



BUDGET 2006

OVERVIEW

The backdrop for the 2006 budget is the most favourable a Minister of Finance has faced since the era of the Celtic Tiger. GDP growth of 4.75-5.0% is being widely forecast for 2006. The public finances are also in excellent shape, with an unexpected government budget surplus in 2005. Thus, even after providing for a 7% increase in spending in the 2006 Estimates, the Minister still had an opening General Government budget surplus of €1.3 billion, before today's budget day changes.

Hence, the Minister has been able to deliver a relatively generous budget today and still target just a small General Government budget deficit of 0.6% of GDP in 2006. Indeed, by our estimates, the deficit will be even lower as the Dept's tax projections are likely to be overshoot again next year. Thus, we expect that the eventual outturn will be a General Government budget that is close to balance in 2006.

Most of the Exchequer's resources are actually allocated in the spending estimates that precede the budget. The budget, then, is largely about fine tuning and policy changes. It can prove an important and influential task. The Minister has to wisely allocate scarce budgetary resources to meet the most pressing economic and social needs. Today's budget also contained quite a considerable number of new measures.

The sizeable increases in income tax credits and bands are particularly welcome. These were frozen in the 2003 and 2004 budgets, pushing low paid workers into the tax net and many middle income earners onto the top tax rate. Today's income tax cuts are the most generous since 2001, costing €681 million in a full year. They should help ensure continued strong growth in labour supply and could have a positive impact on the upcoming pay talks.

Increases in indirect taxes were avoided, which will help sustain the low inflation environment, helping competitiveness. The Minister ended some tax exemptions, especially on many property-based tax incentive schemes. He also capped the size of pensions funds at €5 million for high income earners. Meanwhile, measures are likely to be contained in the Finance Bill to encourage more low income earners to make pension contributions.

On the expenditure side, additional resources were allocated for child benefit payments. As expected, the increases in these payments are being mainly targeted at pre-school children, where childcare costs are greatest. Other sectors to benefit in the budget were social welfare recipients, with generous increases in all payments. Additional resources were also provided for services for the elderly in need of care. Capital spending was also increased.

Overall, the focus of the budget was very much on ensuring continuing robust economic growth but also greater social inclusion, as in the 2005 budget. Overall, it is a generous and politically astute budget that it is likely to be broadly welcomed. At the same time, it maintains the public finances in good order with the the General Government budget likely to be close to balance in 2006. Further out, the Dept is forecasting continuing small budget deficits in 2007 and 2008, with the Government debt/GDP ratio stable at 28%.

**AIB Global
Treasury
Economic
Research**

**John
Beggs**
Chief
Economist

**Oliver
Mangan**
Chief Bond
Economist

**Geraldine
Concagh**
Senior
Economist

**Jenny
Pollock**
Senior
Economist

Oliver Mangan/Jenny Pollock - 7th December 2005

BUDGET 2006: KEY FEATURES

2006 BUDGET TARGETS

- * **Exchequer Deficit** of €2,927m (2.0% of GNP) in 2006, compared with government expectations for a 2005 deficit of €852m (0.6% of GNP). **General Government Deficit** of €952m (0.6% of GDP) in 2006 against an expected 2005 surplus of a €497m (0.3% of GDP).
- * The Exchequer Deficit is projected to measure 1.9% and 1.8% of GNP in 2007 and 2008 respectively, with the General Government Deficit estimated at 0.8% of GDP in both these years.
- * The General Government Debt as a percentage of GDP is projected to be 28.0% in 2006, unchanged from 2005. This is expected to remain broadly stable in 2007 and 2008 at 28.2% and 28.3% respectively.

EXPENDITURE MEASURES

Current Spending

- * Gross Non-Capital supply services expenditure figure for 2006 at €37.3 billion, up 11% on the 2005 level.
- * Budget day Social Welfare measures totalling €1,065m in 2006 and €1,120m in a full year.
- * Old age pensions increased by €14 per week, bringing the Old Age Contributory Pension to €193.30 per week, effective from January 2006. Other personal social welfare rates increased by up to €17 per week.

Childcare/Maternity

- * Child Benefit increased by €8.40 for first and second children to €150 per month; and by €7.70 per month for each of the third and subsequent children to €185 per month, effective from April 2006.
- * Early childcare supplement of €1,000 per year, paid quarterly, up to a child's 6th birthday.
- * Individuals providing child minding facilities to be able to earn up to €10,000 per year tax free.
- * Investment programme aimed at providing an additional 50,000 childcare places by 2010.
- * Maternity benefit increased from 75% to 80% of reckonable earnings.
- * Paid and unpaid maternity leave both increased by 4 weeks from March 2006, additional 4 weeks from March 2007.

