IRISH BUDGET 2010

Today, the Irish Finance Minister delivered another tough budget which should achieve his main aim of stabilising the rapidly rising fiscal deficit through budgetary savings of €4 billion next year. The budget targets look realistic as they are based on fairly downbeat economic forecasts, with GDP projected to contract by a further 1.3% in 2010.

The strong corrective measures in today's budget include unpopular decisions to cut public sector pay and social welfare benefits. However, these are needed given the speed and scale of the deterioration in the public finances. While additional corrective measures will be required over the next few years, today's budget is another key step towards restoring stability to the public finances.

Key Points

- **The main aim of the 2010 budget is to stabilise the rapidly rising budget deficit.** This required budgetary savings of €4 billion, which are to be achieved via expenditure cuts. The budget also saw the introduction of a carbon tax, offset by cuts in other indirect taxes.

- **The main focus of the budget, then, is on spending cutbacks,** with reductions in public sector pay, social welfare and capital spending. Overall, gross voted current spending will fall by 1.8% next year, with gross voted capital spending declining by 10.7%.

- **The budgetary savings of €4 billion announced today equate to some 2.5% of GDP.** This follows the corrective fiscal measures implemented in 2009, totalling €8 billion or 4.7% of GDP. It implies a continuing, though less contractionary fiscal stance next year.

- Nonetheless, the government is still facing a large **general budget deficit of €18.7 billion in 2010, or 11.6% of GDP, below the level of €19.3 billion (11.7% of GDP) in 2009.**

- **The economic backdrop remains difficult,** with the Dept of Finance forecasting that GDP will decline by 1.3% in 2010 after falls of 7.5% and 3.0% in 2009 and 2008, respectively.

- The Dept of Finance sees a return to growth thereafter, with GDP forecast to rise by an average of around 4% per annum in the 2011-2014 period.

- The government has indicated that **further corrective fiscal measures will be required post 2010** to reduce the budget deficit to below 3% of GDP by 2014. However, it is not expected that these will need to be anywhere near the same scale as in 2009 and 2010.

- Ireland's gross public debt/GDP ratio is forecast to climb to 78% next year from 65% in 2009 and 44% in 2008. It is seen as peaking in 2012 at 84% of GDP.

- However, **in net terms the debt ratio is significantly lower, at 39% in 2009 and 51% in 2010**, allowing for the exceptionally large cash balances held by the authorities and the value of the National Pension Reserve Fund.

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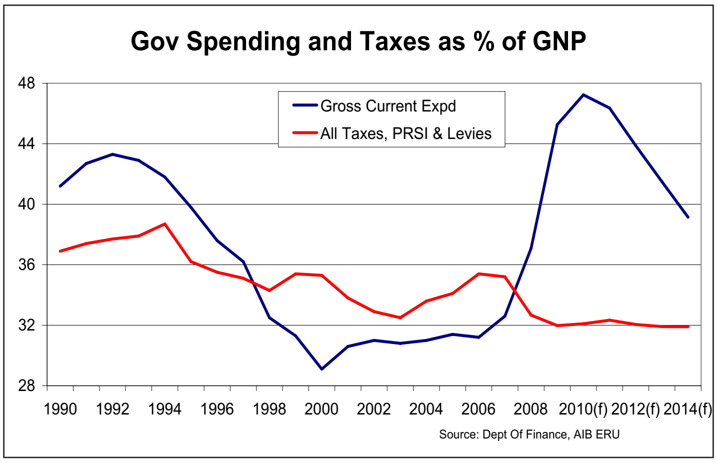
Challenging Budgetary Position

- The public finances have been caught in a pincer movement whereby tax receipts have fallen sharply and government spending has risen steeply, all in the context of a severe contraction in the economy, which is likely to see GDP fall by 12.5% in the period 2008-2010. As a result, **the general government budget balance has moved from a surplus of 0.3% of GDP in 2007 to a deficit of 11.7% of GDP in 2009.**

- **Tax receipts have fallen sharply, but the government has acted over the past year to boost tax revenues via various tax hikes.** Total tax receipts (including PRSI, levies etc) are set to amount to 32% of GNP in both 2009 and 2010, down from 35.2% in 2007. This is a sharp, but hardly catastrophic, fall.

