

Friends First Budget 2012 – An Assessment



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ECONOMIC BACKGROUND TO BUDGET 2012.

The background against which Budget 2012 was set was very difficult and challenging. The international economic backdrop is very difficult. Economic activity in the developed world has slowed markedly over the past six months due to a combination of excessive government debt levels and the ongoing impact of the sub-prime implosion in 2007 on global credit conditions. For a small open economy such as Ireland, this does not set a very constructive background, but the uncertainty is exacerbated by the escalating crisis in the Euro Zone, which is threatening the continued viability of the single currency.

EU Finance Ministers have issued some vague statements in recent weeks about agreement having been reached on boosting the strength of the European Financial Stability Facility and the possibility was raised about the IMF receiving more resources to help out those countries who are finding it impossible or very expensive to borrow money on international markets. While this was all a bit vague, it does hold out the prospect that the ECB will turn on the printing press and give the money to the IMF to buy the bonds of those countries in difficulty. This indirect way of doing it, might just be enough to circumvent the legislation which prevents the ECB from intervening directly. It might also make it easier for the German Chancellor to sell the message of what needs to be done to a very sceptical German public.

In the dying days of November the ECB, the US Federal Reserve, the Bank of England, the Bank of Canada, the Bank of Japan and the Swiss central bank all intervened in the markets and started providing cheap dollars to the banks in an effort to alleviate the fear that now dominates market sentiment. This move is intended to reduce the cost for banks of accessing funds and will hopefully improve overall liquidity and sentiment in the market. At the same time the Bank of China eased liquidity in the Chinese banking system in order to stimulate growth in that economy.

Despite these developments, it is clear that the survival of the EMU project in its current form has become very high risk and its future is in the balance. From an economic perspective, the decisions needed to save it are reasonably straight forward - in the short-term this will necessitate the creation of an EFSF of at least €3 trillion and massive bond purchasing by the ECB based on quantitative easing of money supply, Greek default of at least 50%, and re-capitalisation of the affected banks. This will have to be followed up in the longer-term with the creation of a euro-bond guaranteed by Europe and greater fiscal discipline imposed from the centre. In other words, this would be the creation of fiscal federalism. This should have happened back in 1999.

The French and German leaders are now proposing strict fiscal disciplines for Euro Zone member countries. They are backing automatic sanctions against EU member states that exceed a 3 per cent deficit; a Golden Rule for every country restricting the ability to run current budget deficits; and the European Court of Justice should be tasked with verifying that national budgets are satisfying deficit rules. The latter suggestion would appear to have been scrapped, but much will be revealed this weekend. There is no acceptance of the creation of a Euro bond market. This saga still has a long way to go.

Friends First Budget 2012 – An Assessment



BACKGROUND TO BUDGET 2012

The fiscal background to Budget 2012 is straight forward but is also very challenging. In the eleven months to the end of November 2011, the Exchequer ran a deficit of €21.4 billion. €10.65 billion of this deficit is due to once-off payments relating to the banking system. When these payments are excluded the Exchequer deficit was €2.6 billion better than expected. Notwithstanding this, the fiscal challenge remains very intense, with most tax headings remaining under pressure and the task of reducing spending is very difficult.

Table 1

EXCHEQUER RETURNS JAN-NOVEMBER 2011		
TAX HEADING	ANNUAL GROWTH	AGAINST TARGET €m
Customs	+4.8%	+4
Excise Duty	+0.9%	+15
Capital Gains Tax	-18.6%	-30
Capital Acquisitions Tax	+1.6%	-10
Stamps	+51.6%	+442
Income Tax	+22.5%*	-272
Corporation Tax	-4.3%	-236
Value Added Tax	-3.3%	-464
Total Tax	+7.9%	-520
Total Net Voted Spending	-0.2%	-1,020

Source: Department of Finance *Includes Universal Social Charge

Table 1 provides a breakdown of tax revenues and total net voted spending in the first 11 months of the year, both in terms of percentage change on first 11 months of 2010 and against expectations. Overall tax revenues are €520 million behind expectations. Expenditure is being kept under control with both current and capital spending cumulatively €1 billion lower than anticipated.

