PMCA ECONOMIC CONSULTING

Economic Commentary

Reflections on Budget 2013 and Beyond

December 2012

Synopsis

Perhaps the most truthful, and insightful, statement following Budget 2013 came from Communications Minister, Mr. Pat Rabbitte TD, when he uttered the words "The country's still broke". This austerity budget is the latest instalment in an ongoing programme of fiscal consolidation, under the direction of the 'Troika' (the IMF, European Commission and the European Central Bank, ECB), and there will be at least two further austerity budgets. Cumulative austerity – however necessary to address past economic mismanagement – is hitting residents and businesses hard, with disposable incomes being eroded in an environment of rising costs. Competitiveness is unevenly distributed as consumers and small businesses are faced with escalating prices and costs. In principle, the residential property tax will serve to broaden the tax base and take pressure off businesses in respect of local government funding. However, the practical reality could be very different if the refusal rates witnessed in the case of the current €100 charge are repeated. The new tax is likely to be a highly divisive issue in 2013 and the operational practicalities remain to be worked out. As the country continues down the tunnel of fiscal correction, each subsequent step becomes more difficult to take and next year could be a particularly challenging one for many. Over next year and beyond, a key policy challenge will be to 'manage' the economic 'correction' underway, particularly the distributional aspects.

Introduction

Nothing damages a country and its people more than bad economy policy. That is the hard lesson that Ireland and its residents are coming to terms with in the aftermath of Budget 2013, the latest in a series of austerity budgets since 2008. The harsh budgets are the consequence of mismanagement and poor regulation of the Irish economy over many years and the effects will be felt for decades to come. Sure, there was economic mismanagement in other countries as well. But the crisis in Ireland has been, and continues to be, particularly severe and, when one considers both public and private debt, the country is the most indebted in the world. As the Minister for Finance, Mr. Michael Noonan TD, put it, “Debt” is the watchword of this crisis. And as the Communications Minister, Mr. Pat Rabbitte TD, remarked after the budget, “The country’s still broke”.

Commentators have been debating the merits or otherwise of Budget 2013 and whether it is “fair”, “progressive” or even “innovative”. These arguments miss the point, which is that this budget cannot be seen in isolation; rather it is part of a catalogue of austerity measures or programme of fiscal consolidation aimed at bringing the public finances under control and hopefully stimulating jobs in the economy. Next year and the year after, there will be further austerity budgets, with planned cuts of €3.1 billion and €2 billion respectively. Considered in isolation, Budget 2014 and 2015 might appear to be less savage than Budget 2013, but they could end up being a lot more severe when the *cumulative* effects of austerity are factored-in.

It is therefore instructive to consider the performance of the Irish economy and the prospects for the coming years. The most worrying trend is lower disposable incomes and rising living costs – Ireland is becoming a high cost country and competitiveness is unevenly distributed, with consumers and small businesses faced with rising prices and costs. In other words, signs are emerging of ‘stagflation’ – rising prices and costs in a recessionary/depressed environment.

Positively, there are some signs of hope. Foreign direct investment (FDI) is performing strongly – driven primarily by Ireland’s low corporate tax rate (12.5%, which will not change). Overseas visitors are up and certain sectors of the indigenous economy are doing well, such as agri-food and other export-oriented activities. Government bond yields are down substantially this year, reflecting improved international confidence in the Irish economy. The markets, it appears, are giving their blessing to the fiscal consolidation or perhaps more accurately to the Irish people’s resolve (so far).

This article considers some of the main features of Budget 2013, including the central item in the form of the property tax. Other noteworthy features include the VAT initiatives for small and medium enterprises (SMEs), designed to improve cash flow, and continuation of the 9% VAT rate, which will hopefully sustain the recovery in tourism. Other jobs facilitation measures – including the venture capital and urban regeneration initiatives – are welcome. This comment also applies to the enhancement of the R&D tax credit scheme, where there is evidence that such initiatives are associated with more patenting.[1]

[1] See, for example, the article ‘Global Patent Strategies: Ireland as a Case Study’, New Morning Intellectual Property, 27 November 2012 (http://www.newmorningip.com/?p=871).

Irish Economic Performance – Key Facts

In what follows, we review the performance of, and prospects for, the Irish economy and come to the view that recovery will be muted, and costly, due to the higher cost of living. The main risks to recovery are the uncertainty over the euro and the austerity programmes now underway in Ireland's largest trading partners as well as the adverse cumulative effects of the country's own austerity programme (accumulative austerity both over time and across countries).

