

BUDGET 2005

OVERVIEW

The last two budgets did not provide for any increase in personal income tax credits or the standard rate band. The result of the freezing of these allowances was that many low paid workers remained in the tax net, while the proportion of income earners paying tax at the top rate rose from 26.7% in 2002 to 32.6% in 2004. Thus, it was critical that today's budget started to redress this situation. At a minimum, it needed to ensure that the income tax burden on workers did not rise further in 2005.

Indeed, it is worth pointing out that tax receipts overshot target by €0.5bn in 2003 and €2.3bn in 2004. Meanwhile, the General Government budget balance remained unexpectedly in surplus in both years. Thus, there was scope in the past two years to fully index personal income tax credits and the standard rate tax band.

The continued success of the Irish economy is very much dependent on strong labour force growth. With the unemployment rate at a relatively low level of 4.5%, and demographics turning less favourable, continued strong labour force growth is becoming more dependent on rising participation rates and net inflows of migrant workers. Taxation policy should not act as a disincentive to labour force growth in this regard.

Thus, the increases in personal income tax credits, the employee tax credit and the standard rate band in today's budget are very much to be welcomed. The tax cuts were very much focused on low paid workers with those on the minimum wage being taken out of the tax net altogether. The standard rate tax band was increased by 5% for all earners, broadly in line with wage inflation. The income tax package will cost €508m in 2005 and €682m in a full year.

Today's budget was also very much about social inclusion. The social welfare package was very generous, costing €902m in a full year, compared to €630m in last year's budget and a €530m package in the 2003 budget. Most social welfare weekly rates will rise by between €12 and €14. Significant increases in spending on disability services were also announced. Child benefit payments are to be increased by €10-12 per month.

Taken together, the income tax cuts and social welfare increases announced today will cost €1.35bn in 2005, boosting personal disposable income by some 1.8%. This suggests that the 2005 budget is expansionary. The relatively generous increases in spending, with voted current spending rising by 9% and voted capital spending up an underlying 15%, also suggest that this is a relatively stimulatory budget.

Not surprisingly, then, the General Government budget balance is forecast to move from a surplus of €1.35bn (+0.9% of GDP) in 2004 to a deficit of €1.2bn (-0.8% of GDP) in 2005. In cyclically adjusted terms, the Dept of Finance estimates that the budget balance will disimprove by 1.4% of GDP. This also points to an expansionary budget. In particular, it should boost personal consumption and fixed investment and help underpin the housing market. However, it should not prove unduly inflationary, especially with no increase in indirect taxes.

There is a fairly broad consensus that the economy will grow by around 5% next year, close to its trend rate. Inflationary pressures are expected to remain relatively subdued with the CPI forecast to rise by around 2.5%. Strong job growth and low unemployment are expected to continue with the public finances remaining in excellent shape. While it may not match the feats of the Celtic Tiger era, it is still pretty close to economic nirvana.

**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 - 1st December 2004

BUDGET 2005: KEY FEATURES

2005 BUDGET TARGETS

- * **Exchequer Deficit** of €2,988m (2.3% of GNP) in 2005, compared with government expectations for a 2004 deficit of €202m (0.2% of GNP).
 - * **General Government Deficit** of €1,200m (0.8% of GDP) in 2005 against an expected 2004 surplus of a €1,348m (0.9% of GDP).
 - * The Exchequer Deficit is projected to measure 2.1% of GNP in both 2006 and 2007, with the General Government deficit estimated at a 0.6% GDP in each of these years.
 - * The General Government Debt as a percentage of GDP is projected to be marginally lower at 30.1% in 2005 from 30.5% in 2004. This is expected to remain broadly stable in 2006 and 2007 at 30.1% and 30.0% respectively.
-

EXPENDITURE MEASURES

Current Spending

- * Budget day Social Welfare measures totalling €834m in 2005 and €902m in a full year.
- * Old age pensions increased by €12 per week, bringing the Old Age Contributory Pension to €179.30 per week, effective from January 2005.
- * Other maximum personal social welfare rates increased by €14 per week.
- * Child Benefit increased by €10 for first and second children to €141.60 per month; and by €12 per month for each of the third and subsequent children to €177.30 per month, effective from April 2005.
- * Gross Non-Capital supply services expenditure figure for 2005 at €38.8 billion, up 8.9% on the 2004 level.

