and international experience of fiscal consolidation and focusing on public spending. In this regard, current expenditure, which is estimated to stand at around €56 billion in 2009, encompasses three areas of broadly equal weight: the public service pay-bill, social welfare spending and programme spending. In order to achieve the necessary savings, the Government has indicated that none of these areas can be excluded from consideration.

Emerging Economic and Budgetary Position

GDP is projected to decline by 7½ per cent this year, a figure which is broadly in line with forecasts published in the April Supplementary Budget. Activity is projected to decline at a more moderate rate next year – probably by around 1½ per cent – although annual growth is expected to turn positive during the second half of the year. A General Government Balance of the order of -12 per cent of GDP is likely in 2009. The National Debt is forecast to increase from €50 billion at end-2008 to an estimated €76 billion by end-2009. If no corrective action is taken the deficit is likely to rise to around 14 per cent of GDP in 2010. However, the Government has stated its intention to introduce measures in Budget 2010 that will stabilise the deficit at the 2009 level. **The forecasts contained in this document are the current working forecasts of the Department of Finance and will be updated in light of further economic and fiscal data as well as taking account of the specifics of policy measures announced on Budget day.**

Rationale for taking action now

The conditions for economic recovery encompass three broad strands. The Government has taken action in each of these aimed at:

- Repairing our banking system, thereby facilitating the provision of adequate credit within the economy;
- Restoring the public finances to sustainable and lower deficit levels over the medium-term;
- Fostering sustainable employment through improving competitiveness, thus safeguarding future living standards.

Repairing our banking system – a separate issue to the fiscal challenge

Repairing our banking system is a prerequisite for economic recovery and is a separate issue from the deterioration in the public finances. Financial intermediation – directing funds from lenders to borrowers – is a key part of any modern economy. Global financial market turmoil, which began in mid-2007 and intensified in the autumn of last year, has had adverse implications for the world financial system. This global background, compounded by domestic factors, has had serious consequences for the Irish banking system. This has necessitated various public supports for the banking system, including the introduction of the bank guarantee, recapitalisation of some banks and, in one instance, nationalisation. The purpose of these measures is to facilitate the security of savings and the efficient flow of credit to the wider economy in order to support activity and underpin employment; economic recovery is not possible without a properly functioning banking system.

Notwithstanding the measures already taken, there remain concerns about the exposure of the Irish banks to the property market and, in particular, the uncertainty regarding potential losses on land and development loans. It is clear, therefore, that these loans are obstructing the normal functioning of the banking system in Ireland, restricting the flow of credit and weighing on economic activity. To address this issue, the Government is establishing the National Asset Management Agency in order to remove the riskiest loan portfolios from banks' balance sheets. The

Government considers that without this measure, economic recovery will be seriously hampered. In addition, this asset management approach has been supported by well-respected international institutions such as the IMF, OECD, the EU Commission and ECB and financial markets have also taken a positive view of this approach. The Government has also taken measures to ensure that the risk to the taxpayer is minimised.

Restoring Sustainability to the Public Finances

Separate to the banking problem, we are facing a serious fiscal challenge as there is a significant gap between expenditure and revenue. The budgetary position has deteriorated rapidly and we are now in a much more difficult period. Tax revenues are back at 2003 levels, while current expenditure has increased by over 70 per cent since then and the Exchequer deficit is forecast to be in the region of €26 billion this year. Continuing to borrow at a high level to bridge the gap between our revenues and our expenditures is unsustainable in the medium to long-term.

The expected improvement in the economy over the medium term will not be sufficient on its own to eliminate the gap between revenue and expenditure because of the narrow tax base and the fact that the tax content of export-led growth is less than that of domestically-driven growth. In other words, a large part of the deficit is of a permanent nature and not transitory. This structural imbalance between the levels of public spending and revenue will not be eliminated without discretionary, targeted action. This is why revenue-raising and expenditure-reducing measures have been necessary and why further adjustments are unavoidable.

The Supplementary Budget set out a path to return the public finances to stability over the medium-term based on the economic assessment as pertained at that time. Very significant steps have already been taken. Measures estimated to yield approximately 5 per cent of GDP in 2009 have been taken since July 2008. The priority for Budget 2010 is to stabilise the deficit. Delaying action would mean that the General Government Balance in 2010 would increase to around -14 per cent of GDP. Allowing that to happen would mean that tougher decisions would be required in the future.

Taking action now is necessary to:

- Restore economic competitiveness, without which we will be unable to benefit from the global upswing;
- Inspire confidence, internationally and domestically, that the deterioration in the public finances is being arrested;
- Prevent the debt level rising to unsustainable levels so that the cost of servicing that debt is contained;
- Assist economic growth by taking responsible action on fiscal and incomes policies, which will avoid unnecessary further adjustment in the labour market; and
- Restore expenditure and taxation to more sustainable levels.

It is noted that on 11 November 2009 the EU Commission reported on the effective action taken by member states found to be in excessive deficit i.e. running General Government deficits greater than 3 per cent of GDP. The Commission concluded that Ireland has already begun to take effective action to address the fiscal deterioration and that taking account of the commitments entered into by the Irish Authorities and weaker conditions, the Commission has now proposed an extension of the excessive deficit correction path to 2014 in Ireland's case. The Council of Ministers will decide on this recommendation at the December Ecofin Council. While the extension of the time period is welcome and will make the necessary corrective action less onerous in the later years, it is predicated on Ireland continuing to take effective action, in particular, addressing the immediate need of stabilising the deficit in 2010.

Fostering sustainable employment through improving competitiveness

Restoring the banking system and bringing sustainability back to the public finances in a measured way will help underpin and foster economic activity. This is a prerequisite for the improvement of living standards and the well-being of all. To achieve this there is a need to reposition the economy on a more sustainable, export-led growth path. Ireland's cost competitiveness deteriorated in recent years and this has not been helped by the euro appreciation in recent months, especially vis-à-vis sterling. Various input costs are higher than elsewhere, and this has been well documented by the National Competitiveness Council. In particular, labour costs in Ireland have moved out of line with productivity developments. Reducing labour costs – through some combination of nominal pay reductions and enhanced productivity – must therefore form part of the strategy to improve competitiveness. Account must be taken of wage developments elsewhere, particularly so in relation to developments in those countries with which we share a common currency. In line with the shifting of global activity, strategies to develop new markets in emerging economies are also necessary.

The Government has already taken measures to reduce the public service pay bill and there is some evidence of downward adjustment in private sector earnings. In addition, the price of goods and services is falling much more rapidly than elsewhere. In this context, it must be borne in mind that the decline in consumer prices over the past year or so has been broadly based – the harmonised index of consumer prices, which excludes the impact of changes in mortgage interest rates, fell by 3 per cent year-on-year in September (latest available data).

Over the medium term, boosting productivity is the key to improving competitiveness and raising living standards. For example, the Government's *Smart Economy* initiative provides the framework for sustainable medium-term economic expansion based on shifting resources into sectors characterised by higher levels of knowledge-input and innovation.

Conclusion

A number of challenges face us and must be addressed: the public finances must be put on a more sustainable path – this means continuing on the difficult adjustment process started in July 2008; bank lending must be facilitated and competitiveness restored. Implementing measures in all of these areas will enable the economy to return to a more sustainable growth path over the medium term and this will facilitate a return to employment growth and a sustainable improvement in the living standards of all.

Section 2 - Economic Outlook¹

International Background

Signs of international stabilisation...

This year has been the most difficult one for the global economy – and especially for the world’s advanced economies – in decades. Following exceptionally weak conditions in the first quarter, when global trade and industrial production declined at unprecedented rates, tentative signs of stabilisation in many regions have emerged in recent months, partly on foot of aggressive policy actions. However, while the outlook has improved, uncertainties remain. First and foremost is the uncertainty surrounding the extent to which recovery in key regions will be self-sustaining; in other words, the extent to which private sources of demand will be able to compensate for the eventual withdrawal of fiscal stimulus initiatives remains unclear at this stage. In addition, monetary policies – conventional and unconventional – in many regions will, over time, have to become less accommodating as conditions improve. A key downside risk in this regard is that policy stimulus could be withdrawn too rapidly.

Forecasts produced by the EU Commission for GDP growth in various regions are outlined in table 1 below. Following the sharp declines recorded this year, activity is projected to expand next year in our main export markets, albeit at rates which are relatively modest by historical standards.

Table 1: GDP forecasts for our main trading partners

	2009	2010	2011
UK	-4.6	0.9	1.9
US	-2.5	2.2	2.0
euro area	-4.0	0.7	1.5
Global economy	-1.2	3.1	3.5

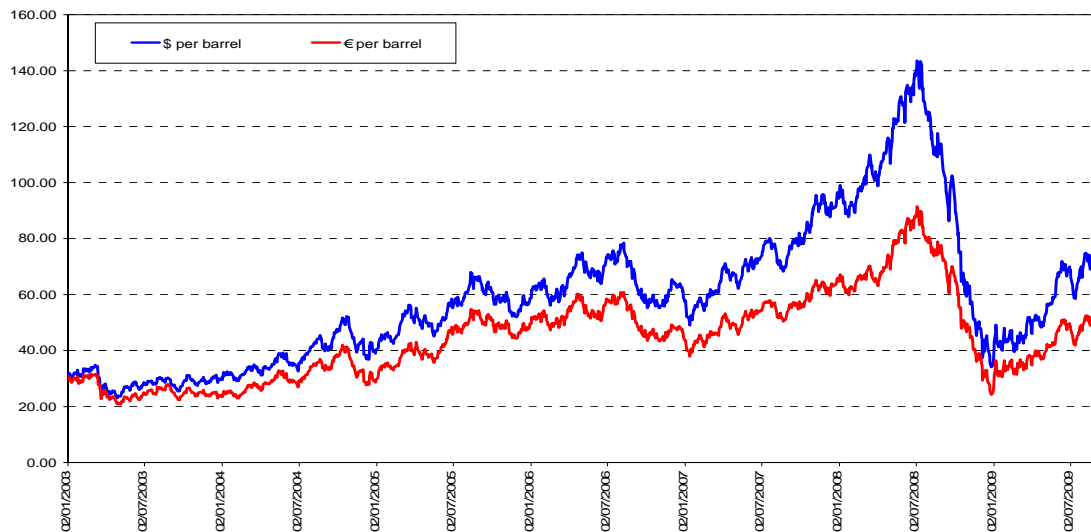
Source: EU Commission Autumn 2009 European Economic Forecast.

Oil prices have risen from earlier lows...