Elderly

- * Additional funding for services for the elderly in need of care totalling €110m in 2006 and €150m in a full year.

Carers

- * Increased carers allowances and other improved benefits.

Education

- * €300m over 5 years allocated to Strategic Innovation Fund with commitment to increase number with Ph.D qualifications.

Capital Spending

- * Additional €469m in capital expenditure measures.
- * Gross voted capital expenditure is projected to rise to €6.7m in 2006, an increase of 12% on the 2005 level.

TAXATION MEASURES

PRSI

- * Employee PRSI ceiling raised from €44,180 to €46,000, an increase of 5.5%.

Income Tax

- * Basic single person tax credit increased by €50 to €1,630. Married person credit increased by €100 to €3,260.

- * The standard tax band to be widened by €2,600 to €32,000 (+9%) for a single person; for a married couple with one income by €2,600 to €41,000; for a married couple with two earners by €5,200 to €64,000, subject to a limit on the transferability of individual bands of €41,000.
- * Employee PAYE tax credit increased by €220 to €1,490 (+17%).
- * Health Levy threshold increased €40 per week to €440.

VAT and Excise Duties

- * Excise Duty on home heating oil halved in order to remove differential with Northern Ireland over next two years.
- * No other changes in VAT or Excise Duties.

Property

- * No changes to property taxation

Pensions

- * Finance Bill to contain measure to encourage pension savings by low wage earners and those not taking up their full entitlement.
- * Total allowable pension fund at retirement capped at €5m and tax free lump on retirement at €1.25m.
- * Approved Retirement Funds to be subject to some income tax to prevent use for tax deferral.

Tax Exemption/Relief Schemes

- * Measures introduced to limit the use of tax breaks by those with high incomes (gross income plus reliefs totalling €250,000). Tax exemption for artists to remain, subject to these measures.
- * Most property-based tax incentive schemes to be discontinued on a phased basis.
- * End of tax exemption for profits from stallion and greyhound fees from July 2008

Business Taxation

- * Bank Levy was not renewed.
- * VAT Registration threshold for small business increased.
- * Companies Capital Duty abolished.

Green Measures

- * Excise relief for Biofuels.
- * Vehicle Registration Tax relief for flexible fuel vehicles.
- * Establishment of Carbon Fund to enable State to purchase Carbon Credits.

Capital Gains Tax

- * No changes in capital gains taxes.

Other Measures

- * Betting tax cut from 2% to 1% from July 2006, to be borne by the industry.
- * Package of tax reliefs for the farming community.

CORPORATE IMPACT

- * This is a stimulatory budget with sizeable increases in government spending, generous social welfare rises and significant increases in income tax allowances.
- * The minimal impact on inflation will protect competitiveness.
- * The Dept's forecast a General Government deficit of under 1% of GDP will be welcomed.
- * Continued commitment to capital spending measures to reduce the infrastructural deficit will also be welcomed.

BUDGET ASSESSMENT

EBR Forecast At €2.9bn In 2006

The table below sets out the principal features of the 2006 budget arithmetic. Central Fund expenditure is forecast to rise by almost 10% reflecting higher debt interest payments and increases in international payments, including the EU budget contribution. Net supply service spending is forecast to rise by 12.2% next year.

Turning to the other side of the balance sheet, non-tax current revenue is expected to be largely unchanged in 2006. Meanwhile, the tax changes announced in the budget will cost €763 million in gross terms but just €275 million in net terms next year, when allowance is made for the impact on the buoyancy of tax receipts of the budget giveaways. Tax receipts are forecast to rise by a modest 6% in 2006.

On the current side, then, the budget surplus is projected to fall to €4.4bn from €6.1bn in 2005. On the capital side, net voted expenditure is forecast to rise by 12%. Capital receipts are expected to rise by almost €600m next year. As a result, the capital borrowing requirement is projected to rise only modestly to €7.3bn from €7.0bn in 2005.

Overall, then, the government is forecasting an Exchequer Borrowing Requirement of €2.9bn in 2006, up from an estimated EBR outturn of €0.85bn in 2005. The Minister is targeting a small General Government deficit of just under €1bn next year, or 0.6% of GDP. This compares to an estimated surplus in 2005 of €0.5bn (+0.3% of GDP).