Capital Spending

- * Additional €334m in capital expenditure measures.
- * Gross voted capital expenditure is projected to rise to €6,057m in 2005, an increase of 10.4% on the 2004 level.
- * Period of capital envelope for transport extended to 10 years to give greater flexibility and clarity in planning investment in transport.

Services for People with a Disability

- * An additional €75m in capital spending is being allocated on top of the €290m in resources allocated in the Estimates. A multi-annual investment programme is being introduced for disability support services over 2006-2009. Over the four years, this will involve €600m in current spending and €300m in capital spending.
-

TAXATION MEASURES

PRSI

- * Employee PRSI ceiling raised from €42,160 to €44,180, an increase of 4.8%.

Income Tax

- * Basic single person tax credit increased by €60 to €1,580. Married person credit increased by €120 to €3,160.
- * The standard tax band to be widened by €1,400 to €29,400 for a single person and for a married couple with one income by €1,400 to €38,400.
- * The standard tax band for a married couple with two earners increases by €2,800 to €58,800, subject to a limit on the transferability of individual bands of €38,400.
- * Employee PAYE tax credit increased by €230 to €1,270.
- * Health Levy threshold increased €44 per week to €400.

VAT and Excise Duties

- * No change in VAT or Excise Duties.

Property

- * Purchases by first time buyers of second hand properties up to €317,500 exempt from stamp duty. Rate of duty reduced on properties up to €635,000.
- * Level of rent paid for private rented accommodation on which tax relief can be claimed increased by €230 to €1,500 per annum for a single person and by €460 to €3,000 for a married couple.

Business Taxation

- * Rate of duty charged on issuing of share capital reduced from 1% to 0.5%.

Capital Gains Tax

- * No changes in capital gains taxes.

Other Measures

- * Complete review and evaluation of tax incentives and exemptions announced with a view to introducing measures in next year's budget.
- * Stamp duty relief from the double charge arising from switching financial cards such as credit, charge and ATM and laser cards.

CORPORATE IMPACT

- * The budget is broadly pro-business with a focus on protecting and increasing jobs in a more competitive environment.
- * It is also 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 medium term commitment to maintain the general government deficit at below 1% of GDP will be welcomed.
- * Capital spending measures to reduce the infrastructural deficit will also be welcomed.

BUDGET ASSESSMENT

EBR Projected To Rise To €3bn In 2005

The table below sets out the principal features of the 2005 budget arithmetic. Central Fund expenditure is forecast to rise by almost 10% reflecting higher debt interest payments and a big jump in the contribution to the EU budget. Net supply service spending is forecast to rise by just over 10% next year, with the Minister announcing increases in social welfare spending in the budget amounting to €900m in a full year.

Turning to the other side of the balance sheet, non-tax revenue is forecast to fall by €171m in 2005 because of a decline in the central bank's surplus income. Meanwhile, the tax changes announced in the budget will cost €600m in gross terms but just €270m in net terms when allowance is made for the impact of the buoyancy of tax receipts of all the budget day giveaways. Tax receipts are forecast to rise by a modest 5% in 2005. The Dept has allowed for €200m in receipts from Revenue Commissioners' investigations into tax evasion.

On the current side, then, the budget surplus is projected to fall to €4.1bn from €5.55bn in 2004. On the capital side, net expenditure is forecast to rise sharply by over 20% or €1.4bn. This is partly due to timing factors in relation to EU payments which will rise by €643m in 2005. This will unwind in 2006. Capital receipts are expected to rise by €81m next year. As a result, the capital borrowing requirement is projected to rise to €7.1bn from €5.8bn in 2004.