Oil price trends are shown in figure 1. Prices bottomed in the early part of this year due to lower demand on foot of global economic contraction. Since then prices have picked up somewhat, in part due to restrictions on supply as well as the improving economic outlook. The latest figures show spot prices of around \$77 (€52) per barrel in recent weeks, while futures data currently point to prices in the region of \$85 per barrel over the next year or so.

¹ The analysis in this document is based on data available up to the end of October.

Figure 1: Oil Price Developments



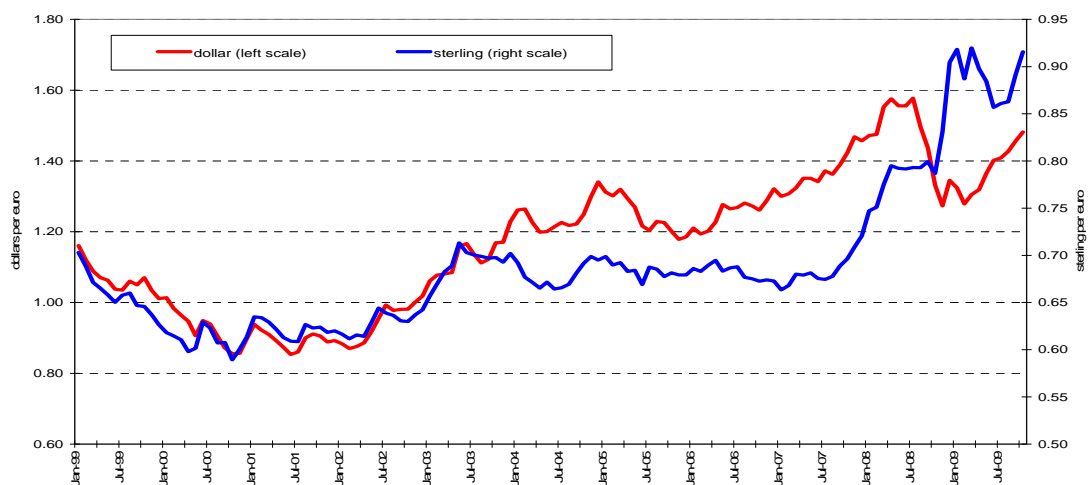
Source: Ecwin.

Unhelpful currency movements...

Developments in key bilateral exchange rates are shown in figure 2 (monthly averages). In the early part of this year, the euro-sterling rate appreciated to its highest level since the inception of the single currency, before easing back after the first quarter. However, renewed appreciation has been evident from mid-August, with the rate moving above €1 = stg£0.90 during October. If sustained, this will have a negative impact on the exporting sector, especially for the more traditional sectors of manufacturing.

Against the dollar the euro has gradually appreciated from €1 = \$1.28 in February to around €1 = \$1.48 in recent weeks. In trade-weighted terms, the exchange rate has appreciated by around 2 per cent since the beginning of this year.

Figure 2: Exchange Rate Movements



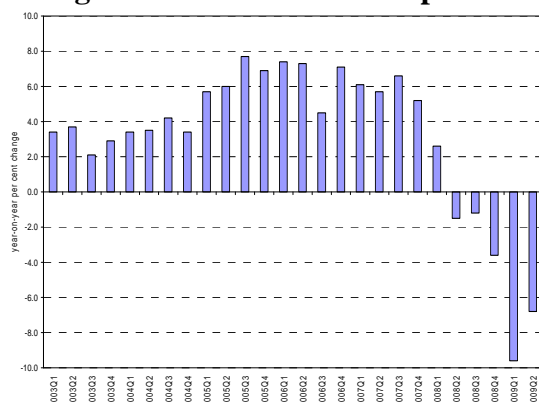
Source: Central Bank of Ireland

Short Term Prospects for the Irish Economy

Personal consumption falling sharply...

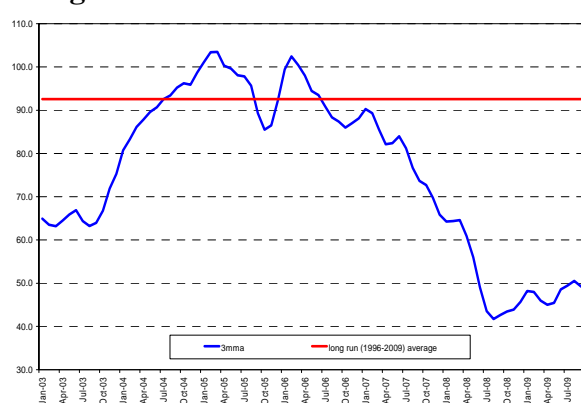
Quarterly national accounts data show that consumer spending fell at an annual rate of 8.2 per cent in the first half of this year. Consumers have reduced their outlays on foot of falling disposable incomes which, in turn, reflect lower levels of employment, nominal wage reductions (partly offset by declining consumer prices) and a rising direct tax burden. The fall in consumption, however, appears to be larger than the decline in disposable incomes, suggesting that households are setting aside a greater portion of their incomes for savings purposes. This could reflect increased precautionary savings – consistent with the decline in consumer confidence – on the part of households. Alternatively, households may be attempting to repair their balance sheets, given the fairly high level of indebtedness of some households. Taking into account data for the first half and likely trends over the remainder of the year, it is anticipated that consumer spending will fall by around 7½ per cent for the year as a whole.

Figure 3: Personal Consumption



Source: CSO.

Figure 4: Consumer Confidence



Source: KBC/ESRI.

On the basis of projections for employment, wages and non-labour related components, household incomes are likely to fall again next year. Moreover, falling consumer prices will not provide the same level of support to real incomes as was the case this year given the projected profile for inflation. Partly offsetting these developments is the possibility that households will reduce their levels of precautionary savings somewhat, although the need for balance sheet adjustment means that the household savings rate will remain relatively high by recent standards. All of these considerations suggest that a decline in personal consumption of around 3½ per cent is in prospect for next year.

Government consumption is projected to fall by ¾ per cent this year and by a further 1¾ per cent next year, in line with the assumed decline in public service employment arising from natural attrition, as well as reduced purchases of non-labour goods and services.

Sharp fall in house building is depressing investment...

The correction in the house building sector continues to be a major source of weakness. Available data point towards new house completions of around 23,000 units this year, the lowest level of annual output since the early 1990s. Quarterly national accounts data show that other parts of construction, including commercial activity, also fell sharply in the first half of this year and this is expected to continue over the remainder of the year. Notwithstanding an improvement in the second quarter (mainly due to aircraft purchases), firms look set to continue to postpone investment in machinery and equipment in the short term, given the uncertain outlook. In overall terms, therefore, investment spending is projected to decline by 34 per cent this year.

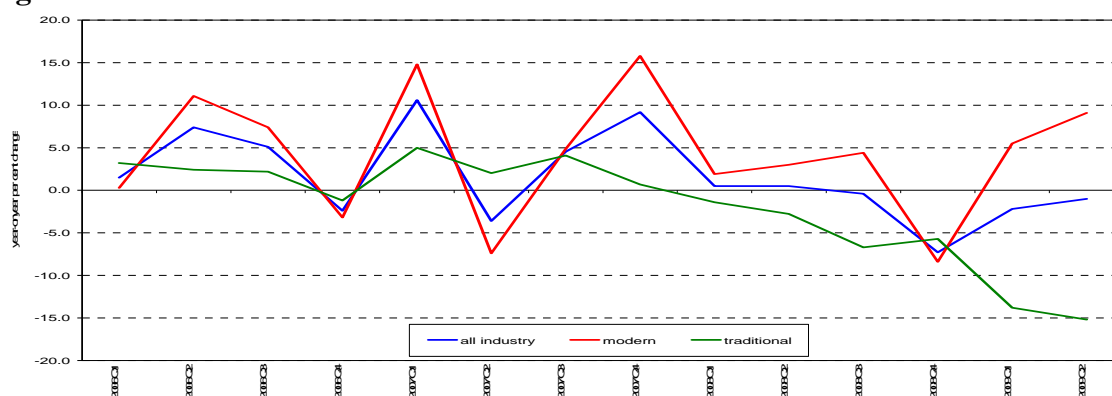
While difficult to accurately quantify, it is clear that there is a considerable overhang of unsold new housing and this excess supply will restrain investment in the housing stock at least in the short term. On the basis of available housing start data, total completions next year are projected to be just over 10,000 units. Other components of building and construction are also likely to perform poorly, while ongoing uncertainty will weigh on machinery and equipment spending. In these circumstances, investment is projected to fall by a further 19¼ per cent next year.

Firms have run down stock levels this year, thus depressing overall economic activity. Some increase in stock levels is expected over the course of next year, as the outlook begins to improve, thus providing some support to economic activity.

Export resilience reflects compositional effects...

While exports of goods and services declined at an annual rate of 2.7 per cent in the first half of the year, this was nevertheless one of the strongest export performances in the EU. The relative resilience is explained by strong export growth in the pharmaceuticals/chemicals sectors, which are less sensitive to the global economic cycle than other sectors. Elsewhere, exports have recorded double-digit falls in many of the more traditional sectors, where production tends to be more labour intensive (see figure 5). As a result, merchandise exports fell at an annual rate of 3.4 per cent in the first half of the year. Services exports also declined, although not to the same extent, with exports of business services performing well. Taking into account likely developments over the second half of the year, the volume of exports is forecast to decline by 3 per cent this year.

Figure 5: Industrial Production



Source: CSO.

Turning to prospects for next year, it is clear that headwinds remain. As outlined above, the consensus among the international forecasting institutions is that the global recovery will be fairly modest, while the loss in competitiveness in recent years means that Irish exports will lag the expected global improvement. The current elevated level of the exchange rate will also be a restraining factor,² so that exports are expected to decline once again next year, probably by around ¼ per cent.

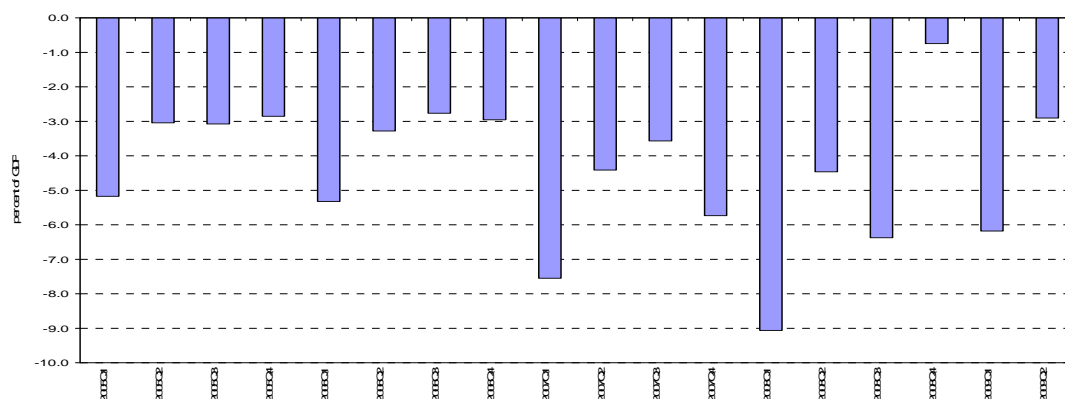
Narrowing balance of payments deficit...