- It will not be until 2015 before real gross domestic product (GDP) will reach the pre-crisis peak level witnessed in 2007 (**Figure 1**);
- During 2007-2009, real GDP fell more rapidly in Ireland compared with the Euro Area but is expected to grow faster in Ireland from this year, although by less compared with the years preceding the crisis (**Figure 2**) (Ireland went into the crisis deeper than other countries but is expected to come out of it 'relatively strongly');
- During 2005-2008, unemployment was appreciably lower in Ireland compared with the Euro Area but the pattern has been markedly reversed since 2009 and unemployment is expected to peak in Ireland this year, falling to just over 10% by 2017 (**Figure 3**) (thus unemployment will remain a problem for at least the next five years);
- The last four months have seen falls in the Live Register, although autumnal effects have been observed in the last three years and reflect emigration (**Figure 4**);
- The cost of living has been climbing since 2010, a worrying trend in an environment of falling disposable incomes and high unemployment (previous generations of economists referred to this as 'stagflation') (**Figure 5**, **Figure 6** and **Figure 7**, which show rising consumer prices, capital goods prices and industrial prices (energy products) respectively);
- General government revenue as a proportion of GDP is appreciably lower in Ireland compared with the Euro Area, suggesting that the aggregate tax-take in Ireland is relatively low and will remain that way for the foreseeable future (**Figure 8**);
- In the years preceding the crisis, general government spending as a percentage of GDP rose steadily in Ireland, peaking in 2010 with the bank bailout but is expected to fall sharply in the coming years, reflecting further austerity (**Figure 9**);
- Just as Ireland experienced a dramatic deterioration in its public finances 2007-2010 so there will be an equally dramatic 'correction' in the government's net lending/borrowing situation in the coming years, converging on that of the Euro Area (**Figure 10**);
- In attempting to get the budget deficit down to 3% of GDP in 2015, a key policy challenge will be the distributional implications – how shoulders the burden?
- During 2007-2010, social protection expenditure as a proportion of national income grew relatively rapidly in Ireland, reflecting the marked increase in the number of unemployed (**Table 1**);
- Spending on older people as a proportion of overall social protection expenditure is low in Ireland compared with other EU countries (**Table 2**);

- Income inequality fell during the 'boom' years (**Table 3**) and there was a particularly sharp decline during the years preceding the crisis (where the Gini coefficient fell from 0.315 in 2005 to 0.293 in 2008) – increases in public sector pay and social welfare benefits before the crisis in part are likely to have accounted for the lowering of income inequality during this time;
- Since the crisis, the available evidence suggests that income inequality has continued to fall as has the percentage of people at risk of poverty (but the latest year is 2010) (**Table 4**);
- The national debt has escalated rapidly since the crisis but is expected to slow down in the years ahead, although the level of debt at over €200 billion towards the end of the decade will still be unacceptably high (**Figure 11**);
- The national debt does not include private debt (comprising mainly property debt) – when added to the unsustainable national debt, Ireland is the most indebted country in the world and this will haunt future generations;
- The national/public debt as a proportion of GDP will still exceed 100% in 2017, a percentage way out of proportion with the EU's target (60%) in respect of closer fiscal and monetary integration (**Figure 12**);
- The same chart also shows the unsustainable debt in the Euro Area, suggesting the scale of the challenge in keeping the single currency together;[2]
- Ending on a positive note, **Figure 13** shows that Ireland has a positive current account balance of payments (since 2010) – illustrating the country's strong exports performance – and this is anticipated to endure over the next five years.

Further to the above, more up-to-date reliable quantitative data should be compiled and made available in respect of income inequality. The available evidence from the OECD and the CSO indicates that income inequality fell in the years up to 2010 but more information on the situation post-2010 needs to become available. In a recessionary environment with deep austerity, and rising living costs, it is expected that income inequality or the proportion of people at risk of poverty will rise and these variables need to be tracked by the government for information and policy purposes, not least to monitor distributional aspects of the cumulative austerity.

The Property Tax

Undoubtedly the main measure in Budget 2013 is the property tax. Most countries – including the UK – have a property tax, and the level proposed in Ireland is comparably low (at least for now).

In principle, a (residential) property tax serves to widen the tax base and takes pressure of businesses in respect of commercial rates. These issues are especially acute in Ireland where the public finance crisis has shown how narrow the Irish tax base is and where businesses have had to shoulder the burden of local authority rates for many years. Further, as the crisis has revealed, residential property can seriously damage the economic health of the nation and a general principle in economics is 'tax things that damage and subsidise things that benefit'.

2 According to latest data from Eurostat (22 October 2012), only five EU countries have a gross-debt-to-GDP ratio less than 60% and an exchequer deficit of less than 3% of GDP: Bulgaria; Denmark; Estonia; Luxembourg; Finland; and Sweden. Only three are members of the 17-country Euro Area (Finland, Luxembourg and Estonia).

It is reasonable to expect that the property tax will form part of the overall reform of local authority financing and Budget 2013 provides that local authorities will have the scope to vary the rates by 15% above or below the central rates.

In the years ahead, it is possible that tighter local authority budgeting will become a key local authority election issue as councillors pledge not to raise the property tax. This should also enhance local authority openness and accountability, and residents are likely to take a greater interest in the operations and funding of their local authorities, as happened in the UK when the Community Charge was introduced in the early 1990s.

However, the new property tax is not without its issues, which relate to its practical implementation. One such issue concerns estimating residential values when the market has failed to function for many years (one might even argue that the property market before the crash was dysfunctional). Another issue concerns neighbours potentially paying different rates, based on home improvements, conservatories etc. It seems reasonable to expect that Revenue will take leadership for the administration of the property tax, and this will necessarily involve a detailed register of properties across the land, web resources for residents and an appeals procedure (adding to the complexity of the system).

Expenditure Measures

On the spending side, one of the big ticket items is the reduction in child benefit. The payment will be reduced from €140 to €130 per month for each of the first, second and third child. For each subsequent eligible child, the previous €140 rate will apply in 2013. However, from the beginning of 2014, the monthly rate for the fourth and subsequent child will be €130. Thus, for example, a family with three eligible children will receive €390 per month during 2013; a family with five such children will receive €670 per month in 2013, reducing to €650 from January 2014.[3]

For many hard-pressed families, child benefit should be seen in the context of the rising cost of living in Ireland (Figure 5), where it is expected that prices and costs will continue to escalate (insurances, banking, not mention the advent of water charges).

Advanced economies generally provide (tax-free) cash payments (like child benefit), services and tax breaks for families, in recognition of the fact that natural increases in the population are good for productivity and economic growth, other things being equal.

