



IBEC Supplementary Budget Proposals

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1. Summary of Recommendations

The April 2009 Supplementary Budget is the first in a series of budgets required to address the structural deficit in the public finances. On a pre-budget basis, IBEC forecasts that the Irish economy will contract by 7.5% in 2009 and the General Budget Deficit will be 12.5%. Government must not over-react, however, to the current deterioration in tax revenue by introducing measures which will excessively contract economic activity. It must strike a balance between its efforts to stabilise the public finances and the need to sustain activity in the real economy.

In summary, IBEC recommends:

- The April Supplementary Budget should be a holding position for the remainder of 2009 in advance of a more comprehensive appraisal of tax and expenditure policy in Budget 2010 following the publication of the work of the Commission on Taxation and that of the Expenditure Review Group
- An adjustment of €3 bn in net terms is the maximum which the Irish economy could bear at the current point in the business cycle. Two thirds of this should come from expenditure reductions and one third from taxation increases
- Expenditure on public sector pay and pensions and on the provision of current services should be cut by 9% - yielding a gross saving of €2.1 bn for the remainder of 2009
- Social welfare rates should be adjusted in line with changes in the cost of living and should therefore be reduced by 3%, resulting in savings of €400 mn during 2009
- The existing income levy should be adjusted so that it yields an additional €1.2 bn in gross terms over the remaining eight months of 2009
- There should be no increases in corporation tax, employers' PRSI, excise levies or VAT. IBEC strongly believes that any increases in VAT or excise would further incentivise cross-border shopping and would be counter productive from a tax revenue perspective
- A reallocation of €1 bn should be made from the NDP to a programme to support employment in enterprise
- Off-balance sheet options should be explored in order to maintain the existing volume of infrastructure activity under the public capital investment programme

The total gross savings for the remaining eight months of 2009 arising from the above adjustments would therefore be €3.7 billion, with €1.2 billion coming from income tax and €2.5 billion from reductions in current expenditure. Negative revenue buoyancy would of course limit the final savings to the Exchequer as the adjustments would directly and indirectly result in lower tax revenues. Given the substantial increase in the savings ratio of households over recent months it is difficult to accurately estimate the current negative revenue buoyancy factor. If large numbers of households have already increased their savings ratio on the basis that tax increases were imminent, then the consumption impact of the adjustments might not be as large as in normal circumstances. We have therefore estimated that the gross adjustment of €3.7 billion would result in a net Exchequer adjustment of about €3 billion.

2. Economic Context

2.1 What is happening to the Irish economy?

Economic growth as measured by GDP averaged 5.5% in the five years to 2007. In 2008, output fell by 2.3%; it is set to fall by about 7.5% in 2009 and will fall by even more after the April Supplementary Budget measures come into effect. In ten out of the eleven years to 2007, the general government balance was in surplus; in 2008, it plunged to a deficit amounting to 6.3% of GDP and without further correction is on course to record a deficit of 12.5% in 2009.

The economy is being hit simultaneously by a crisis in the financial sector, which is global in nature but has some home grown adverse elements, a fiscal crisis of untold magnitude - of our own making and a real economy crisis, which is a mixture of unsustainable imbalances, a loss of competitiveness, a global recession and sterling's devaluation.

In the following sections, we give our assessment of the fiscal outlook and what a credible recovery plan must contain. Here, we briefly sketch the direction in which we believe the economy is going in the immediate future and over the next few years and put some indicative numbers on the main variables. This is indeed a severe scenario, with which we must deal; it requires decisive actions, which will have very unpleasant short-term consequences for everyone. We will notice our living standards fall.

In Table 1, we present a stylised profile of the course we see the economy taking after the April Supplementary Budget. GDP is set to decline by the order of 8.9% this year and by a further 3.1% in 2010. We expect the economy to grow at above trend rates in both 2012 and 2013, reflecting post recessionary catch-up.