The weakness of final demand is reflected in a sharp fall in imports. Quarterly national accounts show that in the first half of the year, the volume of merchandise imports fell by nearly 24 per cent compared with the first half of last year. The equivalent figure for services imports was a rise of 3.7 per cent, with imports of business services and royalties recording relatively strong positive increases. As a result, overall imports fell by just under 9 per cent year-on-year in the first half. With final demand likely to remain depressed over the second half, imports are projected to fall by 8¾ per cent for the year as a whole. Taken in conjunction with the fairly resilient export performance, net exports are projected to make a significant positive contribution to the level of activity this year.

With another year of declining final demand in prospect next year, imports are forecast to fall by a further 2¾ per cent.

The increase in the volume of net exports combined with favourable movements in the terms-of-trade resulted in an improved trade surplus during the first half of this year. This was only partially offset by higher net income outflows, so that the current account of the balance of payments recorded an annual improvement during the first half of the year (see figure 6). Some further narrowing of the current account deficit is expected over the course of the second half, with a deficit of 2 per cent of GNP anticipated for the year as a whole. Next year, the investment-to-GDP ratio is projected to fall further so that higher private sector savings are expected to move the current account into surplus. Effectively, this means that the domestic private sector is providing a large part of the savings necessary to finance the public deficit, so that the need to borrow from abroad is lessened.

Figure 6: Current Account



Source: CSO

² forecasts in this document are based on the technical assumption of unchanged exchange rates from those prevailing at end-October.

Economic activity to fall this year and next...

For the year as a whole, GDP is forecast to contract by 7½ per cent this year, broadly in line with projections made at the time of the Supplementary Budget last April. In the first half of the year, the gap between GDP and GNP widened significantly, partly due to a fall in profit inflows and rising debt-service payments to non-residents. In these circumstances, the projected full-year fall in GNP is more severe, at 10½ per cent (see table 2).

On the basis of trends in the components of demand outlined above, activity is projected to bottom out in the first half of next year and to turn positive during the second half. Nevertheless, for the year as a whole, a GDP decline of 1½ per cent is currently forecast, with GNP projected to fall by 2 per cent.

Table 2: Economic Forecasts 2009-2010

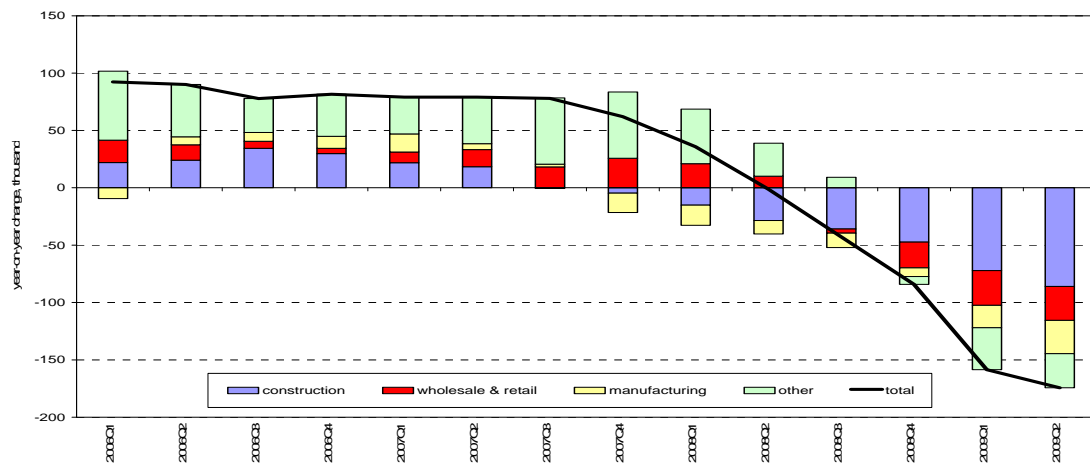
% volume change (unless otherwise indicated)	2009	2010
GDP	-7½	-1½
GNP	-10½	-2
Private consumption	-7½	-3½
Government consumption	-¾	-1¾
Gross domestic fixed capital formation	-34	-19¼
Exports of goods and services	-3	-¼
Imports of goods and services	-8¾	-2¾
BoP Current account (% GNP)	-2	¾
Consumer Price Index	-4¼	-¾
Unemployment (% of labour force)	11¾	13¾
Employment (% change)	-7¾	-3¾

Labour Market Developments

Rapid deterioration in the labour market...

The current recession has taken a heavy toll in the labour market. In the first half of this year, the level of employment was 7.9 per cent below that in the same period a year earlier, the equivalent of 166,000 job losses. Employment losses were especially severe in the construction, retail and manufacturing sectors (see figure 7). Further employment losses are expected over the second half of the year so that for the year as a whole, employment is forecast to decline by 7¾ per cent.

Figure 7: Employment Change



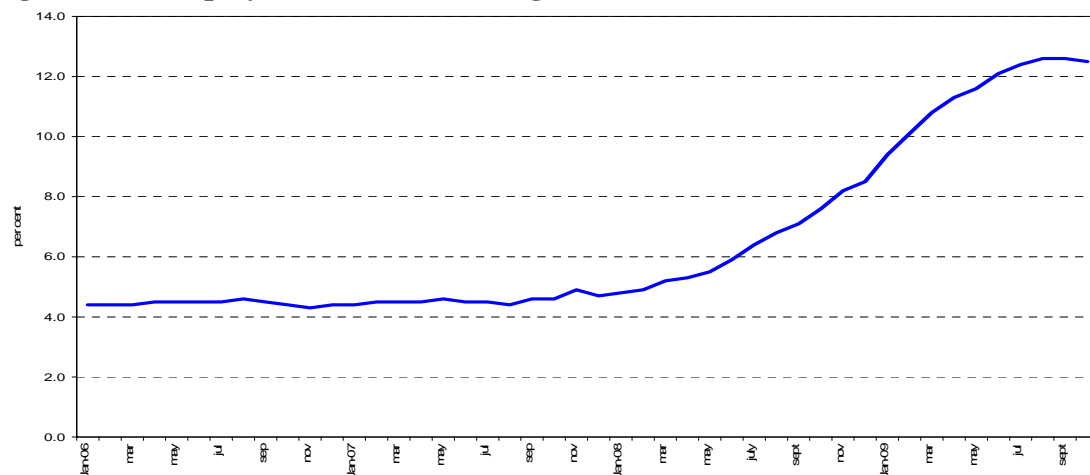
Source: CSO.

Rate of increase in unemployment has slowed...

After increasing very rapidly in recent years, the labour force has begun to decline, with some responding to the fall in labour demand by exiting the labour force either through outward migration or through lower participation. While unemployment has increased, the increase would have been even larger but for falling labour supply.

Live Register trends since the beginning of the summer (see figure 8) suggest that the rate of increase in unemployment has slowed. The continued decline in income tax revenue would suggest that this reflects continued adjustment of labour supply – including further outward migration – rather than any stabilisation or improvement in labour demand. Taking these developments into account, an average unemployment rate of 11¾ per cent for the year as a whole is now expected.

Figure 8: Unemployment Rate (Live Register)



Source: CSO

Given that employment tends to lag activity, a further deterioration in the labour market is expected next year. Employment is projected to fall by around 3¾ per cent (a loss of around 75,000 jobs). Labour supply is likely to continue falling, with further net outward migration, so that the unemployment rate is forecast to average around 13¾ per cent.

Prices and Costs

Downward pressure on wage costs...

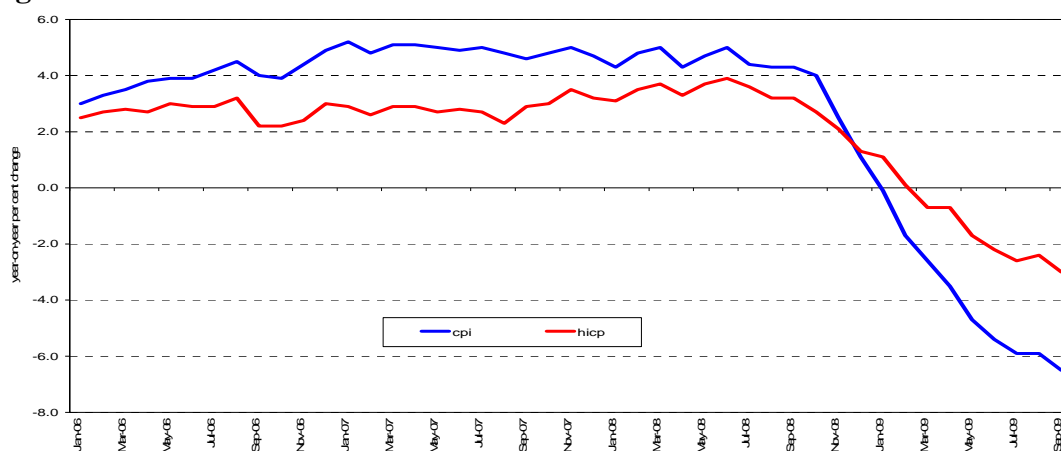
The introduction of the public service pension levy last February reduced public service salaries by around 7 per cent. The evolution of private sector per capita wages is a source of some uncertainty. A number of surveys undertaken by various institutions have indicated that private-sector wages were adjusting downwards in response to the changed economic environment. This is expected to be confirmed when more up-to-date official CSO data become available.

Prices on a firm downward path...

Consumer prices continue to fall at a rapid rate, supporting households' real disposable income and domestic living standards. In September, the latest month for which data are available, the consumer price index fell at an annual rate of 6.5 per cent. While part of the decline reflects the impact of lower mortgage interest repayments, the figures show that prices are declining for a wide range of goods and services. Because of base effects and other factors, the rate of price decline is expected to ease over the remainder of the year, so that for the year as a whole, consumer prices are expected to decline by 4¼ per cent. On the basis of continued underlying weakness in the economy and the current euro-sterling exchange rate, consumer prices are likely to fall once again next year, although not to the same extent as this year. An annual average decline of ¾ per cent is currently projected.