- **The main damage has been done on the spending side.** Gross current government spending is expected to amount to 45.3% of GNP in 2009 and 47% in 2010, up from 32.5% in 2007, a very sharp rise indeed. Gross current spending rose by 9% in both 2008 and 2009. This is partly due to cyclical factors such as rising debt interest and unemployment payments. However, the public sector pay bill has also risen, climbing by 11% in the past two years.



- **Compared to elsewhere, the rise in total government spending as a share of GDP has been very marked in Ireland.** EU Commission figures show that by next year, it will have risen by 15 percentage points (pps) since 2006, compared to rises of 4pps in the eurozone, 5pps in the US and 8pps in the UK. Furthermore, **government spending in Ireland now represents a much higher share of GNP than elsewhere in the EU.**

- Taxes were substantially increased over the past year and while the tax base needs to be broadened, the scope for a big increase in the total tax take is limited. Even with further tax increases, **the tax base is simply not there to sustain the current very high level of government spending.** Thus, the burden of fiscal adjustment has to fall predominantly on the spending side. **It is difficult to see order being restored to the public finances without big cuts in public spending** to bring about a significant reduction in government expenditure as a proportion of GDP over the next number of years.

Government Aims To Stabilise Budget Deficit In 2010

- **As well as a cyclical deficit, it is clear that a large structural deficit has emerged in the public finances.** There has been rapid growth in government spending while the collapse in housing activity and employment has left a large and permanent hole in tax receipts. This size of the structural deficit is difficult to estimate. The Dept of Finance estimates it at 9% of GDP in 2009. This is the extent of the fiscal adjustment that is required if the budget is to be eventually restored to a broad balance. The ESRI, though, believes that the structural deficit, while still large, is lower than this.

- **Today, the Irish Finance Minister delivered a tough budget** aimed at reducing the structural deficit and capping the sharp rise in the overall fiscal deficit. In total, the budget involves expenditure cuts of €4 billion, equivalent to 2.5% of GDP**.** The government expects that the general budget deficit in 2010 will amount to €18.7 billion or 11.6% of GDP, just below the level in 2009.

- **The budget targets look realistic. They are based on fairly downbeat economic forecasts** with GDP projected to contract by a further 1.3% next year, led by another sharp fall in consumer spending and investment. Labour market conditions are expected to remain difficult, with the unemployment rate forecast to average 13.2% in 2010 and employment projected to fall by 3.4%. The HICP inflation rate is forecast to average -1.2% in 2010.

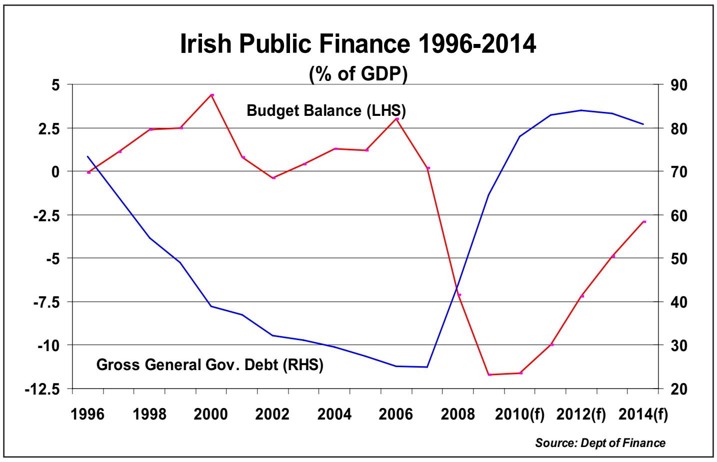
- There are concerns that today's contractionary budget could prolong the recession in an already fragile Irish economy. However, **Ireland is a very open economy so some of the impact of these measures will be dissipated through lower spending on imports.** In this regard, the very contractionary supplementary budget introduced last April does not appear to have weakened the economy much further.