Of interest is the degree of variation in child benefit payments across countries and OECD data reveal that such payments are relatively high in Ireland (however, the latest year covered is 2007). In that year, Ireland had the second highest level of cash payments to families, at 2.32% of GDP, after Luxembourg (2.66%) and well ahead of the 33-member OECD average of 1.22% (the figure for the UK was 2.13%).

[3] Child benefit in the UK is £20.30 for the oldest child and £13.40 for each subsequent child (which includes young children less than 20 years in full-time education up to A-Level or equivalent or on certain training courses). From early January 2013, high income families in receipt of child benefit in the UK will be subject to extra tax.

However, public spending on family services and tax incentives were relatively low in Ireland in 2007 (i.e. taking out cash payments to families such as child benefit). The OECD data show that total public spending on family benefits in cash, services and tax measures was 2.7% of GDP in that year, a little higher than the OECD average of 2.2% but below that in the UK (3.58%).

Final Remarks

Budget 2013 has heralded another set of challenging reforms, on top of the austerity budgets delivered so far since 2008 and there is more to come. Ireland's economic performance will depend to a large extent on the cumulative effects of the austerity and the austerity programmes underway in the UK and our other main trading partners.

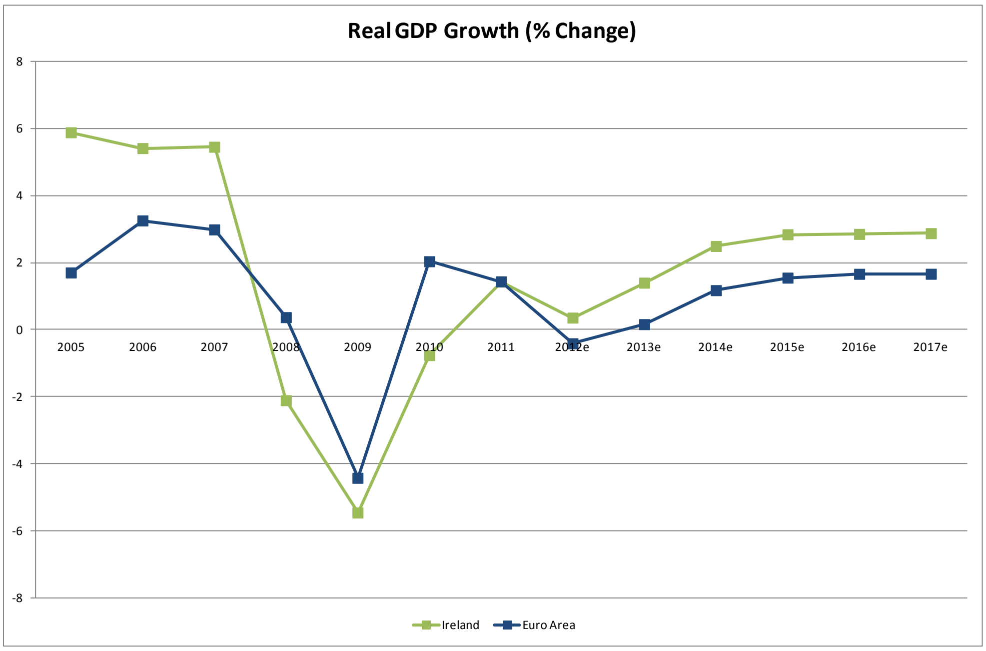
In addition to the comments made above, some of the other measures unveiled in Budget 2013 could have (unintended) adverse consequences, such as a rise in the informal or 'black' economy, less tax receipts (income and VAT) and a return of cross-border shopping. These reflect people's responses to fiscal changes (such as the rush to buy wine in supermarkets on the night the budget was announced) and show that people generally react in the manner predicted by economic principles.

Exhibits of Key Economic Performance Facts

Figure 1: Real GDP in Ireland (2005-2017)

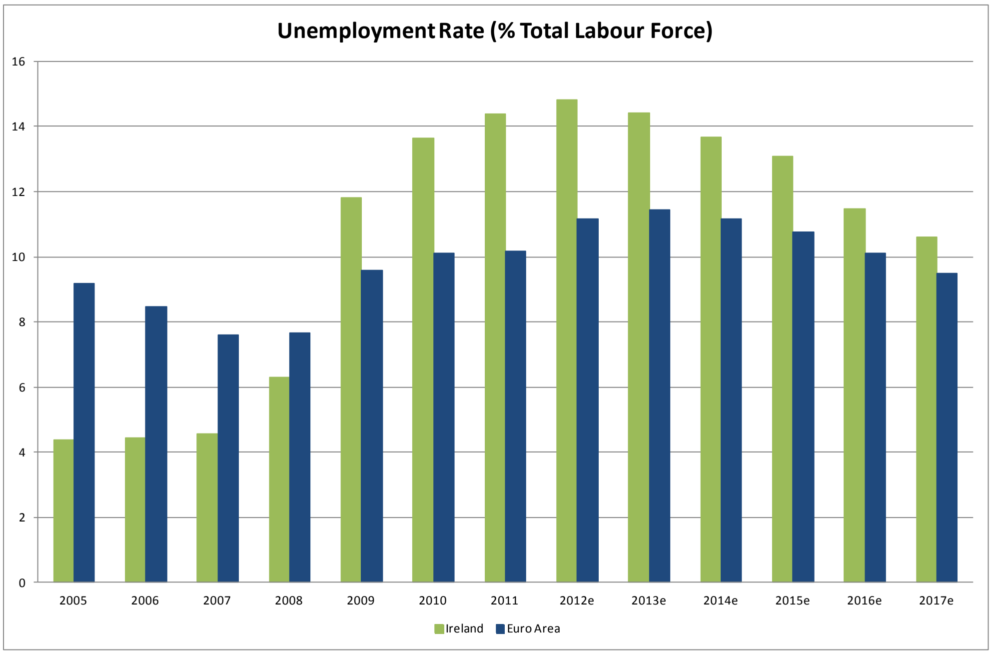
Source: IMF World Economic Outlook (October 2012).