On an internationally comparable basis, the harmonised index of consumer prices (which excludes mortgage interest costs) fell at an annual rate of 3.0 per cent in September, the fastest pace of decline in the euro area. For the year as a whole, an average decline of 1½ per cent is expected; the equivalent figure for the euro area is an increase of 0.3 per cent.³ Notwithstanding this relative improvement, price levels in Ireland remain much higher than in the rest of the euro area. For next year, the HICP is forecast to decline by 1 per cent. Many of the factors currently depressing prices are temporary in nature and once the impact of these fades, a period of low but positive price changes is in prospect.

Figure 9: Consumer Prices



Source: CSO.

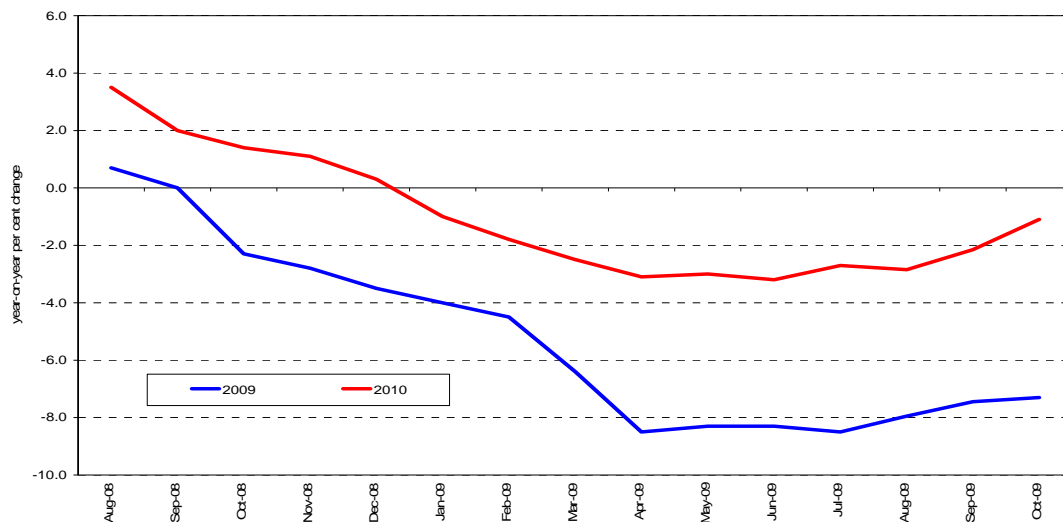
³ EU Commission Autumn Forecast 2009.

Comparison with other Forecasts

Consensus has bottomed out...

Each month, Reuters publishes a consensus forecast for the main macro-economic variables compiled from a survey of around ten mainly private sector forecasting institutions. In the interests of transparency and for comparison purposes, the consensus for GDP and how it has evolved over time is set out in figure 10. As recently as summer 2008, the consensus was for positive growth this year. The consensus fell sharply from September last year. By April, the expectation was that GDP would fall by over 8 per cent this year; the Department of Finance forecast in the April Supplementary Budget was for a contraction of 7.7 per cent. The consensus forecast stabilised over the summer and has become less negative in recent months. The current consensus forecast is for a GDP contraction of 7.3 per cent this year. In terms of next year, the current consensus is for a GDP contraction of 1.1 per cent.

Figure 10: Comparison of GDP Forecasts



Source: Reuters.

Medium Term Outlook

The Government's fiscal consolidation plan necessitates the production of medium term economic projections. Because it is very difficult to forecast cyclical influences beyond the short-term, medium term economic projections instead involve an assessment of the economy's potential growth rate. Essentially, the approach is to assume that over the medium term positive and negative cyclical influences cancel each other out, so that the economy expands at its estimated trend rate, which in turn is dependent upon the underlying growth in labour supply and in productivity. In other words, the potential growth rate provides the 'anchor' for the medium term forecast.

The forecasts covering the period 2011–2013 broadly follow this approach (see table 3). Unfortunately, the global financial market crisis and the fall-out from the contraction in the construction sector have implications not just for the demand-side of the economy but for the supply-side also. It is estimated that the potential growth

rate of the economy is now around 3 per cent per annum, lower than was the case in the past. However, the economy is assumed to grow faster than this for a number of years as under-utilised capital and labour are brought back into productive use. As a result, the projected annual average growth rate achievable over the period 2011-2013 is around 4 per cent per annum.

The ‘bottom up’ approach to taxation forecasting necessitates projections of the individual components of demand. To do this, a number of assumptions must be made, including the following:

- Housing investment bottoms out at around 10,000 units next year and very gradually rises to around 30,000 units by the end of the forecast horizon;
- While easing back from this year’s very high level, the household savings rate remains above the levels which preceded the crisis. As households re-assess their future disposable income stream it is assumed that they will maintain higher savings in order to fund future consumption. Thus, while the household savings rate is expected to fall, it is assumed to remain above pre-crisis levels. This will restrain growth in consumer spending somewhat;
- Further improvements in competitiveness and a strengthening of the global economy beyond next year lead to an improvement in our export performance, particularly so for the non-high technology sectors;
- The level of employment is expected to rise and unemployment will fall. However, the need to re-allocate workers from declining sectors to expanding sectors may be prolonged, so that unemployment is not expected to revert to pre-crisis levels for some time;
- Consumer prices are assumed to be positive and to be slightly lower than elsewhere as competitiveness improves.

Table 3: Economic Forecasts 2011-2013

% volume change (unless otherwise indicated)	2011	2012	2013
GDP	3¼	4½	4½
GNP	3	4	4
Private consumption	1¼	2¼	2½
Government consumption	-½	-½	-½
Gross domestic fixed capital formation	3	7	9½
Exports of goods and services	3	3¾	3½
Imports of goods and services	2½	2¾	3
BoP Current account (% GNP)	2	3	3
Consumer Price Index	1¾	2	2
Unemployment (% of labour force)	13¼	12	11¼
Employment (% change)	¾	2¼	2¼

Risks to the Outlook

While the projections outlined above provide a balanced assessment of how the economy will evolve over the next few years, it is – as always – a conditional forecast (i.e. in the current circumstances it is conditional upon the world economy evolving as expected etc). At any stage, positive or negative disturbances, arising domestically or externally, have the potential to move the economy off the assumed growth path. And while there are inherent risks in any set of macroeconomic forecasts, it is also clear (as has been acknowledged internationally) that the risks are heightened at the current juncture.

For most of the last 18 months, since the global economic crisis began, the risks to the macroeconomic projections have generally tended to be on the downside. However, now it is more credible to signal that there are also upside risks, such as the possibility of stronger world growth and more robust domestic consumer activity on the basis of an improvement in consumer confidence. It is not within the scope of this document to assign a probability to the likelihood of the risks materialising. Instead, some of the main identifiable risks are identified below:

International

- A different growth path in our main export markets – a more rapid rebound in activity or lower than expected growth if, for instance, macro-economic stimulus was withdrawn too quickly.
- The projections are based on the technical assumption of unchanged exchange rates from those prevailing at end October, but of course further appreciation cannot be ruled out.
- Commodity price increases, especially the potential for oil price increases.

Domestic

- Households continue to maintain a high level of savings, representing a continued drag on personal consumption.
- The necessary domestic competitiveness adjustment does not materialise.
- At some stage over the medium term interest rates will inevitably return to more ‘normal’ levels, raising the cost of borrowing for all.

Section 3 - Supporting the Banking Sector

For a number of years Irish banks increased their lending at a more rapid pace than their deposit base was expanding. In order to do this, banks resorted to borrowing from financial institutions abroad, thereby increasing their exposure to global money markets.

Unfortunately, global liquidity conditions deteriorated from the summer of 2007 following the emergence of difficulties in the sub-prime mortgage market in the US and concerns about which institutions would bear the associated losses. In the autumn of 2008, risk aversion reached unprecedented levels, with the result that the flow of funds between financial institutions effectively came to a standstill.

Irish banks were especially exposed to the drying up of liquidity conditions given their increased dependence on external sources of funding. Concerns over the exposure of Irish banks to the property sector further impacted on their ability to secure funding. Restricted access to funding negatively impacted on the normal functioning of the banking system in Ireland.

These developments necessitated Government intervention in order to support the banking system. The various public supports are designed to ensure that banks can access funding to enable lending to firms and households.

The main supports have been:

- Bank guarantee
- Recapitalisation
- Nationalisation of Anglo Irish Bank

In addition, the Government is establishing a National Asset Management Agency (NAMA) to further underpin the banking system and thereby support economic recovery. NAMA builds on the progress in stabilising the banking system which has already been made by Government. NAMA will remove the riskiest loan portfolios from the banks' balance sheets, which will help the normal flow of credit from the banks to the wider economy to resume and protect the security of depositors' savings.

Section 4 - The Public Finances

The sharp deterioration in the economic environment has had a very significant effect on the public finances, in particular tax receipts. This has meant that a large gap has opened up between the revenues raised and expenditure. Action has already been taken over the last eighteen months to address this issue but there remains a very large deficit which is currently being filled by borrowing. It is not sustainable to continue borrowing at such high levels and consequently efforts must continue to put the public finances on a more stable footing. Budget 2010 is being prepared against this backdrop.

This section looks at the public finance under three headings:

- Recent developments and the current outlook for the public finances;
- Rationale for taking action to restore sustainability to the public finances; and
- The medium-term outlook.

There has been a sharp deterioration in the public finances...

The current outlook is for a General Government Balance of -12 per cent of GDP in 2009.⁴ This follows a balance of -7.2 per cent of GDP in 2008 and surpluses in ten of the eleven years prior to that.

The Supplementary Budget forecast a General Government Balance of -10¾ per cent of GDP for 2009. There has been a deterioration of 1¼ percentage points in the ratio since then – approximately one percentage point reflecting a worsening in the budgetary outlook and one quarter percentage point to a revision to the estimate for the GDP level due to revisions by the CSO to the GDP outturn for 2008.

The deterioration in the budgetary outlook largely reflects the poorer than expected tax revenue performance. The Supplementary Budget forecast that €34.4 billion in tax revenue would be collected in 2009, a deterioration of 15½ per cent on the 2008 yield. Based on data to end-October, tax revenue in 2009 is now expected to be in the region of €32 billion, around 21 per cent down on 2008. Some savings are expected on expenditure – largely due to the slowdown in the rate of increase in the Live Register which will yield savings for this year and more importantly in future years, although these savings are offset to some degree by pressures on health sector expenditure. In addition, it is expected that there will be savings of about €475 million in cash terms on servicing the national debt, although due to accounting rules only about €200 million of this will count towards improving the General Government Balance.