The Minister for Finance has laid out the broad fiscal parameters for the period 2012 to 2015. Based on what may turn out to be optimistic economic projections, the Government aims to deliver a package of €12.4 billion in fiscal austerity over the period. It is intended that expenditure reductions will account for 62.5 per cent of this massive fiscal adjustment, with tax and revenue raising measures accounting for the rest. In 2012 the correction will be in the region of €3.8 billion, with €1.6 billion coming in tax and revenue raising measures. In the Budget speech, GDP growth for 2012 has been revised down to 1.3%.

Friends First Budget 2012 – An Assessment



Table 2

BUDGETARY & ECONOMIC PROJECTIONS				
	2012	2013	2014	2015
Total Consolidation	€3.8 bln	€3.5 bln	€3.1 bln	€2.0 bln
-Tax	€1.6 bln	€1.25 bln	€1.1 bln	€0.7 bln
-Current Expenditure	€1.45 bln	€1.70 bln	€1.9 bln	€1.3 bln
-Capital Expenditure	€0.75 bln	€0.55 bln	€0.1 bln	€0.0 bln
General Government Deficit (% GDP)	8.6%	7.5%	5.0%	2.9%
General Government Debt (% GDP)	114.3%	118.3%	117.0%	113.5%
GDP	1.6%	2.4%	3.0%	3.0%

Source: 'Medium Term Fiscal Statement', Department of Finance, November 2011

BUDGET 2012

EXPENDITURE MEASURES

Minister Brendan Howlin announced an expenditure adjustment of €2.2 billion for 2012. Cuts in capital expenditure will account for €755 million of this, and cuts in current expenditure will account for €almost €1.4 billion.

Of the adjustments to current expenditure the Department of Health will account for €543 million; the Department of Social Protection for €475 million; the Department of Education and Skills will account for €132.3 million; the Department of Agriculture, the Marine and Food will account for €105 million; the Department of Transport, Tourism and Sport will account for €45 million and the Department of the Environment, Community and Local Government will account for €34 million.

The public sector pay bill will be reduced by €400 million in 2012 and the size of the public sector workforce will be reduced by 6,000 in 2012. Between 2008 and 2015 it is intended that the public sector workforce will be reduced by 37,500 of 12 per cent.

Friends First Budget 2012 – An Assessment



GENERAL TAXATION AND REVENUE MEASURES

Minister Michael Noonan presented the second half of the budget, covering taxation and revenue measures.

The key measures include:

- A 2 per cent increase in the top 21 per cent rate of VAT which is expected to raise €670 million;
- No changes to income tax rates, allowances or bands;
- The income exemption for the Universal Social Charge has been increased to €10,036 from €4,004;
- Carbon Tax has been increased from €15 to €20 per tonne, which will add 1.4 cent to a litre of petrol, 1.6 c to a litre of diesel. Home heating oil and gas will go up from May;
- Cigarettes will be increased by 25 c on a pack of 20;
- Motor tax rates are being increased;
- No change to excise duty on alcohol, but legislation is planned on low-cost alcohol;
- A Loan Guarantee Fund and Micro Finance Fund are being created for the SME sector;
- The first €100,000 of R&D expenditure for all companies will be allowed on a volume basis for the purpose of the R&D Tax Credit;
- The corporate tax exemption for new start up companies is being extended for next 3 years and will be available for companies that commence trading in 2012, 2013 and 2014;
- Smaller companies will be given export incentives to sell into BRIC countries;
- CAT and CGT rates are being increased from 25 per cent to 30 per cent;
- The Group A tax-free threshold for CAT is being reduced from €332,084 to €250,000;
- The DIRT rate is going up from 27 per cent to 30 per cent; and
- There will be a further broadening of the base for PRSI to cover rental, investment and other forms of income from 2013.