Figure 2: Real GDP Growth in Ireland and the Euro Area (2005-2017)



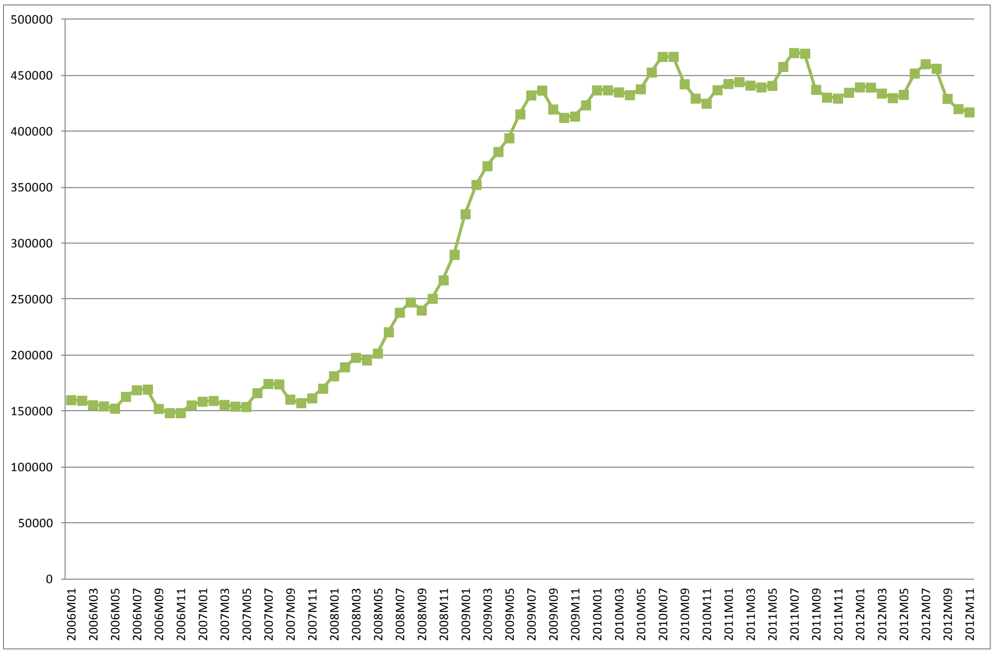
Source: IMF World Economic Outlook (October 2012).

Figure 3: Unemployment Rate in Ireland and the Euro Area (2005-2017)



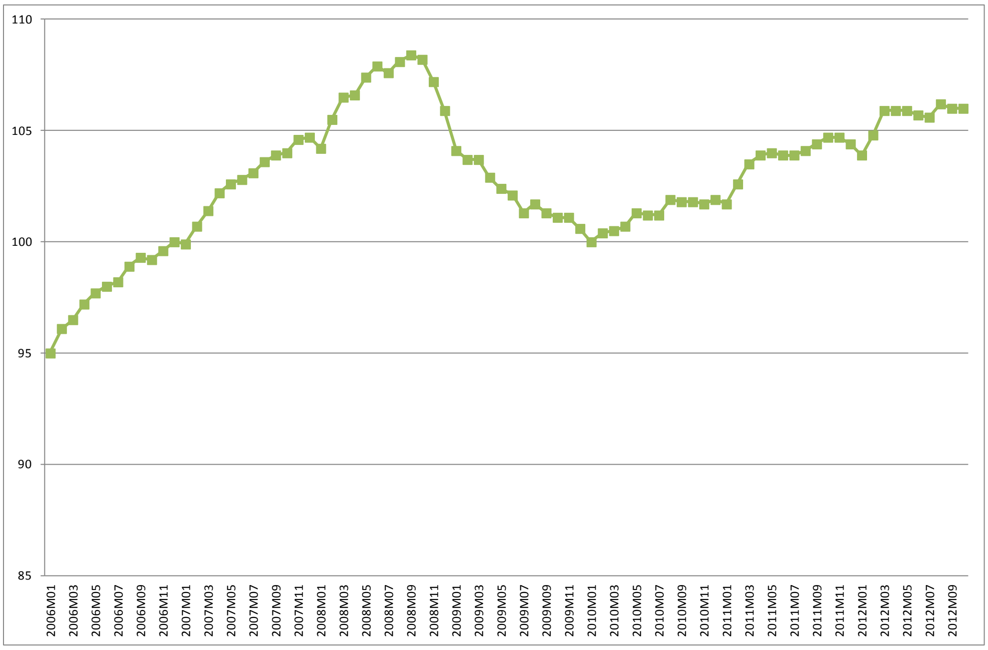
Source: IMF World Economic Outlook (October 2012).