Tax Revenue

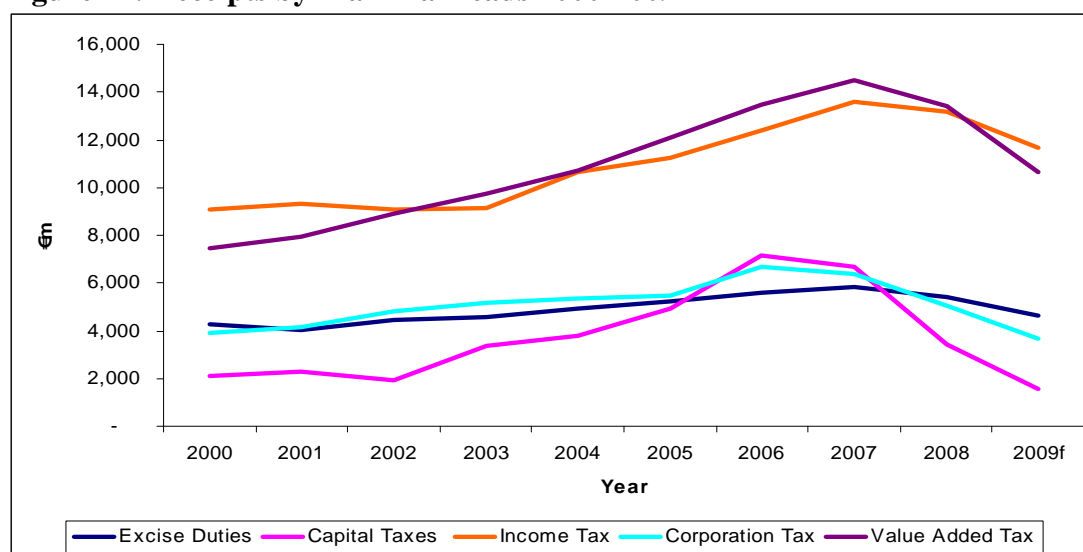
By end-October 2009, €26,096 million in tax revenue had been collected. This was €1,074 million below the target for that point in the year and was 17 per cent below what had been received to end-October 2008. VAT and Income Tax were showing the biggest shortfall on target and the capital taxes were continuing to perform poorly albeit their significance in the annual target is greatly diminished. Corporation Tax was ahead of target largely due to the receipt of once-off unexpected payments and

⁴ Based on data to end-October 2009. This projection is subject to further revision as more data become available.

Excise Duties were also marginally ahead of target. It is now expected that taxes in 2009 will be in the region of €32 billion, around €2 billion below target. While the weakness seen to date in Income Tax and VAT is expected to continue to the end of the year, it is anticipated that the additional weakness in the tax take will come from those taxes for which the November/December period is of more importance, namely Corporation Tax, self-employed Income Tax and Capital Gains Tax.

With tax revenue in 2009 now expected to be in the region of €32 billion, this represents a decline of over 30 per cent on the level of taxes received in 2007. Tax revenues are now back at 2003 levels. Figure 11 below outlines the trends in tax receipts over the last number of years. All tax-heads have experienced declines in their yield over the last two years with the decline particularly noticeable in the performance of the capital taxes (Capital Gains Tax, Capital Acquisitions Tax and Stamp Duty). In 2006, €7.2 billion was collected from capital taxes, almost 16 per cent of total tax revenue in that year. In 2009, it is estimated that about €1½ billion will be collected from capital taxes, representing less than 5 per cent of total taxes. It is not expected that a resumption of the economic cycle will restore the previous levels of capital taxes. Therefore 95 per cent of tax receipts are accounted for by four tax heads – VAT, Income Tax, Excise Duties and Corporation Tax.

Figure 11: Receipts by Main Taxheads 2000-2009



In the past it was estimated that on average a 1 percentage point change in nominal growth would lead to a 1.1 per cent change in tax revenues. In the last two years this relationship has broken down – tax revenues have declined by about 32 per cent over the period 2007-2009 while in the same period the value of GDP has declined by about 13 per cent. The current fiscal forecast assumes that over the medium-term this relationship will be re-asserted. That said, when economic growth resumes it will be export-led growth, which is not as tax rich as the domestic growth of the recent past. Consequently the expected pick-up in tax revenues based on existing policies will not bridge the significant gap that has emerged in the public finances.

Current Spending

While taxation receipts have declined, total current expenditure has continued to increase. Although taxation is now back at 2003 levels, expenditure by Government Departments and Offices (known as voted expenditure) in 2009 is about 70 per cent above the level it was in that year.

Table 4: Gross Voted Current Expenditure 2003 - 2009

	2003	2009	Increase	Increase
	€m	Estimated Outturn €m	€m	%
Health & Children	8,789	15,589	6,800	77
Social Welfare	10,435	20,415	9,980	96
Education	5,450	8,642	3,192	59
Other	8,330	11,347	3,017	36
Total	33,004	55,993	22,989	70

Despite the very significant adjustments already made on expenditure, if no action is taken, gross voted current spending will be around €8 billion in 2010, an approximate increase of €2 billion over 2009 and over €4½ billion on 2008. This increase is in spite of a series of measures announced by the Government over the last twelve months which were designed to stabilise the public finances and to commence a return to a sustainable fiscal position. Upward pressures on spending, predominantly the rising cost of social transfers due to the increase in unemployment, have more than offset the expenditure economies already announced. Annex 1 provides a breakdown of the expenditure projections for each of the Ministerial Vote Groups, making clear the baseline against which Budget policy decisions fall to be considered.

Another significant pressure is the upward movement of the Public Service pay bill which increased by 115 per cent between 2000 and 2008. This growth has arisen through a combination of an increase in the number of Public Service employees and increasing rates of pay. Average remuneration per employee increased by 68 per cent in the period since 2000 and public service numbers have increased by 29 per cent, which is a rise from 247,343 at end-2000 to 317,960 at end-2008. Numbers employed in each of the various sectors have also increased, with the exception of the Defence Forces.

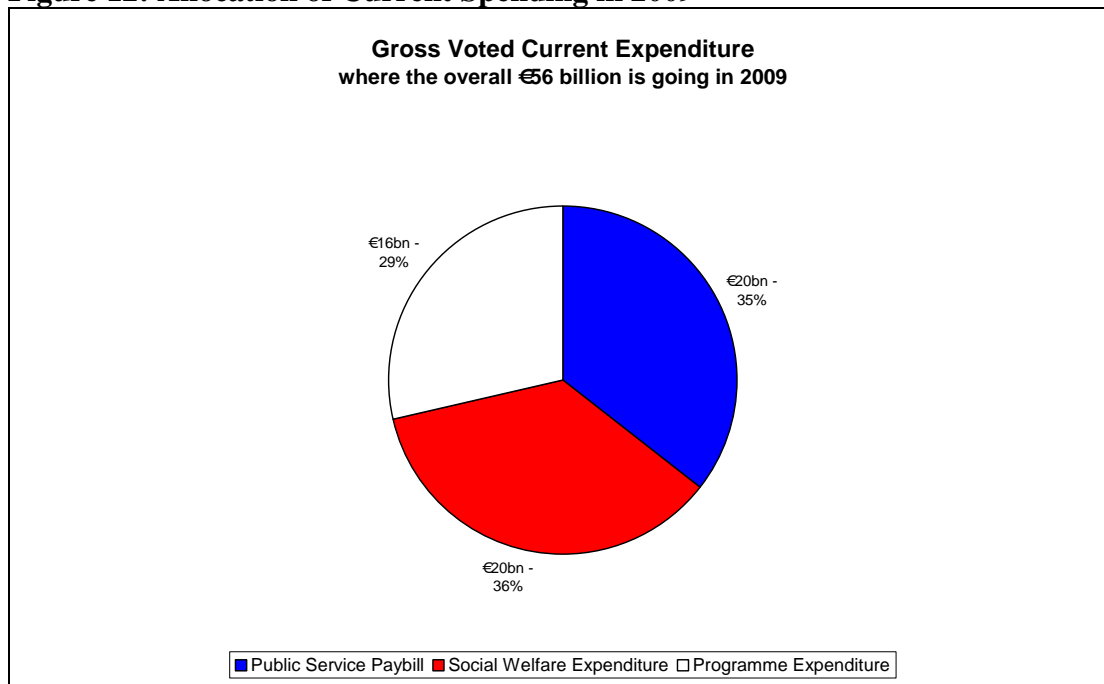
Table 5: Public Service Numbers 2000-2008

Sector	Increase/Decrease 2000-2008 (%)	Increase/Decrease 2000-2008 ('000)
Education	+39%	+26,264
Health Services	+37%	+29,980
The Garda Síochána	+26%	+3,156
Local Authorities	+20%	+5,917
Non-Commer. State Spons. Bodies	+19%	+2,018
Civil Service	+14%	+4,928
Defence Forces	-8%	-946

Allocation of Spending

Currently, Social Welfare spending makes up the largest single block of Exchequer gross voted current expenditure, accounting for 36 per cent of the total, while Exchequer Pay and Pensions accounts for a further 35 per cent, and other programme expenditure (not including pay) accounts for the remaining 29 per cent.

Figure 12: Allocation of Current Spending in 2009



Evidence from international organisations, such as the IMF, EU Commission and the OECD, suggests that consolidation driven by cuts in expenditure is more successful in reducing deficits than consolidation based on tax increases. It is in this regard that all areas of spending need to be considered in the context of restructuring the public finances and falling prices. The *Report of the Special Group on Public Service Numbers and Expenditure Programmes*, published in July of this year, identified a wide range of savings options which are now being taken into account by the Government in the overall context of the 2010 Budget preparations.