General Government Budget Maybe Close To Balanced

How realistic are the Minister's budgetary targets? Every year sees an undershoot on debt interest payments in the Central Fund. Interest savings are likely again next year. Meanwhile, supply service spending has come in slightly under target in the past two years. Against this, no provision has been made in the 2006 budget for a new pay deal. Thus, current spending may finish the year close to target.

BUDGET 2006				WHITE PAPER TAX REVENUE PROJECTIONS			
(€ Million)	2005 Projected Outturn	2006 Budget Target	% Change	(€ million)	2005 Projected Outturn	2006 Opening Position	Chg. %
Current Spending	33,799	37,824	11.9	Excise Duties	5,235	5,520	5.4
<i>of which</i>				VAT	12,125	12,760	5.2
(i) Central Fund	3,956	4,339	9.7	Income tax	11,400	12,420	8.9
(ii) Supply Services	29,843	33,485	12.2	Corporation Tax	5,470	6,005	9.8
Current Revenue	39,910	42,220	5.8	Capital Taxes	2,215	2,285	3.2
<i>of which</i>				Stamp Duties	2,630	2,690	2.3
(i) Tax	39,308	41,650	6.0	Other	235	245	4.3
(ii) Non-Tax	602	570	-5.3	Total	39,310	41,925	6.7
Current Budget Surplus	6,112	4,397					
Capital Borrowing	6,964	7,324					
Exchequer Bal.	-852	-2,927					
(% of GNP)	(-0.6%)	(-2.0%)					
General Gov. Bal.	497	-952					
(% of GDP)	(+0.3%)	(-0.6%)					

Capital receipts are likely to be close to target. Capital spending should also be close to target as there is scope for government departments to hold on to up to 10% of their allocation if monies remain unspent. This can be carried forward into the following year. Even so, capital spending still came in slightly below target in both 2004 and 2005 and may do so again in 2006. Hence, capital borrowing may be slightly below target. As usual, though, the main uncertainty in relation to the budget outturn relates to tax revenues.

Cautious Tax Forecasts

Tax receipts have overshoot target by around €2 billion in each of the last two years. Although this was partly due to special investigations by the Revenue Commissioners into tax evasion, most of the overshoot reflected a higher than expected take from general taxation, most notably capital taxes, stamp duties and VAT receipts.

The White Paper on Receipts and Expenditure estimates that tax receipts will rise by 6.7% in 2006, before today's budget changes. This seems rather modest but the tax take in 2005 was boosted by some €0.5 billion from Revenue investigations into tax evasion. Allowing for this factor, the White Paper projects a rise in tax receipts next year of 8%, broadly in line with the expected nominal growth rate of the economy.

This seems reasonable enough. However, when one looks at some of the individual tax heads, the Dept forecasts actually seem quite cautious. The receipts from three tax heads which overshoot target in the past two years - capital taxes, stamp duties and VAT - are forecast to rise by just 3.2%, 2.3% and 5.2%, respectively, in 2006. At end November 2005, though, capital taxes, stamp duties and VAT receipts were up by 27%, 28% and 13.6%, respectively. On a carryover basis, alone, these tax headings should record further strong growth in 2006. We think that they could overshoot target by around €1 billion in total next year.

On the other hand, the White Paper forecast growth of 8.9% in income taxes (or 14% excluding proceeds from Revenue investigations) and 9.8% in corporation taxes seems a bit optimistic, especially given the modest growth in these tax categories in 2005. Maturing SSIA's will start to have some positive impact on income tax revenue in 2006. Nevertheless, receipts from these two tax heads could undershoot target by up to €0.5 billion next year.

Thus, overall, we think that total tax receipts could be some €500 million ahead of projection. Overall spending should be close to target. Thus, the EBR could come in at about €500 million below target in 2006. This implies that the General Government budget could be quite close to balance, with small a deficit of just €500m or 0.3% of GDP likely in our view.

A Stimulatory Budget

The Minister started today with an opening current budget surplus of €5.77 billion, which was almost €1 billion higher than in 2005 and €2.5 billion more than in both 2004 and 2003. At a broader level, he also had an opening General Government surplus of €1.3 billion. These large opening surpluses indicate that the Minister was in a position to deliver a generous package of budget giveaways today. He did not disappoint.