Budget Deficit To Fall Below 3% of GDP by 2014

- **The measures taken both today and over the past year to stabilise the public finances point to a willingness to take a firm grip of the public finances.** They have helped contribute to a narrowing on the yield spread between Irish and other eurozone government bonds compared to their spring levels. This trend should continue in 2010, particularly as the public finances have deteriorated sharply across the EU.

- The EU Commission is forecasting that budget deficits in the eurozone will average 7% of GDP next year, up from 6.4% this year and a low of 0.6% in 2007. France is expected to have a deficit of 8.2% of GDP, Spain over 10%, Greece above 12%, with the UK deficit put at 13% of GDP. The US budget deficit is also expected to hit 13% of GDP next year.

- **Further fiscal adjustments are in the pipeline for the period 2011-2014 to bring the Irish budget deficit down to 3% of GDP** by the end of this period. These will take the form of additional spending cuts and tax increases, totalling up to €8.5 billion (5.3% of GDP). Overall, the Minister has sent a strong signal that he intends to bring the Irish budget arithmetic under control and return the public finances to a sound footing over the next few years.



- **Ireland is fortunate in that its public debt is at a low level** – one of lowest debt ratios in EU. The reason for the low public debt is that Ireland enjoyed budget surpluses from 1997-2007, which allowed it to greatly reduce the national debt. The public debt stood at 44% of GDP in gross terms at end 2008 or 23% in net terms, when allowance is made for the large cash balances held by the authorities as well as value of the National Pension Reserve Fund. Ireland's gross public debt/GDP ratio is forecast at 65% in 2009 and 78% in 2010. However, in net terms the debt ratio is much lower, at 39% in 2009 and 51% in 2010. **These ratios compare very favourably with the rest of the EU.**

Main Features

- Budgetary savings in 2010 of €4 billion, or 2.5% of GDP, largely through a package of expenditure cutbacks, with net revenue gains of just €17 million from taxation measures.
- Aim is to cap the budget deficit at under €19 billion or 11.6% of GDP in 2010, and to bring it down below 3% of GDP by 2014.
- Budget arithmetic is based on a 2010 GDP forecast of -1.3%, employment growth at -3.4% and an HICP inflation rate of -1.2%.

Detail of Measures Announced in Budget 2010

Expenditure

Public Sector Pay

- Budget day package to cut public sector pay bill cut by over €1billion in 2010. Overall gross savings on pay bill of €1.4bn, or 7.2%.
- Reduction of 5% on first €30,000 of income; 7.5% on next €40,000 and 10% on next €55,000, effective 1/1/2010.
- Cuts in salaries of top civil servants earning over €125,000 (including hospital consultants) in line with the recommendations of the Review Body on Higher Remuneration. Reduction of 8% for those earning €125,000 - €165,000; 12% for those earning €165,000 - €200,000; and 15% for those earning over €200,000.
- Revised pension scheme for new public sector employees to be introduced by end 2010. Retirement age increased and pension to be based on career average earnings.

Social Welfare

- Budget day social welfare cuts totalling €760m in 2010.
- Working age welfare payments to be reduced by about 4.1% with maximum personal rates cut by between €8.20 and €8.50 per week (from current maximum rate of €204.30).
- Jobseekers Allowance for those aged 20-21 cut to €100 and for those aged 22-24 to €150. Rate also reduced to €150 where job offers or activation measures refused.
- Child benefit to be cut by €16 per month to: €150 (-9.6%) for the lower rate and to €187 (-7.9%) at the higher rate. Offsetting compensation for welfare dependent families.
- No change to the old age pension.

Other Current Expenditure Measures

- Total Budget day expenditure savings of €980m.
- Of which: health sector savings of €400m. These include, increase in the prescription drug threshold increased to €120 from €100; introduction of prescription charge of 50c per item for medical card holders.

Capital Spending

- Budget day savings on investment projects of €960m, partly on lower tendering prices.

Taxation

- Net impact of taxation measures of €17.2m in revenue gains.