Table 1 GNP and its components, (reflecting impact of April Budget)

	annual % change							
	2006	2007	2008	2009	2010	2011	2012	2013
Consumer spending	7.1	6.3	-0.8	-8.7	-5.0	2.0	3.0	3.5
Government spending	4.8	6.0	2.1	-1.0	-1.0	0.0	0.0	1.0
Investment	4.0	1.2	-19.9	-30.7	-18.6	5.4	9.2	12.8
Exports	5.7	6.8	-0.4	-3.0	0.0	2.5	5.0	6.0
Imports	6.3	4.1	-4.4	-7.5	-3.5	2.6	4.8	6.7
GDP	5.7	6.0	-2.3	-8.9	-3.1	2.2	3.8	4.6
GNP	6.3	4.1	-3.1	-8.1	-3.7	2.1	3.7	4.6

Consumer spending was set to fall by about 7% in 2009. If the April Supplementary Budget introduces measures to plug the anticipated €4.5 billion shortfall, the drop in consumer spending is likely to be closer to 9%. Although the Consumer Price Index could register a fall of 5% and the lower interest rates will boost disposable incomes of mortgage holders, higher taxes and higher unemployment will depress disposable income. We know that car sales for the first two months of the year are down an annual 65% and consumer confidence remains low. Rising unemployment and uncertainty are likely to encourage savings or paying down debt. In addition, wages across large sections of the economy will be frozen at 2008 levels or indeed will fall. In IBEC's *Business Sentiment Survey* for the first quarter of 2009, 64% of companies said they would be implementing a pay freeze in the next three months and a further 15% said this was under consideration. Furthermore, 20% of companies said they

would implement pay reductions and a further 25% said reductions were under consideration.

The impact on employment will be severe. The latest Live Register figures show that unemployment has risen to 10.4%. There is already solid evidence that the fall in employment is now rapidly spreading out from the construction sector to all other sectors. Data from the National Household Survey recorded an annual decline in employment in the last quarter of 2008 of 86,900 or 4.1%. The decline now goes much wider than the construction sector. In the last quarter of 2007, gross job losses were running at an annual 9,800, with the greater amount being in construction and the remainder in manufacturing. Job gains in other sectors of the economy easily offset these losses so that overall employment increased by an annual 66,800. In the last quarter of 2008, however gross job losses were an annual 101,300. Some 45,900 were in construction - the other 55,400 were spread across the private sector. The wholesale and retail sector shed over 18,000 jobs, manufacturing over 12,000, financial and business services almost 12,000, and hotels and restaurants 11,000. The public sector recorded employment gains of the order of 10,000. We expect total employment now to fall by close to 8% in 2009 and by a further 3.7% in 2010 and not show any significant growth until 2013. Unemployment is likely to average close to 12% in 2009 and 13% in 2010, and will remain in double figures until 2014.

The rebalancing of the construction sector will continue. We now believe that housing output will fall by some 50% in 2009 and a further 30% in 2010. Commercial buildings are also in significant oversupply and output in that sector seems set to decline by 50% over the next two years. The crisis in the state finances may require that elements of the National Development Plan may have to be postponed, making it difficult for the Government to maintain public capital spending at 5% of GNP without recourse to other sources of funding. Total investment will be a further significant downside drag on the economy, falling by some 30% in 2009 and by 19% in 2010. However, we expect that building and construction activity will bottom out in 2010 and a modest growth of the order of 5% is possible after four consecutive years of decline amounting in total to a fall of about 60%.

The loss of competitiveness had weakened the strong contribution of net exports to economic growth over the past five years. The global recession will result in exports of goods and services falling by 3% in 2009 and with only a mild recovery in global demand anticipated for 2010, exports of goods and services are likely to stagnate. In 2011, provided global demand continues to pick up, exports of goods and services should start to grow again. Indeed we expect investment and exports to be the main positive features in 2011 and both should gain some impetus out to 2013.