Overall then, the government is forecasting an Exchequer Borrowing Requirement of €3bn in 2005, up from an estimated EBR outturn of €0.2bn in 2004. The Minister is targeting a General Government deficit of €1.2bn next year, or 0.8% of GDP. This compares to an estimated surplus in 2004 of €1.35bn (+0.9% of GDP).

EBR Target May Be Undershot

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 close to target in the past two years and there is no reason why the spending projections should not be met in 2005.

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 to fund projects in the following year. Even so, capital spending still came in slightly below target in 2004 and may do so again in 2005. Hence, capital borrowing may be close to or slightly below target. As usual, then, the main uncertainty in relation to the budget outturn relates to tax revenues.

BUDGET 2005				ANALYSIS OF BUDGET DAY CHANGES (CURRENT)			
(€Million)	2005 Projected Outturn	2005 Budget Target	% Change	(€ million)	2003	2004	2005
Current Spending	30,905	34,009	10.0	Opening Balance *	+3,401	+3,227	+4,867
<i>of which</i>				Closing Balance	+3,685	+2,989	+4,092
(i) Central Fund	3,658	4,012	9.7	Net Change	+284	-238	-775
(ii) Supply Services	27,247	29,997	10.1	Spending Increases	887	402	505
Current Revenue	36,468	38,101	4.5	Tax Changes	+944	-17	-603
<i>of which</i>				Buoyancy Effect	+227	+181	+333
(i) Tax	35,700	37,505	5.1	Net Change in	+1,171	+164	-270
(ii) Non-Tax	768	596	-22.4	Tax Revenue **			
Current Budget Surplus	5,563	4,092					
Capital Borrowing	5,765	7,080					
Exchequer Balance	-202	-2,988					
(% of GNP)	(-0.2%)	(-2.3%)					
General Government Balance	1,348	-1,200					
(% of GDP)	(+0.9%)	(-0.8%)					

* The opening current budget balance takes account of departmental balances, pre-budget revisions to the Estimates and any adjustments to the Central Fund or non-tax revenue

** Allowing for impact of buoyancy effects

Having undershot target by large amounts in 2001 and 2002, tax revenues overshot target significantly in the last two years. The Dept of Finance has forecast a modest rise of 5.75% in tax receipts in the 2005 White Paper. This seems rather low given that economic growth is likely to be of the order of 8% in nominal terms in 2005. However, tax receipts were boosted by €900m in 2004 through accelerated payments of capital gains and disclosures of non-residents accounts. Allowing for these windfalls, and a provision for €200m in receipts next year from Revenue Commissioners' enquiries into tax evasion, the underlying increase projected for tax receipts in 2005 is 7.9%. This compares with an underlying rise of 8.5% in tax receipts in 2004.

However, the Exchequer could receive much more than €200m in 2005 as a result of enquiries by the Revenue Commissioners into tax evasion, as happened in 2004. Thus, there could be a significant undershoot of the EBR target in 2005 for a third consecutive year, resulting from higher than expected tax receipts in particular, as well as savings on the Central Fund and capital spending. As a result, the General Government budget outturn may be close to balance.

A Stimulatory Budget

The second table on the previous page examines what the Minister did on the current budget side today compared with the last two budgets. The opening current budget surplus of €4.9bn in 2005 is some €1.5bn higher than in 2003 and 2004, pointing to scope for a much more generous budget than in the last two years. The rise in Exchequer spending of €500m announced today (much of the rise in social welfare is financed via expenditure from the Social Insurance Fund) is smaller than the 2003 budget but is larger than in 2004. On the revenue side, unlike in the last two years, this is a tax cutting budget, with total tax cuts amounting to €600m. Reflecting the more expansionary nature of this year's budget, the Minister has reduced his opening current budget surplus by €775m.

The increases in social welfare payments and reductions in income taxes total some €1.35bn in 2005. This will boost household disposable income by 1.8%. On top of this, the budget did not contain any increases in indirect taxes and so will not add directly to inflation, which would have eroded real incomes. Furthermore, following today's budget, gross current voted government expenditure is set to rise by 9% in 2005. On the capital side, underlying voted expenditure will rise by 15%. Combined with the tax cuts, these large spending rises also point to a relatively stimulatory budget.