Carbon/Green Taxes

- Carbon tax of €15 per tonne. Petrol/diesel prices to rise by 4.2/4.9c per litre, effective midnight. Home heating oil/natural gas to increase by approximately 8.7%/6.0%, effective 1 May 2010.

- Extension of VRT exemption/reliefs for electric/hybrid cars.

VAT & Excise Duties

- Excise duties (VAT inclusive) on alcohol reduced by 12c on beer/cider; 14c per half glass of spirits and 60c per bottle of wine - to try and counter cross border trade.

- Standard rate of VAT reduced by 0.5% to 21%, effective 1/1/2010.

Other Personal Taxation

- No change in employee PRSI ceiling, income tax rates, levies, tax credits or capital taxes.

- Extension of period of entitlement for Mortgage Interest Relief for some existing and new home owners.

- For high earners: increase in tax rate for those availing of tax incentive schemes plus Irish domicile tax levy.

Business Taxation

- Commitment to 12.5% Corporation Tax rate reaffirmed.

Business and Job Creation Incentives

- Scrappage scheme of €1,500 for cars over 10 years old.
- €136m in funding for job training places and supports.
- €130m fund for energy efficient measures.

Other Measures to Be Introduced

- Universal social contribution to replace employee PRSI and the health and income levies to be introduced in 2011.

- From 2011, income tax to apply on a more progressive basis to those on higher incomes.

- Private sector pension reforms to await the publication of the National Pensions Framework.

- Work to commence on registration of home ownership and valuation of land as basis for a property tax.

- Preparations underway to introduce a system of water metering and water charges for consumption above a free allowance.

- Efficiency Review of Local Authorities to be undertaken by mid 2010.
- National Solidarity Bond to be introduced aimed at small investors.

Budget Assessment

- The recession has had a very negative impact on **the public finances, which have deteriorated sharply in the past two years** after more than a decade of budget surpluses. The General government budget balance moved from a small surplus in 2007 to a deficit of 7.2% of GDP in 2008 and 11.7% of GDP in 2009.

- The accompanying **table sets out the principal features of the 2010 budget arithmetic.** Net spending on current supply services is forecast to fall by 0.4% next year. Debt interest payments are forecast to rise from €2.66 billion to €4.62 billion, boosting central fund expenditure. On the other side of the balance sheet, tax receipts are forecast to fall by €1.5 billion or 4.7% in 2010 - the spending cuts announced in the budget will depress tax revenues by €900 million. Non-tax revenue will be boosted in 2010 by €1 billion in fees from the banks participating in the Bank Guarantee Scheme. Overall, the current budget deficit is projected to rise to €13.7 billion in 2010, up from €12.1 billion in 2009.

BUDGET 2010

(€ Million)	2009 Projected Outturn	2010 Budget Target	% Change
Current Spending	**45,520**	**47,123**	**+3.5**
of which			
(i) Central Fund	5,152	6,932	+34.5
(ii)Supply Services	40,368	40,192	-0.4
Current Revenue	**33,404**	**33,405**	**0.0**
of which			
(i) Tax	32,570	31,050	-4.7
(ii) Non-Tax	834	2,355	182.4
Current Budget Deficit	**12,116**	**13,718**	
Capital Borrowing	**13,145**	**5,062**	
Exchequer Deficit	**25,260**	**18,780**	
Gen. Gov. Deficit	**19,260**	**18,720**	
(% of GDP)	(11.7%)	(11.6%)	

- On the capital side, gross voted expenditure is forecast to fall by 10.7% to €6.5 billion, although the impact is much less in volume terms because of falling tender prices for construction projects. Overall, capital borrowing is projected to fall sharply from €13 billion to €5 billion, having being boosted in 2009 by €7 billion for capital injections for banks.

- As a result of the above figures, the government is forecasting an Exchequer deficit of €18.8 billion in 2010, down from an estimated deficit of €25.3 billion in 2009. The Minister is targeting a **General Government deficit of €18.7 billion next year, or 11.6% of GDP. This compares to a deficit in 2009 of €19.3 billion** (11.7% of GDP).