2.2 Focus needed on the real economy

To date the government has almost entirely focussed on the crisis in the financial sector and more recently turned its attention to the rapidly deteriorating public finances. The Exchequer returns for the first two months of the year record that Exchequer revenue is down by almost 24% on the first two months of 2008. This finally confirmed for the government that the additional post budget measures aimed at plugging the deficit by €2 billion – cuts in early childcare supplement, the public sector pension levy and an 8% reduction in service providers' fees – were insufficient to contain the deficit at 9.5% of GDP. Despite the depressing effect on an economy already in recession, a further package of expenditure cuts and tax increases is now required. Depending on how these adjustments are

made will influence the impact on the economy. It seems to us that consumer spending will fall by close to 9% in 2009 and by a further 5% in 2010.

IBEC does not dispute that correction of the public finances is a priority and should be addressed at the structural deficit. However, all the measures taken and proposed to date will do nothing to address the fundamental loss of competitiveness manifested in higher costs and prices. We have outlined in *A Programme for Enterprise Development and Sustainability*¹ temporary short-term measures to address particular problems relating to the sterling devaluation and the difficulty companies are experiencing in obtaining credit. Such support is essential if we are to minimise the loss of jobs over the next two years.

More fundamentally, we believe that Ireland's lost competitiveness during this decade amounts to close to 15% relative to our main trading partners. Ireland's wage and cost levels are seriously out of line with trading partners. This must be corrected rapidly if Ireland is to restore its competitive position. Failure to do so will result in sub-optimal growth and will undo much of the progress of the last 15 years, with a return to permanently high levels of unemployment. Government is already seeking to reduce the cost of service providers to the public sector; it should also ensure that it reduces its own service costs and prices by a similar quantum.

As a very open economy Ireland needs to make adjustments to income levels over the next two years if business is to be competitively placed to reap the full benefit of the global upturn. We estimate that wage levels require a downward correction of the order of 10%. Many companies are already taking such action; society needs to be convinced of the necessity to achieve wage reductions on an economy-wide basis. Successful implementation of such policy would reduce price levels in Ireland, would help real living standards and would help restore employment levels through more rapid growth of exports. We recognise that income correction will impart a further deflationary impact on the economy in 2009 and 2010 but will be the foundation for a more solid and sustainable recovery in subsequent years.

¹ Summary of recommendations set out in Section 5 of this submission.

3. Lessons from international fiscal consolidations

The task facing the Government is daunting. It must succeed in bringing the deficit down, while minimising the deflationary impact on the economy. International experience can be helpful in guiding this process; budgetary consolidation has been the subject of considerable economic research, particularly during the 1990s. This literature has some important lessons for Ireland in its current predicament.

Firstly, in successful adjustments, ones resulting in a reduction of the debt-to-GDP ratio, the bulk of the burden has been placed on the expenditure side. Spending cuts have been accompanied by only modest tax increases. Typically, expenditure cuts account for nearly four fifths of the total adjustment, while taxation increases account for only one fifth. Fiscal adjustments where the focus has been solely on increasing taxes have tended to fail.

Secondly, the composition of the expenditure cuts matters. The most politically sensitive components of government spending, transfer payments and government wages, have been cut during successful adjustments. Making these politically difficult choices can be a signal of a government's commitment to cut the deficit. In unsuccessful adjustments, however, almost all spending cuts occurred in investment spending.

The macroeconomic impact will also vary. Tax increases have a negative effect on GDP growth, while cuts in government spending, particularly wages, have a positive impact on growth. This is explained by looking at the fiscal multiplier of the different components of public expenditure. Irish research suggests that a rise in public investment or government consumption boosts economic activity, while higher government wages lead to a contraction in output. Moreover, in the long run higher investment is associated with real (inflation adjusted) exchange rate depreciation, enhancing competitiveness. Higher government consumption on the other hand is associated with a higher real exchange rate. The lesson is: preserve productive public investment as much as possible. Cuts elsewhere, particularly in the wage component, will be less damaging.