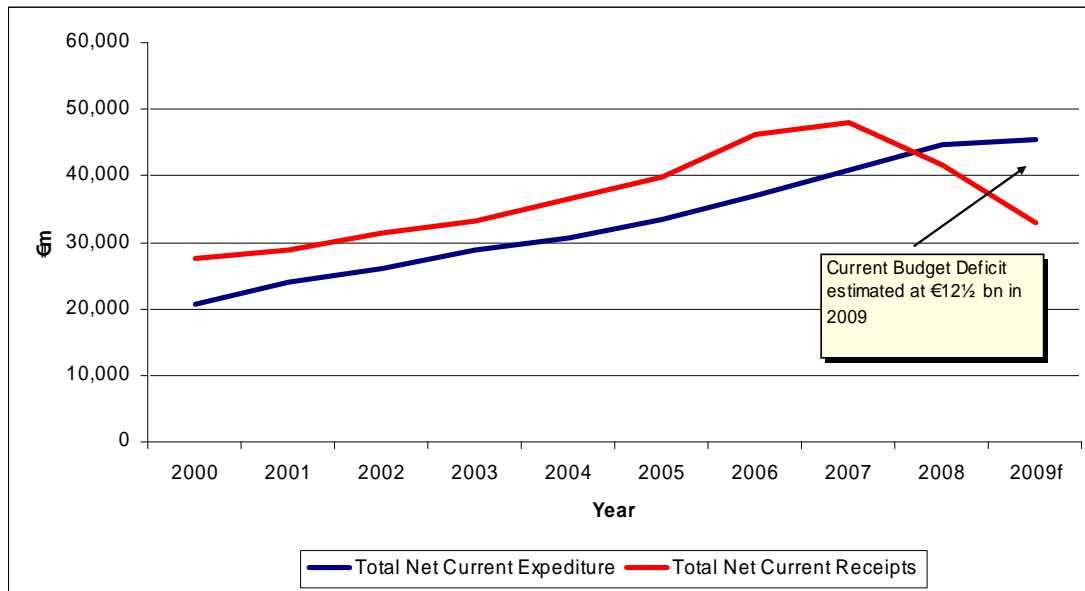
Debt Servicing

In addition to voted expenditure, there is also non-voted Central Fund expenditure. The vast majority of Central Fund spending relates to the cost of paying interest on servicing the national debt. With the volume of debt rising rapidly, the cost of servicing the debt – which is a function of the size of the national debt and the interest rate Ireland pays on the international bond market – also increases significantly and for the foreseeable future will absorb an ever increasing amount of resources. A common measure of debt servicing costs is the ratio of interest paid to tax revenue collected. The cost of the interest element in servicing the national debt represented about 3½ per cent of tax revenue in 2007, having been declining for more than a decade. In 2009, it is estimated that debt interest will account for 8½ per cent of tax revenue.

A large gap – the current budget deficit – has emerged between overall current revenues and overall current expenditure (see figure 13 below). Previously, all day-

to-day expenditures were adequately catered for from day-to-day revenue. Now it is necessary to borrow to bridge this gap to cover day-to-day spending. In 2009, this will amount to about €12½ billion and even with budgetary adjustment will widen further in 2010.

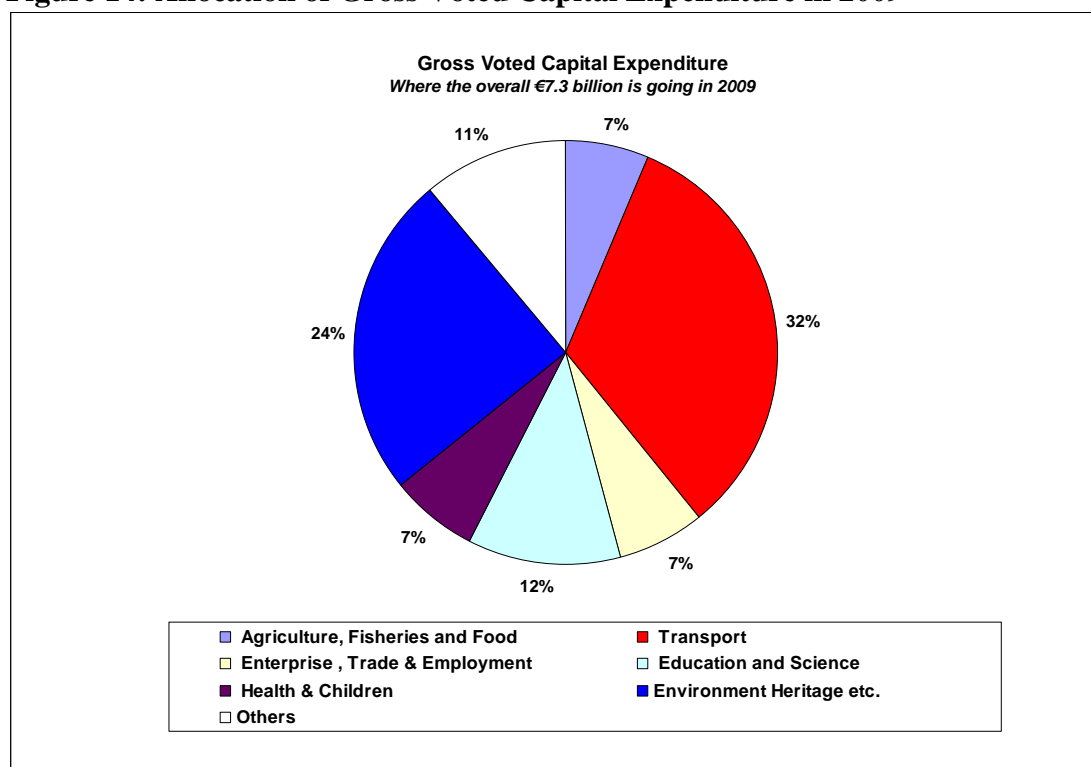
Figure 13: Current Budget 2000-2009



Capital Expenditure

A large scale capital investment programme, averaging 4.7 per cent of GNP has been in place over recent years. The Supplementary Budget, even though it incorporated downward adjustments in allocations, also set out what continues to be a very substantial capital investment, averaging 4½ per cent of GNP over the period 2009-2013. The capital review to be completed in advance of the Budget will ensure that this investment programme focuses on the priorities that are most appropriate to the challenges we now face and which promote economic recovery. Reductions in construction prices mean it is now possible to deliver capital projects more cheaply, thereby enabling many of the goals of the NDP (2007-2013) to be achieved. Figure 14 sets out the main allocation of capital expenditure in 2009.

Figure 14: Allocation of Gross Voted Capital Expenditure in 2009



Overall Budgetary Position - 2009

When the borrowing for day-to-day purposes is added to the borrowing for capital purposes this year, the overall Exchequer Borrowing requirement in 2009 is nearly €26 billion. This means that the National Debt will increase from €50 billion at end-2008 to approximately €76 billion by end-2009. On this basis, the General Government Balance is now expected to be around -12 per cent of GDP in 2009.

Budgetary Outlook 2010

Given the current assumption that economic activity will, in overall terms, contract next year, it is anticipated, based on current policies, that tax revenue will decline again next year and an estimate of approximately €31 billion has been factored into the current forecast. This projection is subject to further revision as more data become available, in particular the tax collection yield for November – the most significant month in the year for tax receipts. If no action is taken on the budgetary position, expenditure will also increase (largely due to higher Live Register related spending). As a result, without corrective action the General Government Balance is estimated at about -14 per cent of GDP and the National Debt would stand at around €100 billion by end-2010.

The Supplementary Budget, presented to the Dáil in April 2009, set out a multi-annual path to restore stability to the public finances. The target set for 2010 was the stabilisation of the General Government Balance at the 2009 level following the introduction of a €4 billion adjustment. This publication assumes that Budget 2010 will be framed with a view to delivering the stabilisation of the deficit in 2010 at the 2009 level, albeit that this is at a higher level than set out in the Supplementary Budget (12 per cent of GDP rather than 10¾ per cent of GDP). Based on current

data, achieving the €4 billion adjustment that has been previously signalled for 2010 is necessary for this stabilisation.

In the Supplementary Budget an indicative split between current and capital expenditure and taxation measures was set out. At the time the Minister for Finance said that the indicated taxation amount was the maximum that would be implemented and the expenditure amount was seen as the minimum amount required. Table 6 overleaf sets out technical budgetary projections for 2010, based on our assumed end-2009 position. As the final allocation of this adjustment is a matter for the forthcoming Budget, for illustrative purposes the amount of the split for capital expenditure as indicated in the Supplementary Budget has been retained. The current adjustment of €¾ billion has not been allocated to either expenditure or taxation.

In this context it should be acknowledged that the Government is committed to the phased introduction of a Carbon Tax in 2010, but has announced that further significant tax increases are not desirable at this time.

Table 6: Technical Budgetary Projections 2009-2010

	2009	2010
	€m	€m
<u>CURRENT BUDGET</u>		
<u>Expenditure</u>		
Gross Voted Current Expenditure	55,993	58,100
Non-Voted (Central Fund) Expenditure	5,241	7,404
Gross Current Expenditure	61,234	65,504
less Expenditure Receipts and Balances	15,700	14,789
Net Current Expenditure	45,534	50,715
<u>Receipts</u>		
Tax Revenue	32,200	30,800
Non-Tax Revenue	828	2,315
Net Current Revenue	33,028	33,115
<i>Less Current Adjustment to be delivered in Budget 2010</i>		
<i>Technical assumption:</i>		3,250
CURRENT BUDGET BALANCE	-12,507	-14,350
<u>CAPITAL BUDGET</u>		
<u>Expenditure</u>		
Gross Voted Capital	7,332	6,606*
Non-Voted Expenditure	4,836	825
Payment to the NPRF	3,000	-
	15,169	7,431
less Capital Receipts	448	481
Net Capital Expenditure	14,720	6,950
Capital Resources	1,452	1,750
CAPITAL BUDGET BALANCE	-13,268	-5,200
EXCHEQUER BALANCE	-25,775	-19,550
GENERAL GOVERNMENT BALANCE	-19,775	-19,380
<i>% of GDP</i>	<i>-12%</i>	<i>-12%</i>

Rounding may impact on totals

**Includes the €750 million capital adjustment for 2010 signalled in the April Supplementary Budget*

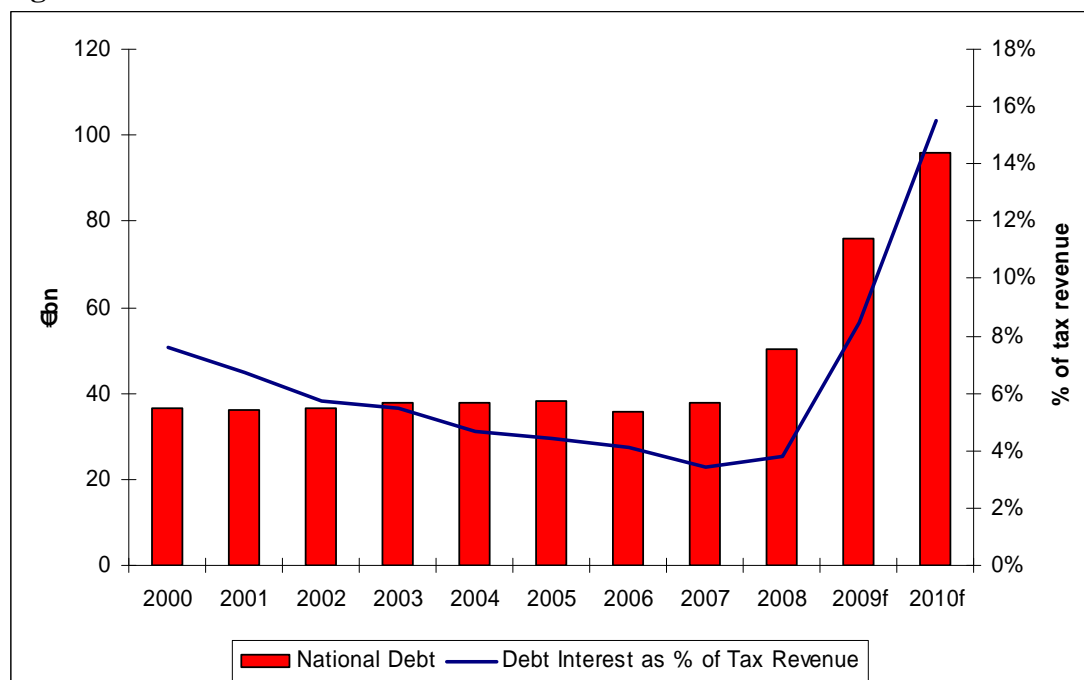
The current working forecast, on the basis of a €4 billion adjustment being delivered in the Budget in December, is for an Exchequer Borrowing Requirement of around €19½ billion in 2010 and a General Government Balance of -12 per cent of GDP. The economic forecasts that are set out in this publication and underscore the tax forecast are based on the assumption that the €4 billion adjustment is delivered.