- The Dept of Finance in its **White Paper on Receipts and Expenditure** for 2010 published at the weekend gives a detailed breakdown of its tax projections, excluding the impact of the changes announced in the budget today. It sees total tax receipts at €31.9 billion in 2010 compared to €32.6 billion in 2009, a fall of 2% and well below their peak of €47.25 billion in 2007. After today's budget changes, the tax take in 2010 is projected at €31 billion.

WHITE PAPER TAX REVENUE PROJECTIONS

(€ Million)	2009 Projected Outturn	2010 Opening Position	Chg. %
Excise Duties	4,575	4,525	-1.1
VAT	10,640	10,460	-1.7
Income Tax	11,810	11,979	+1.4
Corporation Tax	3,790	3,210	-15.3
Capital Taxes	645	580	-10.1
Stamp Duties	900	975	+8.3
Other	210	201	-4.3
Total	**32,570**	**31,930**	**-2.0**

Source: Dept of Finance

- It is noteworthy that **income tax and VAT/Excise duty account for 83% of the total tax take in 2009** following the collapse in receipts from property related taxes and sharp fall in corporation taxes. The narrowness of the tax base is further highlighted by the fact that half of workers do not pay income tax, while 48% of income tax is paid by the top 4% of income earners. It is clear from these figures that the tax base is too narrow.

- The **budget arithmetic is based on fairly downbeat economic forecasts.** The Dept of Finance is forecasting further declines of 1.3% and 1.7% for GDP and GNP, respectively, next year. This is driven by another very large fall in fixed investment in particular, as well as significant declines in consumer spending and government expenditure. Exports are forecast to rise slightly. The unemployment rate is forecast to average 13.2% in 2010.

- Tax revenues have been in sharp decline for the past two years and are very difficult to forecast for 2010. There may well be **downside risks attached to the tax projections** for next year given the big undershoots of the past two years, especially income tax receipts. However, there is **scope for savings on the spending side.** The Department's forecast for a further marked rise in unemployment may prove a touch pessimistic given that the Live Register has been broadly stable since August. There could also be savings on debt interest payments given the rather sizeable increase of 73% or some €2 billion, provided for in 2010.

- **The key thing, based on this budget arithmetic, is that the budget deficit will fall slightly next year, both in nominal terms and as a percentage of GDP.**

- Although the budget contains some small, targeted stimulus measures, overall **its obviously very deflationary,** as it is taking €4 billion gross spending out of the economy, which equates to 2.5% of GDP. The cuts in public sector wages and social welfare payments total €1.7 billion. Allowing for tax effects, these changes will depress disposable income by around 1.5% in 2010.

Government Sees Economy Recovering from 2011

- **The Dept is predicting a recovery by the economy over the period 2011-2014.** It expects a rise of 3% in GNP in 2011, with the economy growing by 4% in 2012 and 2013, driven by a recovery in the world economy and helped by a pick up in housing activity and consumer spending from very depressed levels. It sees a modest fall in unemployment in this scenario.

D/FINANCE MACRO ECONOMIC FORECASTS (%)

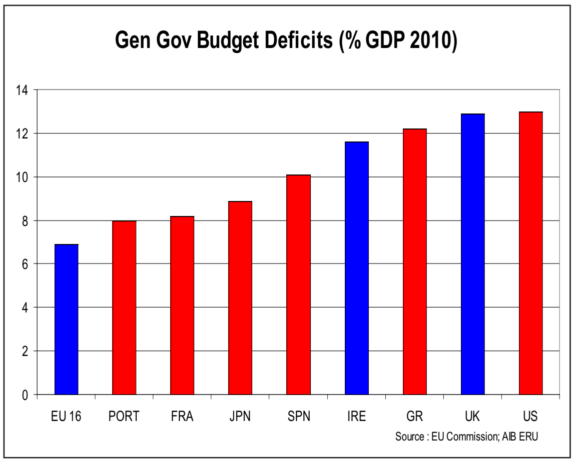
	2010	2011	2012	2013
GDP	-1.3	3.3	4.5	4.3
GNP	- 1.7	3.0	4.1	3.9
Private Cons	-3.0	2.6	3.4	3.3
Gov Expd.	-3.0	-0.5	-0.5	-0.5
Fixed Inv.	-19.2	4.5	7.8	8.5
Exports	0.4	3.4	4.0	3.8
Imports	-2.8	2.6	2.9	3.0
CPI	-0.8	1.8	2.0	2.0
HICP	-1.0	1.0	1.7	1.8
Employment	-3.4	1.0	2.3	2.5
Unemploy. Rate	13.2	12.6	11.8	10.8