On the current budget side, increases in social welfare benefits announced today will cost over €1 billion in 2006. A key component of this year's budget is the National Childcare Strategy costing €314m in 2006, mainly on additional payments for children under 6 years. Additional spending was also announced on homecare for the elderly. Meanwhile, on the capital side, the Minister provided for an additional €469m in spending.

ANALYSIS OF MAIN BUDGET DAY CHANGES (€M)					
	2002	2003	2004	2005	2006
Social Welfare	968	501	608	834	1,065
Other Current (non-pay)	395	3	65	37	446
Capital Expd.	550	209	50	334	469
Tax Changes	+710	+944	-17	-578	-763
Buoyancy Effect	538	227	181	333	488
Net Tax Change	+1,248	+1,171	+164	-245	-275

On the revenue side, this was a reasonably generous tax cutting package, including €681m in income tax reductions. However, some of the social welfare rises and tax cuts will flow back into the Exchequer coffers in higher tax revenues. Overall, as a result of today's measures, the Minister reduced his opening General Government surplus by €2.25m.

The increases in social welfare payments and child benefits and reductions in income taxes total some €2.1bn in 2006. This will boost household disposable income by 2.3%, providing a considerable boost to household spending power. Furthermore, following today's budget, gross current voted government expenditure is set to rise by 11% in 2006. On the capital side, underlying voted expenditure will rise by 18%. Overall, the tax cuts and large spending rises point to a stimulatory budget.

The EBR is forecast to rise from 0.6% of GNP in 2005 to 2.0% in 2006, pointing to a stimulatory budget. Meanwhile, in cyclically adjusted terms, the Dept estimates that the General Government budget balance will fall by 0.6% of GDP in 2006, again suggesting an expansionary budget.

Big Income Boost For Families With Young Children

The table below shows that taxpayers will benefit significantly from the budget, reflecting the increase in the tax credits, the widening of the standard tax band and higher child benefit payments. Families with young children fared best in the budget. Overall, the budget will boost the take home pay of most single people by around 1.5%. Families with two earners and two older children, earning €50,000, will also see their net income rise by 1.5%, while one income families with two young children will see their net income rise by between 3% and 7%.

BUDGETARY CHANGES TO INCOME TAX/PRSI/CHILD BENEFIT IMPACT ON TAXPAYERS (1)								
--- Single Person --			---- Married Couple (2) -----			--- Married Couple (3) ---		
Income €	Total Gained	Gain as % of Net Income	Total Gained	Of which Child Benefit	Gain % of Net Income	Total Gained	Of which Child Benefit	Gain % of Net Income
	€		€			€		
20,000	270	1.5	151	151	0.6	1,651	1,651	7.2
30,000	402	1.6	451	151	1.4	1,971	1,651	6.4
50,000	760	2.1	691	151	1.5	2,462	1,651	5.7
80,000	755	1.4	1,749	151	2.7	2,457	1,651	4.1
120,000	750	1.0	1,747	151	2.0	2,451	1,651	3.0

1. Full rate PRSI contributors. 2. Married Couple, two earners, two older children. 3. Married couple, one earner, two young children.

THE ECONOMIC OUTLOOK

4.75 - 5.0% GDP Growth Consensus For 2006

Although there is still considerable uncertainty about the outturn for 2005, most commentators now estimate that the Irish economy grew by around 4.5% this year, broadly the same as in 2004. What is clear, though, is that growth in the economy in 2005 was very much driven by domestic demand. Both consumer spending and fixed investment have grown strongly this year. Exports, on the other hand, have performed poorly, with national accounts data showing static exports in the opening half of the year.

There is a striking consensus amongst forecasters that GDP growth will accelerate modestly to 4.75 - 5.0% in 2006. The external environment is expected to remain favourable, with a pick up in growth in Europe forecast for next year. On the domestic front, fiscal policy will be expansionary again next year. Although interest rates are now rising, monetary policy is expected to remain accommodatory as just a modest increase in official rates is anticipated in 2006. Meanwhile, SSIA accounts will start to mature from Q2 2006 onwards, providing a major boost to household disposable income.