Figure 4: Number of People on the Live Register (2006-2012)



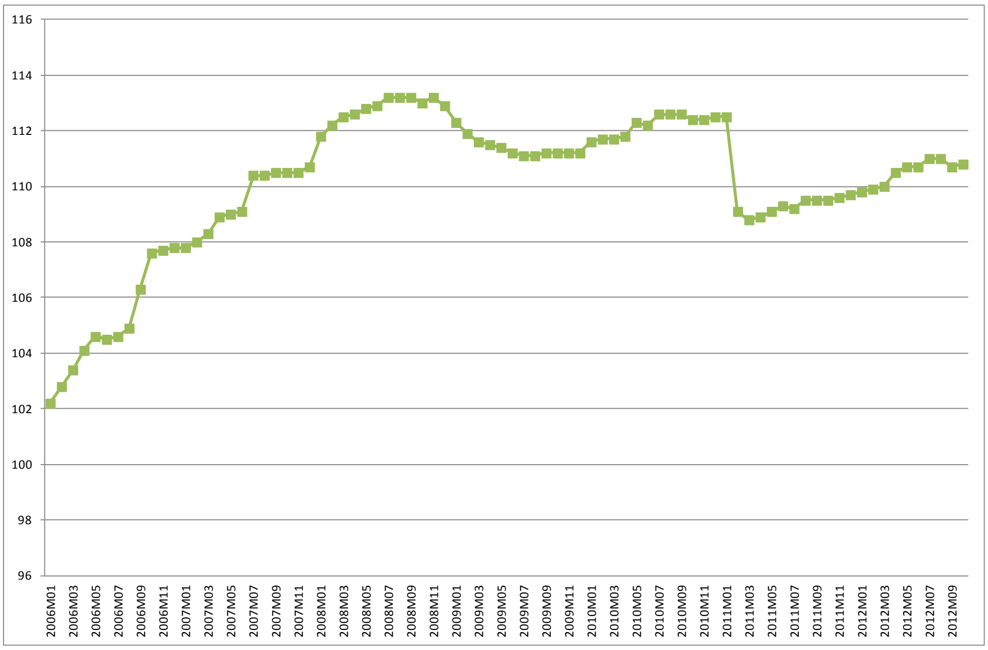
Source: CSO.

Figure 5: Consumer Price Index (2006-2012) (December 2006=100)



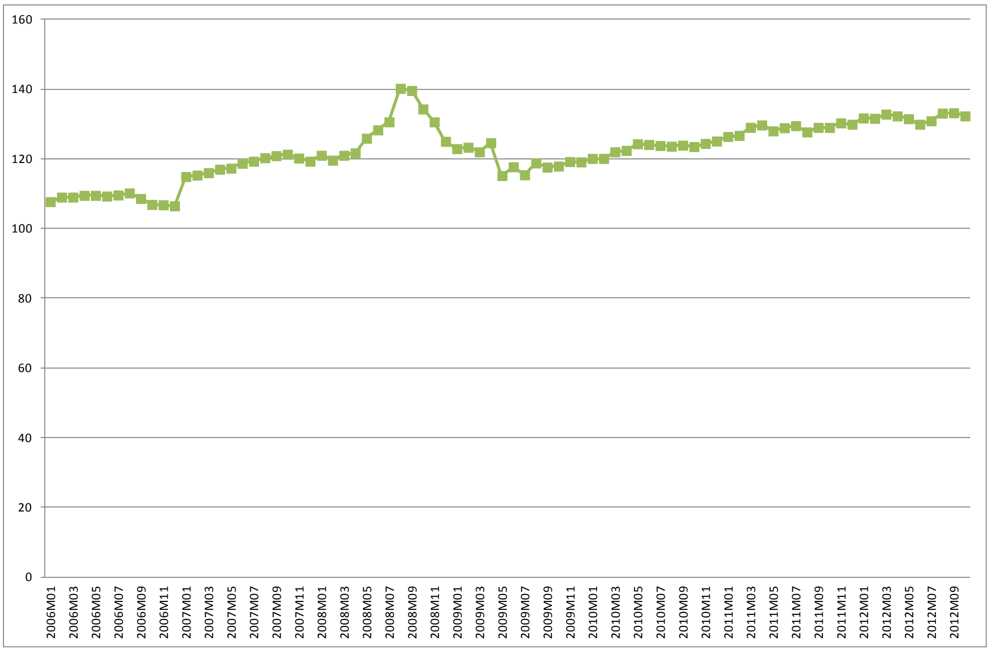
Source: CSO.

Figure 6: Capital Goods Price Index (2006-2012) (2005=100)



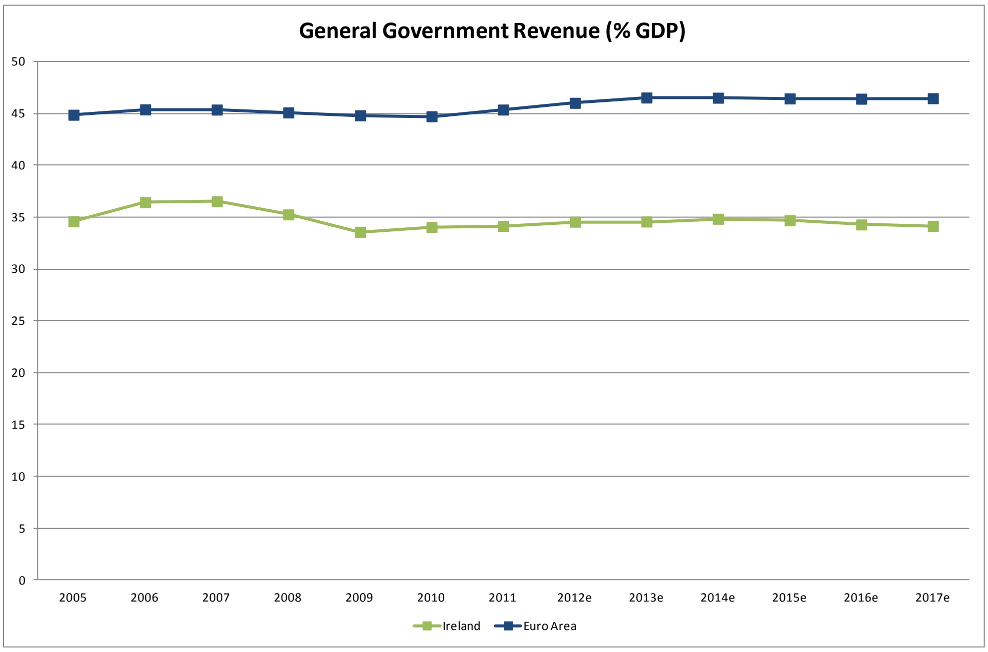
Source: CSO.