- The ESRI, though, argued in a paper earlier this year *(Macroeconomic Context for a Sustainable Recovery)* that Irish growth rates of 5 to 6% are likely in the recovery phase of the next upswing, reflecting a restoration of some of the substantial output losses sustained in the 2008-2010 period.

- This suggests that the Dept's **forecasts may err on the cautious side.** It's forecast **in regard to exports in particular** would seem conservative, at 3.7% growth on average over the period 2011-2013, especially if the recovery currently taking hold in the world economy proves sustained and given the solid performance of Irish exports in this downturn.

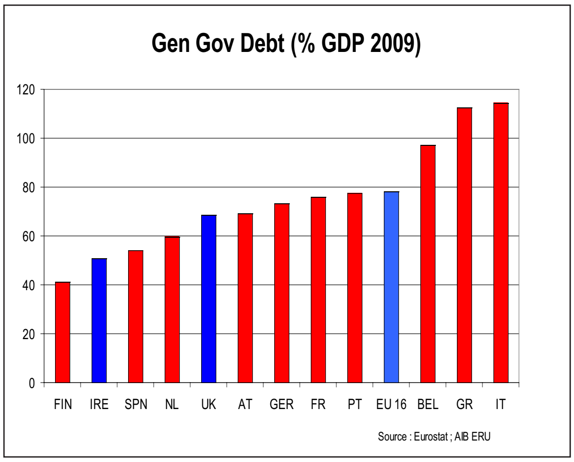
Public Finances To Improve Also

- **The government plans to introduce further spending cuts and tax increases** over the next few years, which could total as much as €8.5 billion (5.3% of GDP) in the period 2011-2014. The expectation of the government is that a combination of these corrective measures and a pick up in economic activity from 2011 onwards will bring about a marked reduction in the deficit to below 3% of GDP by 2014.



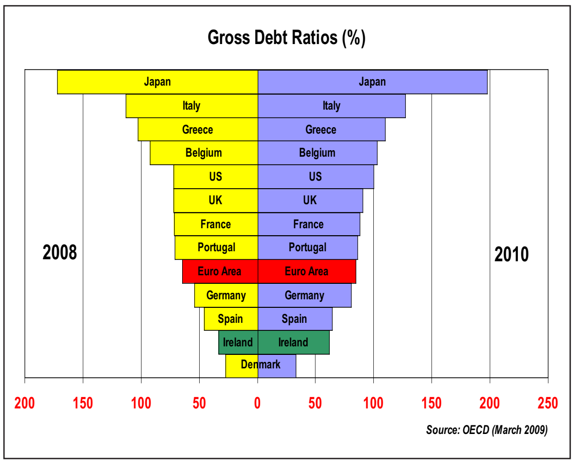
- It is worth noting that **many other countries have seen a sharp rise in their budget deficits**. The budget deficits in the UK and US are projected at 13% of GDP next year. Budget deficits in the eurozone are forecast to average 7% of GDP next year, with France at 8%, Spain at 10% and Greece at 12%.

- **Ireland is fortunate that its public debt is at a low level** – one of lowest debt ratios in EU. The reason for the low public debt is that Ireland enjoyed budget surpluses in the period 1997-2007. This allowed it to reduce the national debt to a very low level of 24.7% of GDP at end 2007.