Debt Dynamics 2009-2010

With the ever expanding economy, the debt to GNP/GDP ratios fell dramatically over the last two decades. At end-2007, the level of the national debt had been stable at that level for more than a decade and stood at about €38 billion or 23 per cent of GNP. In 2008 the Exchequer deficit had increased the debt level to €50 billion or 32 per cent of GNP. By the end of 2009 the national debt is estimated to be around €76 billion – double the 2007 level or 57 per cent of GNP. The consequence of running large deficits is that the national debt has and will continue to increase.

With the volume of debt rising rapidly, the cost of servicing it also increases significantly and will absorb an ever increasing amount of resources. As outlined in figure 15 the interest element of servicing the national debt will account for about 8½ per cent of tax revenue in 2009, up from 3½ per cent of tax revenue in 2007. This estimate will be around 16 per cent in 2010 – such ratios were last seen in the mid-1990s.

Figure 15: National Debt



Failing to take action now means that we risk getting into a vicious circle in which we will be running to stand still in terms of government debt whereby ever more unpalatable decisions will have to be made just to service the debt.

The General Government Debt is the definition used for comparative purposes within the European Union. The General Government Debt's principal component is the national debt, but as it is a gross measure, it does not allow for any offset for the Exchequer cash balances. In addition the General Government Debt also includes local government debt, certain extra-budgetary funds and accrued interest not provided in respect of the retail savings scheme. The General Government Debt is estimated at €80 billion at end 2008 or 44 per cent of GDP. It is estimated at 65 per cent of GDP at end 2009 and on the basis of the adjustments already outlined being delivered in the Budget, it is forecast to stand at 78 per cent of GDP at end 2010.

When account is taken of the value of assets in the National Pensions Reserve Fund (NPRF) and the substantial Exchequer cash balances, it is estimated that the net debt position will be 39 per cent of GDP at end 2009 and 51 per cent of GDP at end 2010 (see table 7).

Table 7: Emerging General Government Debt

	2009	2010
General Government Debt % of GDP	65%	78%
Net debt (GG Debt net of cash balances and the value of the NPRF) % of GDP	39%	51%

Rationale for taking action in 2010...

It can be expected that as the economy picks up, reflecting the improvement in international economic conditions, the deterioration in the public finances will ultimately be halted. However, given that growth will be export-led in nature and that the existing gap between spending and revenue is so large, the public finances will remain in substantial deficit without corrective policies. If such a situation was to materialise, it is questionable if the economy could recover as well as it would do otherwise. Consequently tackling the deficit is essential.

Taking corrective action imposes short-term costs on the economy, however it is considered necessary for the following reasons:

- **The debt level is rising and without action would become unsustainable...**
If no action is taken or the correction process is prolonged the debt level will continue to rise at an unsustainable level and servicing this additional debt will absorb even more resources. Debt interest has the first call on resources – that is, it must be paid before provision for social welfare, salaries, services etc. thus Government’s ability to fund public services would be curtailed and the impact of such a constraint would be felt the most by those least able to afford it. In addition, mounting debt interest would ultimately represent a drag on medium and longer-term growth with the result that much harder decisions would be inevitably required in the future to deal with the problem.
- **Short-term cost for long-term gain...**
There will be a short-term cost – taking money out of the economy (by reducing spending or raising taxes) has a dampening effect on activity and employment, all other things being equal. However, the scale of the adjustment planned and its deflationary impact need to be put in perspective. As mentioned above, delaying adjustment will damage domestic confidence and will ultimately hinder growth.

The window of opportunity to take action to stabilise the deficit is now – at a time of falling prices and low interest rates the impact of reducing spending is less. Delaying the adjustment until a time when inflation has returned to the economy would mean that the adjustment would be even more difficult at that stage and would mean that the impact of the adjustment would be more severe.

- **We must position ourselves for future growth...**
Ireland's future growth will come from a return to sustainable export growth and that means that we have to improve our competitiveness. Taking responsible decisions on fiscal policy and incomes policy will assist economic growth and avoid unnecessary further adjustment in the labour market. Delaying action can also cause uncertainty regarding the future and this in turn could cause households to increase their savings and corporations to reduce their investment in Ireland.
- **The expenditure base needs to be sustainable...**
With the tax revenue base now reduced to a much lower level, reflecting the overall shrinking of the economy and the permanent loss of some income streams, expenditure needs to adjust. Evidence from international organisations, such as the IMF, EU Commission and the OECD, as well as the relevant literature all suggest that consolidation driven by cuts in expenditure is more successful in reducing deficits than consolidation based on tax increases. In addition, past Irish experience suggests that confidence is restored quicker when spending is tackled rather than seeking to significantly increase the tax burden. Therefore, all areas of spending need to be considered in the context of restructuring the public finances.
- **The tax base needs to be adjusted...**
That said adjusting spending alone is not the answer. To date, there have been significant tax increases introduced over the last year and for the reasons set out in Annex 2, the ability to increase taxes further in 2010 is limited. The Report from the Commission on Taxation recommended that the tax base should be made broader and less volatile and this will be an important factor in medium term taxation policy.
- **Need to inspire international confidence...**
A clear, positive signal must be sent to the international investment community that Ireland is continuing to take decisive action to arrest the deterioration in the public finances. Stabilising the deficit is critical in that context. This will help to continue to restore confidence in Ireland internationally and in turn encourage international investment in Ireland and keep our borrowing costs lower.

Medium-Term Outlook...

In keeping with the Supplementary Budget, further adjustments in the fiscal position will be required over the coming years so that we again have a situation in which day-to-day spending is funded out of day-to-day revenues. The scale and the speed of the adjustment will depend on the economic climate that pertains in each of the future years. However, it is clear that the resumption of positive economic activity during 2010 and gaining strength thereafter will not be sufficient to fix the gap in the public finances. Further technical analysis on the structural and cyclical elements of the Irish fiscal position is set out in Annex 3 to this document.

In the Supplementary Budget the Government set out a consolidation plan to achieve a General Government Balance of -3 per cent of GDP by end-2013. Accordingly, the medium term scenario, set out below, is a purely technical assessment of the medium

term need for consolidation based on the amounts set out in the April Supplementary Budget.

On a purely static basis, assuming strong economic growth and taking no account of any adverse effects on our costs of servicing the debt, it is estimated that without corrective action over the period 2010-2013 the General Government Balance would improve from around -14 per cent of GDP in 2010 to stand at approximately -10½ per cent of GDP by 2013. On that basis the National Debt would be around €175 billion by 2013 and the cost of debt interest is estimated to absorb somewhere in the region of 25-30 per cent of tax revenue. If such a scenario emerged then there would be considerably less resources available for the provision of public services than if the Government's correction path is followed. Table 8 below shows the emerging unadjusted General Government Balance for the period 2011-2013 on the basis of no correction. It also and thus shows the cumulative impact of making the €4 billion correction in 2010 and takes account of the subsequent corrections for the later years as set out in the Supplementary Budget. This is a stylised presentation that would vary if growth and other assumptions are changed.

Table 8: Technical General Government Balance Scenarios

	2011	2012	2013
Emerging General Government Balance (% of GDP) – without fiscal correction	-13¾%	-12¼%	-10½%
Annual Adjustment – as set out in the Supplementary Budget	€4 billion	€4 billion	€3 billion
Emerging General Government Balance (% of GDP) – following the cumulative impact of annual adjustments assumed for the period 2010-2013	-9½%	-6%	-3%

In line with normal procedures, the EU Commission reported on 11 November 2009 on the actions taken by Member States, including Ireland, in response to the EU Council recommendations issued last April under the excessive deficit procedure (of the Stability and Growth Pact). In this context the timescale for correction was reviewed. Based on the need to stabilise the deficit in 2010 and on developments elsewhere, the European Commission are now proposing for a number of countries including Ireland an additional year to adjust under the Excessive Deficit Procedure. It is expected that developments in this area will be finalised in early December. If an extension is approved, the impact would be to lessen the action taken in the later years but it would not obviate the need to take action in 2010 to stabilise the deficit.

Notwithstanding any adjustment to the timescale for correction, the exact details of the measures required in the later years is contingent on the strength of the economic cycle and on the budgetary policy measures that are implemented by Government for 2010. The next phase of required consolidation will be assessed in the context of the forthcoming Budget.

ANNEX 1: VOTED EXPENDITURE 2009 to 2012 – PRE-BUDGET

Ministerial Vote Group		2009 Estimated Outturn €000s	2010 Pre-Budget Estimate €000s	2011 Pre-Budget Estimate €000s	2012 Pre-Budget Estimate €000s
<i>Current Expenditure Allocations:</i>					
1	Agriculture, Fisheries and Food	1,508,804	1,370,507	1,370,576	1,370,576
2	Arts, Sport and Tourism	404,881	405,010	404,995	404,995
3	Communications, Energy and Natural Resources	354,474	360,066	360,359	360,359
4	Community, Rural and Gaeltacht Affairs	342,995	330,178	329,778	329,778
5	Defence	1,013,189	1,013,189	1,013,189	1,013,189
6	Education and Science	8,641,794	8,602,813	8,612,834	8,612,834
7	Enterprise, Trade and Employment ^(a)	1,509,789	1,623,656	1,433,656	1,433,656
8	Environment, Heritage and Local Government	875,477	875,597	875,597	875,597
9	Finance Group	1,304,003	1,377,411	1,391,323	1,417,083
10	Foreign Affairs	805,242	753,155	777,580	815,090
11	Health and Children	15,588,546	15,841,256	16,013,256	16,213,256
12	Justice Group	2,440,407	2,548,955	2,601,856	2,601,856
13	Social and Family Affairs ^(a)	20,414,784	22,286,341	22,237,635	21,809,376
14	Taoiseach's Group	193,902	204,971	235,435	200,788
15	Transport	704,520	746,884	785,788	773,172
	Unallocated Payroll / Administrative Adjustments	-110,000	-240,000	-240,000	-240,000
	Total Gross Voted Current Expenditure	55,992,807	58,099,989	58,203,857	57,991,605
<i>less</i>	Appropriations-in-Aid, Funds & Departmental balances	15,699,741	14,788,677	13,738,189	14,256,725
	Total Net Voted Current Expenditure	40,293,066	43,311,312	44,465,668	43,734,880
<i>Capital Expenditure Allocations:</i>					
	Total Gross Voted Capital Expenditure ^(b)	7,332,255	6,605,715	5,475,998	5,985,025
<i>less</i>	Appropriations-in-Aid	448,414	480,981	478,981	478,981
	Total Net Voted Capital Expenditure	6,883,841	6,124,734	4,997,017	5,506,044

(a) Including expenditure from the Social Insurance Fund and the National Training Fund.