The General Government balance (GGB) is a better measure than the Exchequer balance in assessing the overall stance of fiscal policy. The GGB is forecast to move from a surplus of 0.9% of GDP in 2004 to a deficit of 0.8% of GDP in 2005. In cyclically adjusted terms, the Dept estimates that the balance will fall by 1.4% of GDP in 2005, again suggesting an expansionary budget.

Good Income Boost For Taxpayers

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. Low income earners on less than €30,000 fair best. Overall, the budget will boost the take home pay of a single person earning €30,000 by 2.4%. Families with two earners and two children earning in the €50,000-120,000 region will see their net income rise by 1.5-2.0%.

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	690	3.9	180	180	0.8	580	180	2.6	
30,000	598	2.4	1,150	180	3.7	530	180	1.7	
50,000	527	1.5	760	180	1.6	767	180	1.8	
80,000	522	1.0	1,305	180	2.1	762	180	1.3	
120,000	522	0.7	1,300	180	1.5	762	180	0.9	

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

THE MCCREEVY YEARS REVIEWED

Charlie McCreevy was the longest serving Irish Finance Minister in modern times, occupying the office from mid-1997 until his recent departure for Brussels. He also proved to be one of the most controversial Finance Ministers. He was seen by some as a great reformer who created a low tax regime and by others as a far-right neo-liberal who was less than generous in the provision of spending resources for public services. The truth of the matter is that neither of these views are correct.

Let's deal with the tax side first. As the table below shows, the tax take (including PRSI and levies) measured as a percentage of GNP only fell appreciably in two years, 2001 and 2002. The ratio stood at 33.5% of GNP in 2002, compared to 35.4% when Mr McCreevy took office in 1997. The ratio subsequently rose again in the following two years to an estimated 34.9% of GNP in 2004, just 0.6% below its 1997 level.

Thus, while Mr McCreevy introduced many tax reforms, the tax burden did not decline that much during his tenure. Rather the shift to a low tax regime occurred in the 1989-1997 period when the tax burden declined by almost 5% of GNP. While Mr McCreevy did cut income and capital gains taxes quite significantly, other taxes, in particular PRSI and excise duties, were increased.

On the expenditure side, some commentators point to the decline in the ratio of gross current spending to GNP during McCreevy's tenure, especially in the 1997-2000 period, as evidence of a Scrooge-like attitude to public spending. However, much of this decline was attributable to falling debt interest payments. Furthermore, Exchequer financed capital spending rose as a share of GNP in the 1997-2004 period, although this partly reflects the introduction of the National Pension Reserve Fund (NPRF), funded by an annual Exchequer contribution of 1% of GNP.

EXCHEQUER FINANCES 1997 - 2004								
% GNP	1997	1998	1999	2000	2001	2002	2003	2004
Gross Current Expd.	36.5	32.8	31.6	29.4	30.8	31.6	32.5	32.4
Exchq. Capital Expd.	3.7	4.4	5.2	5.8	6.3	6.6	6.0	5.7
Total Government Expd.	40.2	37.3	36.8	35.2	37.1	38.3	38.6	38.1
Central Fund	8.0	6.4	5.7	4.5	3.7	2.7	3.0	3.0
Gross Current Voted Expd.	28.6	26.4	25.8	24.9	27.1	28.9	29.6	29.4
Exchequer Financed PCP	3.4	3.8	4.1	4.5	5.1	5.4	4.8	4.6
Taxes, PRSI & Levies	35.4	34.6	35.7	35.7	34.1	33.5	34.3	34.9
Exchequer Balance	-0.5	1.4	2.0	3.6	0.7	0.1	-0.9	-0.2

More pertinently the table above shows that gross current voted expenditure (which excludes debt interest) amounted to some 29.5% of GNP in both 2003 and 2004, almost 1% above its level in 1997. Granted the ratio fell sharply in the 1997-2000 period, but it rose strongly in the 2000-2003 period. Meanwhile, the Exchequer financed portion of the Public Capital Programme (which excludes the Exchequer's contribution to the NPRF) rose from 3.4% of GNP in 1997 to 5.4% in 2002, before easing back to 4.6% by 2004.