Figure 7: Industrial Price Index (2006-2012) (2005=100) – Energy Products



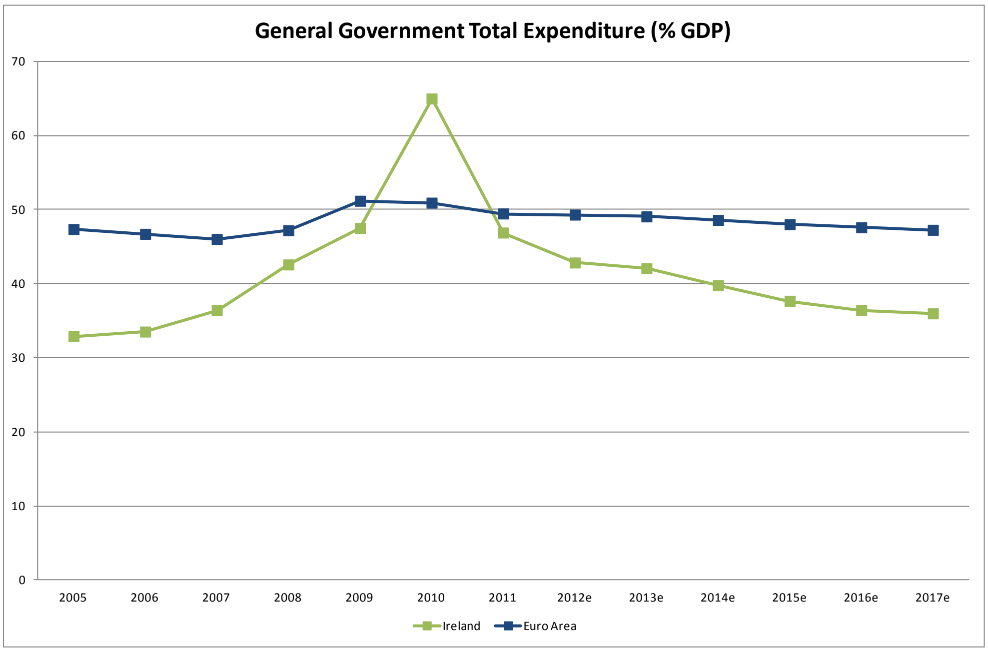
Source: CSO.

Figure 8: General Government Revenue as a Proportion of GDP in Ireland and the Euro Area (2005-2017)



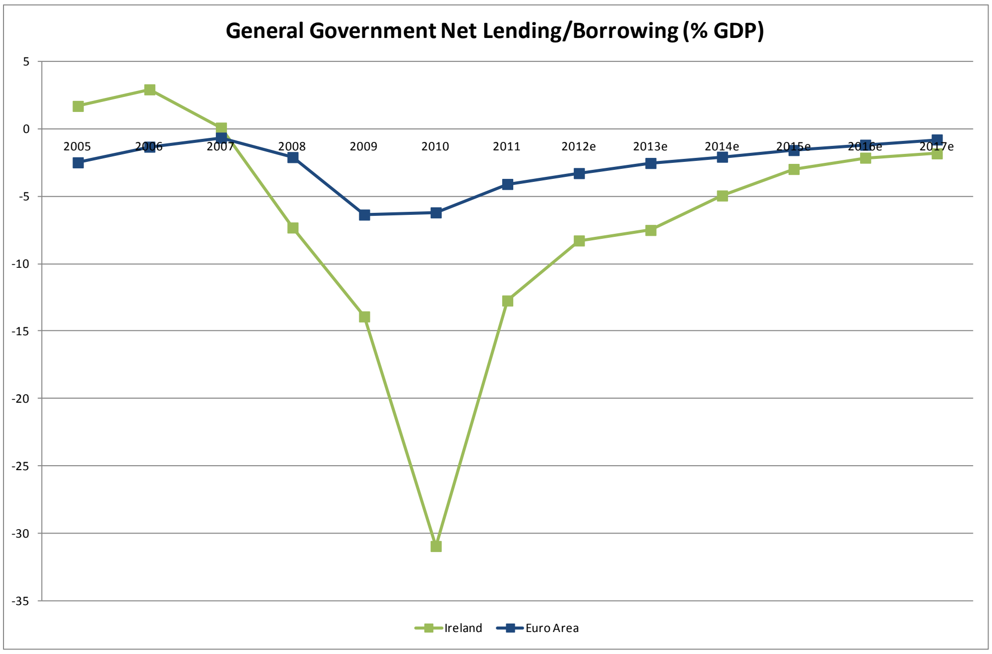
Source: IMF World Economic Outlook (October 2012).

Figure 9: General Government Total Expenditure as a Proportion of GDP in Ireland and the Euro Area (2005-2017)



Source: IMF World Economic Outlook (October 2012).