Finally, research indicates that successful fiscal adjustments are not simply the result of expansionary monetary policy and exchange rate devaluations. The way fiscal policy influences the economy operates autonomously, even when holding constant for the boost from monetary policy. This is extremely important, since Ireland does not have independent monetary policy and cannot therefore boost activity and competitiveness through a currency devaluation. Fiscal policy is the only tool we have left at our disposal and we must use it judiciously.

The process of bringing a budget deficit under control is a multi-year undertaking. Since the cuts that will be the most effective are also the most politically sensitive, communication is paramount. Jens Henriksson's 2007 paper for the Bruegel institute on the Swedish experience is illuminating in this respect. Henriksson worked in the Department of Finance for twelve years and presents a fascinating insider account of what works and why.

In 1994, Sweden was in desperate straits. The deficit hit 11% of GDP and there were rumours on the financial markets that the IMF would be forced to step in.

Though previous attempts at consolidation had laid the groundwork, the consolidation package that ultimately succeeded in restoring stability was bold, totalling 8% of GDP over a number of years. It included cuts in unemployment, disability and parental benefits and ultimately overhauled the social welfare system. This was not, however, the elimination of the welfare state; the Swedish model was preserved.

Henriksson's account has a strong element of common sense. He advocates a comprehensive consolidation package. Government should be honest and transparent on the message: the adjustment will not be easy. Equity should be of great concern and the package should not single out losers. Expenditure cuts must be complemented by tax increases for those judged well off. Distributional concerns should not only focus on income, but should also incorporate other dimensions such as gender, age and location.

In tackling our own budget deficit, we must take on board lessons from the past, and adapt them to our own particular situation. The fiscal adjustment that Ireland must undergo is severe. Compounding the deficit is the structural shortfall in the revenue base. During the construction and property boom years, revenue became far too reliant on this highly cyclical source of income. The unsustainable revenue base helped fund increases in recurring current expenditure, such as social welfare entitlement and public sector remuneration, as well as sharp reductions in income taxes to the point where 40% of Irish employees are outside the tax net.

Government must put in place a comprehensive, multi-year fiscal consolidation package. It must have courage to take the unpopular but necessary decisions. International experience shows that current expenditure must be cut, government wages and transfer payments in particular. Public debt can be brought under control even without recourse to currency devaluation. In fact, in the absence of independent monetary policy, appropriate fiscal policy becomes all the more important. A return to growth will not be possible if the difficult decisions needed to reduce current expenditure are not taken.

4. Medium-term strategy to correct the public finances

4.1 Requirement to address the budget deficit

The addendum to the *Irish Stability Programme Update* aimed at containing the general government balance to a deficit of 9.5% of GDP in 2009 and with the aspiration to reduce the deficit to 2.6% of GDP by 2013. Since its publication in January, it has become clear that the government finances are considerably worse than was thought in January. Meeting the deficit would require at least another net €4 billion in expenditure cuts and tax increases in 2009 and further harsh measures in 2010 and beyond in order to meet a deficit of less than 3% of GDP by 2013. The 2009 planned correction was based on tax revenues of €34 billion; our view is that latest indicators suggest that revenues could be at least €2 billion lower. The Commission estimates that uncorrected the general government deficit was likely to be 11% of GDP in 2009, worsening to 13% in 2010; we estimate that the deficit is already heading to 13% of GDP in 2009.