Furthermore, what these ratios fail to capture is the extent of the very large rise in government spending since 1997. GNP more than doubled between 1997 and 2004, so with spending to GNP ratios rising over this period, government spending obviously rose very rapidly; gross current voted expenditure rose by 111% and Exchequer financed PCP spending climbed by 178% during McCreevy's seven year tenure. Hardly Scrooge-like figures.

Finally, we note that while Mr McCreevy generally ran budget surpluses during his period in office, there was a small Exchequer deficit in 2004, just as when he assumed office in 1997. In summary, debt interest payments fell from 5.5% to 1.5% of GNP between 1997 and 2004, a decline of 4%. These debt interest savings were used to boost gross current voted spending, raise public capital spending, fund the Exchequer contribution to the NPRF and reduce the tax burden, in each case by around 1% of GNP. Hardly the stuff of legends, but it created many myths.

THE BUDGET OUTLOOK TO 2007

Small Deficits Forecast

The multi-annual budget projections for the public finances out to 2007, given in this year's budget, are set out in the table below. In order to get a realistic view of the emerging budgetary situation, some provisions for the cost of likely tax cuts and expenditure increases in the next two budgets are taken into account. A contingency provision is also included in 2006 and 2007 to allow for unseen factors that could impact on the public finances.

In its budgetary projections, the government is forecasting that the Exchequer deficit will be little changed at €2,917m in 2006 before increasing slightly to €3,176m in 2007. It is projected that there will be a slight decrease in the General Government deficit to €1,104m in 2006 (0.6% of GDP) and €1,102m in 2007 (0.6% of GDP). These budgetary projections are based on forecasts of real GDP growth of 5.1% in 2005, 5.2% in 2006, and 5.4% in 2007. The modest changes in the deficit reflect a rise in the current budget surplus, little change in capital borrowing and the impact of the contingency provisions already alluded to.

The deterioration in the current budget position in 2005 partly reflects a decline in non-tax revenue while tax revenue is projected to rise at a slower pace than nominal GDP in 2005, but should be broadly in line thereafter. Spending, meanwhile, is forecast to rise somewhat faster than nominal GDP in 2005 but at a slower pace thereafter. Hence, the current budget surplus is projected to rise in 2006 and 2007. On the capital side, partly due to technical factors, expenditure is projected to surge in 2005 but then grow at a much less robust pace in 2006 and 2007. Meanwhile, capital resources are projected to increase. Overall, this results in a sharp pick up in capital borrowing in 2005 but relatively little change in 2006 and 2007. Overall, these figures point to a relatively benign outlook for the public finances, with continuing low budget deficits.

MULTI-ANNUAL BUDGET PROJECTIONS 2005 - 2007							
	2004 Estimated Outturn €m	2005 Budget €m	% Chg	2006 Projection €m	% Chg	2007 Projection €m	% Chg
Current Budget							
<i>Expenditure</i>							
(i) Central Fund	3,658	4,012	9.7	4,160	3.7	4,516	12.5
(ii) Supply Services	27,247	29,997	10.1	32,144	7.2	34,294	6.7
Total Expenditure	30,905	34,009	10.0	36,304	6.7	38,810	6.9
<i>Revenue</i>							
(i) Taxation	35,700	37,505	5.1	40,505	8.0	43,840	8.2
(ii) Non-Tax	768	590	-22.4	562	-5.7	570	1.4
Total Revenue	36,468	38,107	4.5	41,067	7.8	44,410	8.1
Current Budget Surplus (% of GNP)	5,563 4.6	4,092 3.1	-26.4	4,763 3.4	16.4	5,600 3.7	17.6
Capital Budget							
Capital Expenditure	6,686	8,281	23.9	8,630	4.2	8,956	3.8
Capital Resources	1,120	1,201	7.2	1,636	36.2	1,662	1.6
Capital Borrowing (% of GNP)	5,766 4.8	7,080 5.4	22.8	6,995 4.9	-1.2	7,294 4.8	4.3
Contingency Provision	-	-		685		1,482	
Exchequer Balance (% of GNP)	-202 -0.2	-2,988 -2.3		-2,917 -2.1		-3,176 -2.1	
General Government Balance (% of GDP)	+1,348 +0.9	-1,200 -0.8%		-1,104 -0.6%		-1,102 -0.6%	