Figure 10: General Government Net Lending/Borrowing as a Proportion of GDP in Ireland and the Euro Area (2005-2017)



Source: IMF World Economic Outlook (October 2012).

Table 1: Social Protection Expenditure as a Proportion of GDP in Ireland and Selected Other Countries (2007-2010)

	Social Protection Expenditure % GDP			
	2007	2009	2010	% Change
Ireland	18.9	27.4	29.6	56.6%
Spain	20.7	25.3	25.7	24.2%
Greece	24.8	28.0	29.1	17.3%
Portugal	23.9	27.0	27.0	13.0%
EU27	26.1	29.6	29.4	12.6%
Italy	26.6	29.9	29.9	12.4%
UK	25.0	28.9	28.0	12.0%
Germany	27.9	31.5	30.7	10.0%

Source: Eurostat, PMCA analysis.

Table 2: Social Protection Benefits by Function as a Proportion of All Social Benefits in Ireland and the EU27 (2010)

	Social Protection Benefits by Function (% All Social Benefits) (2010)				
	Old Age & Survivors	Sickness, Healthcare and Disability	Family & Children	Unemployment	Housing & Social Inclusion
Ireland	23.4	48.0	12.9	12.4	3.3
EU27	45.0	37.4	8.0	6.0	3.6

Source: Eurostat, PMCA analysis.

Table 3: Income Inequality in Ireland and Selected Other Countries

	Average Gini Coefficient of Income Inequality				
	1980s	1990s	2000-2004	2005-2008	% Change
Ireland	0.331	0.324	0.309	0.306	-7.6%
GB	0.343	0.358	0.341	0.339	-1.2%
US	0.334	0.358	0.365	0.380	13.8%
OECD	0.291	0.301	0.310	0.315	8.2%

Source: OECD, PMCA analysis.

Table 4: Income Inequality and Risk of Poverty in Ireland since 2004/05

	Income Inequality in Ireland		
	2004-2005	2009-10	% Change
Gini Coefficient			
HBS Data - CSO Estimate	0.320	0.316	-1.3%
HBS Data (Grouped) - PMCA Estimate	0.341	0.340	-0.5%
SILC Data - CSO Estimate	0.324	0.312	-3.7%
At Risk of Poverty			
HBS Data - CSO Estimate	22.0%	15.5%	-29.5%
SILC Data - CSO Estimate	18.5%	15.0%	-19.2%

Source: CSO Household Budget Survey, PMCA analysis.

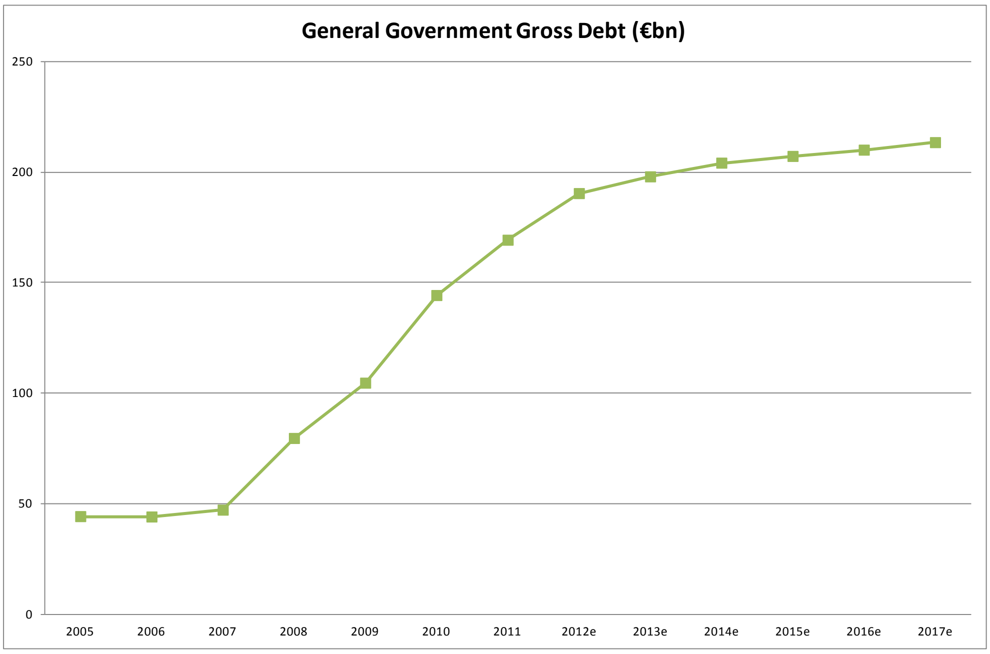
Note: PMCA estimate of the Gini coefficient based on grouped (published) HBS data in the 2004-2005 and 2009-2010 survey results using the Abounoori-McCloughan technique (2003) (Applied Economics Letters, Vol. 10, pp. 505-09, 2003) – the grouped data are reproduced below in Table 5 and note that the data are grouped by gross income decile and the first-moment distribution is by average weekly disposable income; the Gini coefficient and the at risk of poverty values for the SILC data in 2009-2010 are the averages of the corresponding Gini coefficients and at risk of poverty values for the SILC 2009 and 2010; HBS stands for Household Budget Survey; and SILC stands for Survey of Income and Living Conditions.