- The low starting level of Irish government debt means that Ireland still has a relatively low debt/GDP ratio compared to other countries, despite the large borrowing requirement over the past couple of years. The latest official estimates show that the General Government Debt/GDP ratio at 65% at end 2009. However, this does not allow for **a large build up of cash balances by the government authorities to some €25 billion,** or around 15% of GDP. Taking this into consideration would bring the debt ratio down to around 50% of GDP, as shown in the table above.

- Furthermore, deducting also the value of the National Pension Reserve Fund and other funds managed by the NTMA from gross debt would bring the Debt/GDP ratio down to 39% of GDP. By contrast, the General Government debt ratio is estimated by the EU Commission at 78% of GDP for the eurozone in 2009, with the UK ratio put at 68.6%.

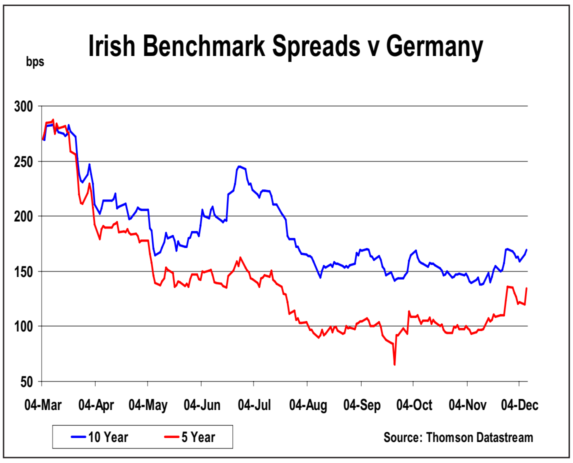


- The OECD has attempted to measure government debt on a standardised basis. The accompanying chart illustrates the OECD estimate of public debt/GDP ratios based on the implementation of the System of National Account principals. It shows **Ireland still retaining a relatively very low level of debt/GDP in 2010,** well below the levels for the eurozone, UK and US.

Lower Funding Should See Renewed Yield Convergence In 2010

- **The NTMA raised €35 billion via bond issuance in 2009, leaving it with large cash balances of €27 billion at end November,** up from €22 billion at end 2008. The Exchequer Borrowing Requirement is put at €25 billion this year, which combined with a bond redemption of €5 billion put the government's funding requirement at €30 billion in 2009. The authorities have thus overfunded by €5 billion, causing cash balances to rise even further from what was an already extremely high level at end 2008.

- **The authorities expect to have a much smaller funding requirement in 2010.** The Exchequer deficit is forecast to fall to under €19 billion next year and there are no major bonds due for redemption. There are indications that the NTMA may run down some of the Exchequer's large cash balances. Thus, it may seek to raise about €15 billion in the bond market in 2010, which would be €20 billion less than in 2009.



- **Demand has been very strong for Irish bonds in the primary market this year,** with investors attracted by the relatively generous yields offered by Irish government paper. In the ten year area, the spread over Germany had narrowed in to under 150bps, having blown out to some 280bps earlier in the year. However, the spread has widened out again somewhat in recent weeks to 160-170bps on a pick up in risk aversion in markets, most notably following the difficulties in the Greek and Dubai debt markets.

- **There should be scope for the spread to narrow again in 2010 following today's measures to stabilise the budget deficit,** the serious budgetary difficulties that are now apparent in many other countries, the much lower Irish Exchequer funding requirement for 2010 and as the markets look more and more to issuers with a good credit rating that offer a generous yield pick up.

- **It is worth pointing out that after this budget, the bulk of the fiscal retrenchment required to get the budget deficit back down below 3% of GDP will have been completed.** The fiscal cutbacks implemented in 2009-2010 will total €12 billion. It is estimated that this leaves another €8.5 billion to be done over the four years 2011-2014.

- Obviously, swings in sentiment on global financial markets, especially with regard to risk aversion, will continue to impact on Irish bonds in 2010 as has been the case in 2009. **The spreads offered by Irish bonds look generous**, though, with the yield pick-ups of 110bps and 85bps available over Spanish and Italian ten year paper, respectively, looking particularly attractive. There should be scope to eliminate the bulk of these very wide yield differentials in the coming year as the Irish public finances are stabilised.

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