(b) Consistent with indicative capital allocations set out in the April Supplementary Budget.

ANNEX 2: TAXATION AND FISCAL CONSOLIDATION

As part of the process of fiscal correction, Budget 2009 and the April Supplementary Budget introduced specific tax measures to raise some €½ billion in additional revenue in a full year. This involved increased tax charges on income (Income Levy and Health Levy), capital (CGT, CAT and DIRT) and consumption (VAT and Excise). The volume, extent and impact of these increases across the economy are significant and include:

Income Tax

- The net income of a single worker on the average industrial wage was reduced by 4.6 per cent while for those on €100,000 and €200,000 reduction was 8.2 per cent and 10.2 per cent respectively.
- Marginal tax rates have increased significantly.
 - *Average industrial wage from 26 per cent to 30 per cent;*
 - *Twice the average wage from 43 per cent to 51 per cent;*
 - *Earnings over €175,000 from 43.5 per cent to 52 per cent.*
- In 2009 it is estimated that the top 4 per cent of income earners (over €100,000) will pay some 48 per cent of income tax.
- For 2010, it is estimated that around half of income earners will pay no income tax (up from around 40 per cent), although they may pay the income levy.

Value Added Tax & Excise

- The standard rate of VAT was increased from 21 per cent to 21.5 per cent.
- Our standard VAT rate is the sixth highest in the EU behind Sweden, Denmark, Finland, Hungary and Poland.
- The UK temporarily decreased its rate from 17.5 per cent to 15 per cent, leaving little if any scope for increasing VAT rates.
- Our excise rates are consistently amongst the highest in the EU.

Capital Tax

- Capital Gains Tax, Capital Acquisition Tax rates have been increased by a quarter from 20 per cent to 25 per cent.
- The Capital Acquisition Tax thresholds have been reduced for the first time ever to reflect the fall in asset values and a reduction in the CPI.
- Despite these changes there is little or no additional revenue yield coming from these measures arising from the general decline in economic activity, market uncertainty and falling asset values.

Income Tax, VAT, Excise and Capital Taxes make up some 88 per cent of all tax revenue. In order to raise additional revenue there is always the option of taxing differently or broadening the tax base. In this regard, the phased introduction of a Carbon Tax will commence in 2010. However, further significant general tax increases are not desirable at this time if we are to avoid undermining confidence, further discouraging work effort and putting a more general economic recovery at risk. Over the recent months, the IMF, OECD and EU have all broadly endorsed the approach to fiscal correction taken in 2009 - a combination of immediate tax increases and expenditure reductions. Equally they have all argued that the main focus should now be on expenditure.

ANNEX 3: THE STRUCTURAL BALANCE – EXPLANATORY NOTE

Background...

Fluctuations in the economic cycle can have a significant impact on the fiscal position in any given period. This arises because of inbuilt mechanisms in the fiscal framework through which fiscal policy can automatically stabilise economic activity. For instance, taxation revenue will tend to be ‘cyclically’ high in an upswing, while unemployment spending will be ‘cyclically’ high in a downturn. In this regard, a frequently used tool in the analysis of fiscal policy is the so-called structural balance. This is the balance which would prevail if transitory elements in net government lending arising from economic fluctuations are removed.

Methodology...

In principle, this structural – or underlying – balance provides the most appropriate benchmark for assessing the stance of fiscal policy. In practice, however, decomposing net lending into its permanent and transitory components is subject to considerable uncertainty, as neither of these can be measured directly and must be estimated. While a number of approaches have been developed, almost all are subject to at least some limitations.

Given the importance of fiscal policy within monetary union, a harmonised methodology to calculate the structural balance has been developed by the EU Commission and Member States. This approach is in line with that used by other international bodies and is that applied by the Department of Finance in the Stability Programme Update each year (as part of the Stability and Growth Pact). Under this approach, first, the cyclical position of the economy is assessed by measuring the deviation of GDP from its trend level and, second, the budgetary impact of deviation from trend is calculated. The structural balance is then calculated by subtracting the resulting estimated cyclical budget component from the actual budget balance.

Estimating the output gap...

Up until the early part of this decade, the output gap was determined in a purely statistical manner. The trend level of output was identified by applying a smoothing filter to GDP, with fluctuations of actual demand around the smoothed series determining the output gap in any period.

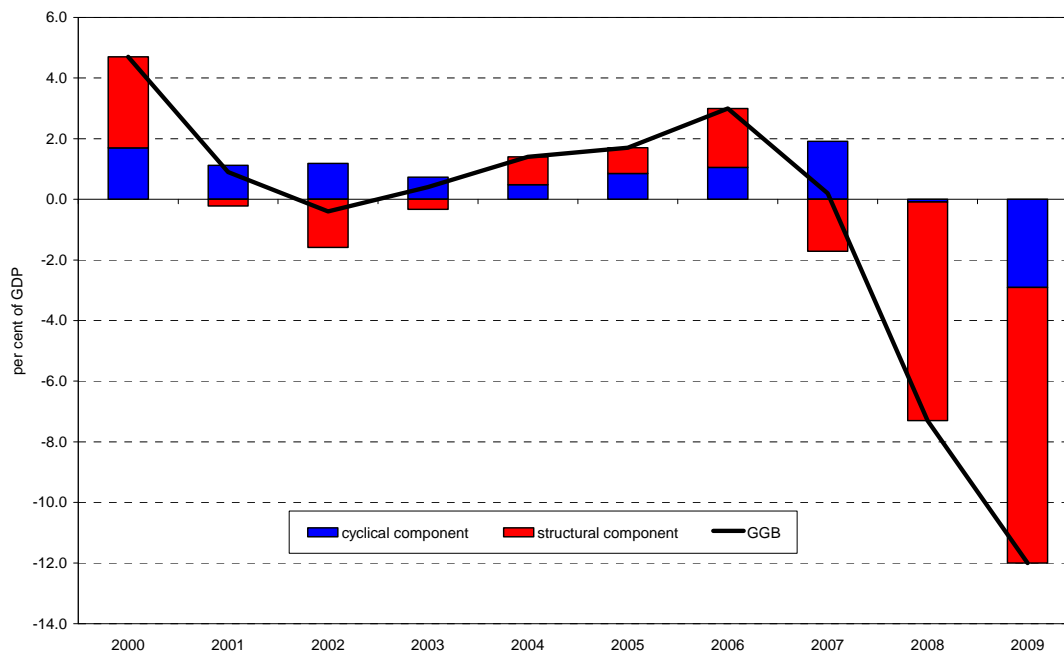
While this approach has the clear advantage of simplicity, such methods have a major short-coming in that they have no theoretical underpinnings. On foot of this, a production function approach has been developed,⁵ and this harmonised methodology is now applied to all Member States. Under this approach, potential output is determined by changes in factor inputs (capital and labour) together with estimates of trend total factor productivity (the efficiency with which capital and labour are combined to produce output). The output gap is the difference between aggregate demand and aggregate supply.

⁵ See *Calculating potential growth rates and output gaps – a revised production function approach* by Cecile Denis, Daniel Grenouilleau, Kieran McMorrow and Werner Roger, European Economy Economic Paper 247, March 2006.

Estimating the sensitivity of the budget balance to the economic cycle...

The sensitivity of the budgetary balance to the economic cycle for each Member State is calculated on the basis of empirical work undertaken by the OECD.⁶ For Ireland, this sensitivity is 0.40, compared with an average of 0.48 for the euro area as a whole.

Figure 16: Cyclical and Structural Components of Government Balance



Current estimates...

Notwithstanding considerable measurement uncertainty, figure 16 above decomposes the headline deficit into its estimated cyclical and structural components. On the basis of the methodology employed the structural component is large both this year and last, amounting to around three quarters of the overall deficit this year. There are a number of reasons for this.

Firstly, even with two successive years of very negative growth, the estimated output gap is just -7¼ per cent of GDP this year. This reflects the fact that output had been well above potential prior to the crisis.

Secondly, the contraction of the tax base in recent years means that even with cyclical recovery in the economy, the potential for taxes to increase is limited. For instance, it is currently estimated that in 2010 around half of income earners will pay no income tax, although they may pay the income levy. In addition, the loss of windfall taxes related to the asset/property market developments is more of a structural rather than a cyclical revenue deterioration. As noted earlier in the discussion on the recent evolution of tax revenue, even with an economic recovery, these tax heads are unlikely to return to the levels reached during the boom. However, it is also the case that revenues in this area are cyclically low and some improvement can be expected when conditions 'normalise'. On the expenditure side, a large part of the increase in unemployment is structural – the reallocation of labour from the construction sector to

⁶ See *Measuring cyclically-adjusted budget balances for the OECD countries* by N. Girouard and C. Andre, OECD Economics Department Working Paper 434.

other sectors is likely to take some time given the need to re-skill; in other words, unemployment could remain relatively high for some time.

Finally, for many of the world's advanced economies there are reasons to believe that the supply-side has been adversely affected by the global financial market crisis. For instance even over the medium term, the cost of capital is likely to be permanently higher while "hysteresis"-type effects (the observed tendency for post-recession unemployment to be higher than pre-recession levels) will probably raise the rate of unemployment consistent with stable inflation. In Ireland, the potential growth rate also appears to have been affected by the crisis, which will reduce the size of the gap between the level of actual output and potential over the next few years.

Implications for public finances over longer term...

The lower rate of potential growth will have adverse implications for the public finances over the longer term. Combined with the major deterioration in the starting position, the reduced rate of potential growth means that our demographic "window of opportunity" is closing rapidly.