Table 5: Grouped Income Data from the Household Budget Survey (HBS) (2004/2005-2009/2010)

	HBS 2004-2005		HBS 2009-2010	
Gross Income Decile	Number of Households	Average Weekly Disposable Income (€)	Number of Households	Average Weekly Disposable Income (€)
1st Decile	525	157.70	508	188.91
2nd Decile	605	244.53	551	300.98
3rd Decile	684	359.06	578	431.28
4th Decile	681	488.56	604	549.20
5th Decile	710	626.69	592	669.46
6th Decile	736	781.12	594	802.56
7th Decile	761	950.20	622	972.03
8th Decile	734	1,162.83	635	1,183.82
9th Decile	741	1,419.89	605	1,472.66
10th Decile	707	2,233.03	602	2,289.38

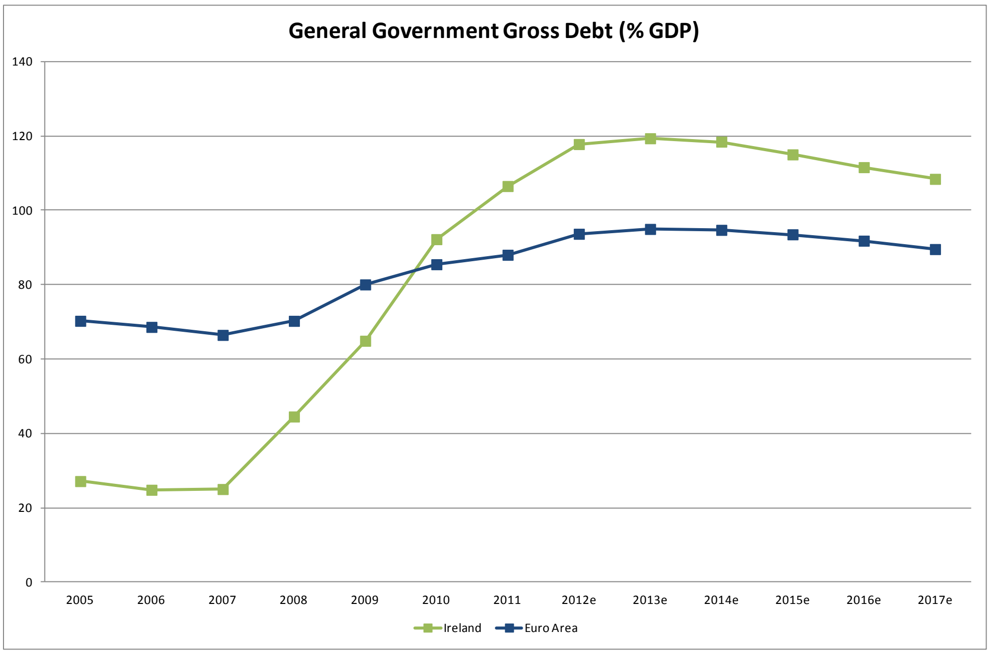
Source: CSO Household Budget Survey.

Figure 11: General Government Gross Debt in Ireland (2005-2017)



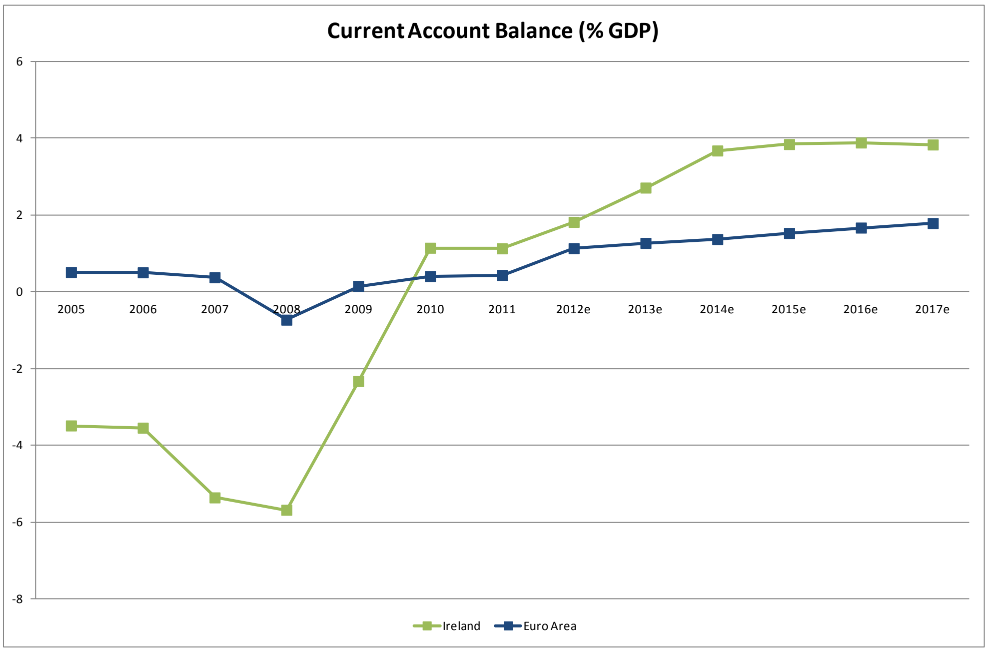
Source: IMF World Economic Outlook (October 2012).

Figure 12: General Government Gross Debt as a Proportion of GDP in Ireland and the Euro Area (2005-2017)



Source: IMF World Economic Outlook (October 2012).

Figure 13: Current Account of the Balance of Payments as a Proportion of GDP in Ireland and the Euro Area (2005-2017)



Source: IMF World Economic Outlook (October 2012).

About the Series

PMCA Economic Commentaries aim to provide independent economic analysis and insightful views on a wide range of developments in economics nationally and internationally, in a jargon-free manner. Articles are available at no cost.

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