2006 IRISH MACRO ECONOMIC FORECASTS (%)						
	AIB	D/Finance	ESRI	Central Bank	EC	OECD
GDP	5.0	4.8	5.0	4.75	4.8	5.0
GNP	5.0	4.6	4.9	4.5	NA	NA
Private Cons	6.0	5.8	5.8	5.75	5.3	5.1
Gov Expd.	4.0	3.5	3.6	3.5	3.0	5.5
Fixed Inv.	2.5	4.7	3.4	3.0	3.2	5.3
Exports	5.0	4.0	4.8	5.25	5.1	5.4
Imports	4.5	4.5	4.7	5.25	4.6	5.8
CPI	3.2	2.7	2.5	2.5	NA	NA
HICP	2.3	2.0	2.6	2.75	2.5	2.5
Employment	3.4	3.1	2.5	2.3	2.2	NA
Unemployment Rate	4.2	4.3	4.2	4.25	4.4	4.2

Not surprisingly, then, consumer spending is expected to be the main engine of growth in the economy next year. Solid growth is also expected in government spending and fixed investment. Exports are forecast to improve on their weak performance in 2005, helped by stronger growth in Europe, a more favourable exchange rate and signs of a revival in Irish manufacturing activity in H2 2005. Overall, GDP growth in 2006 is forecast at 5% by AIB, close to the trend growth rate of the economy.

A notable feature of the economy in 2005 has been the strong growth in employment, which is likely to increase by around 4.5%. Most forecasters expect a significant slowdown in employment growth in 2006 to 2.2-2.5%. AIB is more optimistic and sees employment rising by close to 3.5% next year. The slower growth in employment forecast for 2006 reflects an expectation that the strong uptrend in construction employment will level off next year. Meanwhile, the unemployment rate is forecast to remain low at around 4.2%.



Inflation To Remain Well Behaved

Turning to inflation, most public agencies, apart from the Dept of Finance, are forecasting that the Irish HICP rate will average between 2.5 - 2.75% in 2006. AIB is slightly more optimistic at 2.3%, possibly reflecting the fact that we are assuming that oil prices will average less than \$60 a barrel next year. We would point out that the Irish HICP rate, excluding energy, is currently running at 1.8%. Meanwhile, the Dept is forecasting a 2% HICP rate next year.

However, AIB's 2006 CPI forecast of 3.2% is significantly above other forecasts. This reflects the fact that we have built in two further 0.25% hikes in ECB rates in 2006 into our CPI forecasts, which boosts the headline CPI rate significantly.

Main Risks To Economy Are External

In its recent Economic Outlook, the OECD argued that the balance of risks to its 5% GDP growth forecast for the Irish economy in 2006 is tilted to the downside. It identified an abrupt decline in housing activity as the key domestic risk to the favourable outlook for the economy. On the external side, it identified a marked slowdown in the UK economy or a bout of euro appreciation against the dollar as downside risks, especially for Irish exports.

We are more sanguine, especially in relation to the prospects for the housing market next year. Strong underlying demand for housing as well as the steady trend in leading indicators for the sector point to housing activity being sustained at its current high levels in 2006.

In our view, the main downside risks for the economy are external. Oil prices and the risk of a disruption to oil supply remain a concern. The continuing imbalances in the US economy are also a cause for concern. There are also some signs of a possible weakening in the US housing market, which could have serious knock-on consequences for the rest of the American economy. Any of these factors could trigger a renewed downturn in the dollar next year.

Overall, though, the external economic environment looks broadly favourable for the coming year. The domestic economy, meanwhile, looks set for strong growth, with maturing SSIA accounts set to deliver a major boost to activity in 2006 and 2007. Thus, there is little on the horizon that points towards a marked deterioration in the public finances. Hence, the Dept of Finance is forecasting just small General Government budget deficits over the next three years, averaging 0.75% of GDP.

Little Funding For The NTMA To Do In 2006

It is likely that Exchequer cash balances at end 2005 will be close to their level of the start of the year of €2 billion, a very healthy position. The government is forecasting an Exchequer Borrowing Requirement of €2.9bn for 2006. There is very little by way of maturing bonds next year, with just of €100 million of government bonds due for redemption. Thus, assuming unchanged Exchequer balances, the NTMA will need to raise €3bn in 2006.

This could be easily done through increasing the size of existing benchmark bonds, in particular the 4.6% 2016 issue. This is no benchmark five year bond in the Irish market at present. Thus, an alternative option for the NTMA would be to buy back some short-dated bonds and issue a new five year 2011 benchmark stock, which could also be used for funding purposes. Either way, the NTMA faces a very limited funding agenda in 2006, for the second year running.