MACRO ECONOMIC FORECASTS AND EXCHEQUER FUNDING

Solid Growth and Low Inflation Forecast For 2005

Most commentators, including ourselves and the ESRI, estimate that the economy grew by around 5% this year. Most commentators also agree that growth will be sustained at around this level next year, helped by reasonable growth in the global economy, continuing low interest rates and a stimulatory fiscal stance. The main risks for next year are seen as the strength of the euro and high oil prices, but these factors were evident in 2004 also and did not prevent a strong performance by the economy. The housing market also requires careful monitoring.

Turning to the forecasts for 2005, both ourselves and the ESRI are forecasting GDP and GNP growth rates of close to 5.5% and 5.0%, respectively, for next year. The Dept of Finance is forecasting GDP growth of 5.1%. Forecasters see broad based strength in the economy next year with solid growth in consumer spending and investment and a strong rise in exports.

Employment growth is forecast to remain strong next year. We expect employment to rise by 2.5% in 2005, as in 2004, with the ESRI forecasting job growth of 2.3%. The Dept of Finance is a bit more cautious, seeing job growth easing to 1.9%. All three forecasters see the unemployment rate remaining low at around 4.5%.

The Dept of Finance estimates that, with no hikes in indirect taxes in the budget, the CPI rate will average 2.5% next year. The ESRI has forecast that inflation will average around 2.4% next year. Our forecast is for inflation to average 2.5% in 2005. Thus, the return to low inflation evident since 2003 is expected to continue next year.

Modest Net Bond Issuance Next Year

With around €1.7bn of long term debt maturing next year, and an EBR of €3bn, this points to a gross funding requirement of some €4.7bn in 2005. However, the authorities overfunded greatly this year as the EBR outturn is expected to be €2.6bn under target. At end September, the Exchequer's cash balances stood at €3.7bn, up almost €2.2bn since the start of the year.

The large overfunding in 2004 should finance most of the Exchequer's funding requirement in 2005. Thus, net bond issuance seems likely to be limited next year in Ireland, possibly at a little over €2bn, if all the overfunding of this year is available to finance the EBR and redemptions in 2005.

2005 GDP FORECASTS (%)			
	AIB	D/Finance	ESRI
Private Consumption	4.0	4.1	4.5
Government Expd.	3.5	2.9	3.5
Fixed Investment	4.0	2.5	5.3
Exports	6.5	7.0	7.2
Imports	5.5	5.7	7.0
GDP	5.5	5.1	5.4
GNP	5.0	4.7	5.0

2005 FUNDING REQUIREMENT (€m)*	
Redemptions	
(i) Irish Government Bonds	1,350
(ii) Foreign Debt	350
(iii) Total Redemptions [(i) + (ii)]	1,700
(iv) Exchequer Borrowing Requirement	2,988
(v) Funding Requirement [(iii) +(iv)]	4,688
(vi) Overfunding in 2004	2,600
(vii) 2005 Funding Requirement [(v) - (vi)]	2,088
* Assumes zero net funding via Small Savings	

The publication is for information purposes and is not an invitation to deal. The information is believed to be reliable but is not guaranteed. Any expression of opinions are subject to change without notice. This publication is not to be reproduced in whole or in part without prior permission. Allied Irish Banks p.l.c. is regulated by the Irish Financial Services Regulatory Authority.