PROPERTY MARKET

In relation to the property market, a number of measures have been introduced to try to stimulate activity levels. The commercial market in particular is currently paralysed, which is not in the best interests of tax revenues and the job of NAMA.

The key measures include:

- A reduction in stamp duty on all non-residential property, including farmland as well as commercial and industrial buildings, transactions from 6 per cent to 2 per cent. This may stimulate foreign interest in the commercial property market, particularly as more certainty has been created in relation to Upward Only Rent Reviews. This is recognition of legal realities. However, NAMA will have the opportunity to approve rent reductions where it can be shown that rents are in excess of the current market levels and where viability is threatened. The new policy also applies for the appointment of an independent valuation of market rent where necessary. These changes may just make it somewhat easier to shift some of its vast property portfolio;

Friends First Budget 2012 – An Assessment



- There is no change to stamp duties on residential property transactions;
- For properties bought between midnight on December 6th and the end of 2013 and which is held for a period of seven years, will be exempt from CGT;
- Mortgage Interest Relief is being increased to 30 per cent for those who bought homes between 2004 and 2008. Mortgage interest Relief will not be available for those who buy a house after the end of 2012 and will be fully abolished from 2018. For those who wish to buy a house in 2012, Mortgage Interest Relief will be given at a rate of 25 per cent rather than 15 per cent, and non-first time buyers will benefit from relief at 15 per cent instead of 10 per cent;
- A property relief surcharge of 5 per cent will be imposed on investors with an annual gross income over €100,000. Reliefs for Section 23 type investors will not be restricted for investors with an annual gross income under €100,000;
- An announcement to deal with mortgage arrears will be made in the near future; and
- A household charge of €100 is being imposed on most primary residences, and this €100 will be applied on all non-primary residences which are already subject to a €200 levy.

PENSIONS

Some changes have been introduced in relation to pensions, but they are not too dramatic following last year's significant changes which seriously damaged the incentive for people to make private pension provision. The main changes announced in Budget 2012 include:

- The base for PRSI will be broadened through removal of the remaining 50 per cent employer PRSI relief on employee pensions;
- The rate of notional distribution on the highest value Approved Retirement Funds (ARFs) and similar products will be increased to 6 per cent;
- The rate of tax on the transfer of an ARF on death to a child over 21 will be increased from 20 per cent to 30 per cent;
- The pensions sector will make a contribution of €750 million to the Exchequer in 2012 following changes to pension relief adopted in Budget 2011 and the Finance Act, and the Pensions Levy. Despite IMF/EU commitments, no change is being made to marginal tax relief on pension contributions at this time. However, the Department of Finance will work with the Revenue Commissioners and other stakeholders in 2012 to ensure that the regime for supplementary pension provision is reformed to make it more sustainable and equitable over the longer term.

Friends First Budget 2012 – An Assessment



CONCLUSIONS

Budget 2012 will take a lot of money out of an economy still struggling to emerge from the deepest recession in its history. Following Budget 2012, current expenditure will be cut by €1,395 million, capital spending will be cut by €755 million, the tax changes are intended to raise €1,015 million, and PRSI changes are intended to raise €57 million. This gives a total of €3,222 million, but this rises to €3,822 million when the €600 million expected to be raised in 2012 as a result of the full-year effect of the changes introduced in Budget 2011 are factored in. This is one hell of a fiscal adjustment.

The tax and revenue package is certainly not as bad as might have been expected. The lack of change to income tax rates and bands will at least support employment; the increase in capital taxes will placate the left, but will not raise much in revenue as capital gains are currently as elusive as hens' teeth; the changes to mortgage interest relief will provide some help to those in difficulty; the increase in the threshold for the USC will help the lower paid and offset some of the pain imposed yesterday; the reduction in the stamp duty on commercial property transactions might just give some stimulus to a totally dead and dysfunctional commercial property market; there is no basis to the claim that these property-related measures will re-create another property bubble; the increase in VAT rate to 23% heralded in advance and will not be as negative as a 2% increase in income tax. Furthermore, some retailers will absorb the VAT increase and will not be inclined to pass it on to a very resistant consumer.

In overall terms, the tax and revenue part of the budget is not too bad in the circumstances. It was never going to be easy, but at least some attempt at economic stimulation is being made. That is a relative term however, as the overall package today and yesterday will act as a significant drag on the economy in 2012.

Budget 2012 will take a lot of money, €3.8 billion, out of an economy still struggling to emerge from the deepest recession in its history. Given the ongoing weakness in domestic demand, the contractionary nature of Budget 2012, the ongoing Euro Zone Crisis and the deteriorating international economy, there would appear to be a high probability that the budgetary targets may not be met in 2012. It is inconceivable that if this turns out to be the case the Government will be in a position to target more adjustments of more than the planned €3.6 billion in 2013.

Social welfare rates, state pensions, income tax rates and public sector pay were not touched directly in 2012. However, it will become much more challenging over the 2013 to 2015 period to identify and deliver the fiscal adjustment targeted over that period without re-visiting these areas. It is clear that Ireland has considerable more fiscal pain ahead, but there is little choice other than to re-create a sustainable public finance situation.

Friends First Budget 2012 – An Assessment



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Overview

It is important to stress that no additional reductions in rates of personal reliefs, earnings cap or Standard Fund Threshold were announced.

Given all the scaremongering over the last couple of months, the absence of any further restrictions in these areas is very welcome. Having said that, Finance Act 2011 did hit the pensions sector very hard. Minister Noonan acknowledged that the sector contributed €750m in 2011, a combination of the pensions levy and restrictions in reliefs.

The pension related changes announced yesterday by Minister Noonan are summarised below :

Relief for employer PRSI on employee contributions abolished

This measure follows on from the 50% reduction in the last budget and is no big surprise. The measure is estimated to increase the PRSI take by €90m in a full year.

ARF imputed distribution rate increased to 6% where the aggregate value of an individual's ARF exceeds €2m. The increase is based on asset values at 31/12/2012.

The increased distribution rate on ARFs will ensure that an ARF fund is likely to disappear prior to the death of the ARF owner. In the absence of any investment return, an annual 6% withdrawal will reduce the fund to zero over time. Life expectancy for a 60 year old is now in the mid-eighties. Is Minister Noonan attempting to force individuals down the annuity route ? Will 6% apply to all ARF assets or just the amount over €2m ? This seems a bit harsh if the ARF is valued at €2,000,010?

ARF imputed distribution regime, including the 6% rate where assets exceed €2m, extended to vested PRSAs. The imputed distribution rules will apply to assets in all individuals PRSAs once one PRSA becomes vested.

It was only a matter of time before imputed distributions were extended to PRSAs. This removes a significant anomaly as retirees will no longer be able to use a PRSA to avoid an imputed distribution. We await publication of the Finance Bill for much of the detail. Hopefully there will be an opportunity for discussion on practical issues with officials prior to publication.

Friends First Budget 2012 – An Assessment



On the death of an ARF owner, the rate of tax paid on distributions to a child over 21 is increased from 20% to 30%.

No increase in a tax rate is welcome. The Minister also increased the rate of CAT to 30% and reduced the personal exemption thresholds so using an ARF for inheritance planning will remain an attractive option in some case.

DIRT rate increased to 30% and Exit Tax on life policies increased to 33%

As both the relief for personal pension contributions, and the tax exemption on investment return, remain unchanged the increase in DIRT may encourage those who do want to save, to reconsider pension savings as an option.

Further reform of Exchequer support for supplementary private pensions will be considered. This review will also look at initiatives to encourage pension savers to invest in Ireland. The Minister has given a commitment that the Department of Finance and Revenue will engage with stakeholders.

A major concern is how the pensions industry will respond. A favourite Government tactic is the old 'divide and conquer' routine. This was evident this year where some supported a levy and others favoured restrictions in personal reliefs. Clearly the Minister listened to those who sought an increase in the ARF imputed distribution rate. This piecemeal approach helps no-one. Is it possible that we can persuade competing representative groups and commercial interests to present a united front to Government ?