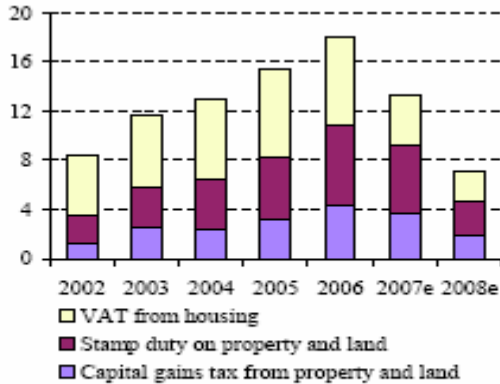
The European Commission, which has initiated an excessive deficit procedure against Ireland, said in its communiqué of 24 March that it had recommended to the Council that the Irish authorities take measures to achieve the 2009 deficit target. Thereafter additional annual efforts going beyond those foreseen in the January 2009 Stability programme addendum might be necessary to bring the deficit below the 3% of GDP reference value by 2013 if downside risks to the budgetary targets were to materialise.

We believe that such a correction would impart a far too negative impact on the economy, which is already in deep recession. There is no question that urgent measures are required to stem the deteriorating situation in 2009; this will require expenditure cuts and an increase in taxation. Further planned correction of the Exchequer finances will be required over the next five years, which must focus on the changed structure of the real economy. Ireland has been unfortunate that the correction in the imbalance in the economy is coincident with the global financial crisis and global recession. The combination has resulted in an extraordinary and unprecedented collapse in tax revenues. However, it is crucial that we do not confuse the fundamental structural problems with the transient grossly adverse effects of the global downturn. To do so would risk deflating the economy in the next two years in a most damaging way resulting in an unnecessary and probably permanent loss of output and loss of jobs.

4.2 Focusing on the structural deficit

Neither the addendum to the Stability update nor the Commission's communiqué adequately addresses this distinctive current problems facing the economy. However, the Commission analysis of the October update to the Stability programme does draw attention to the significant rise and fall of tax revenues associated with the property boom. As the graph below shows, revenue from property related activity rose from an estimated 8% of total tax revenue to peak at 18% in 2006 and reduced to just below 8% in 2008. In 2009, it will have fallen even further.

Figure 4.1 Property-related tax revenue as % of total tax revenue.



Source: Irish Revenue Commissioners, Department of Finance, Commission services' calculations

Property related tax revenue as a percentage of GDP also rose significantly from an estimated 1.9% of GDP in 2002 to 4.6% in 2006. Following the bursting of the housing bubble, the percentage of revenue fell back to 1.6% of GDP in 2008. The distortion of tax revenue is greater than these figures suggest because of the substantial impact on associated income tax and expenditure taxes resulting from higher direct and indirect employment resulting from the construction boom.

Figure 4.2 Total property-related tax revenue as % of GDP



Source: Irish Revenue Commissioners, Department of Finance, Commission services' calculations

An informative note from the Economic and Social Research Institute points to the fact that about half Ireland's deficit in 2009 arises from the global downturn and that the structural deficit resulting from permanent changes in the Irish economy amounts to some six to eight per cent of GDP. Rightly, the automatic stabilisers, i.e. higher social welfare payments and lower tax revenue from reduced economic activity should be allowed to operate even though the depth of the recession increases the deficit far beyond what would be deemed normal or desirable. To try to "correct" for this cyclical shortfall would simply make a bad situation worse – a return of global growth will correct for most of this element of the deficit.

The structural problems faced by the economy are serious and significant and have affected in a material way the current difficulties relating to government revenues as illustrated above. The building and construction boom which resulted in particular in the housing bubble contributed to and disguised the sharp loss of competitiveness of the Irish economy. This resulted in a deterioration of the contribution from net exports, which must be reversed if Ireland is to tackle its

structural problems and revert to a sustainable growth path. Restoring competitiveness is crucial to both sustainable growth and living standards and in tackling the Exchequer finances.

4.3 Medium term budgetary priorities

Over the next five years, the government must focus on eliminating the structural deficit estimated at around 8% of GDP. For the 2009 budget outturn there is little time to effect a medium term coherent plan; this must be a relatively crude exercise in damage limitation, involving temporary supports to viable businesses, expenditure cuts involving both pay and social welfare and inescapably a hasty revenue raising exercise through an increase in the income levy applicable only in 2009.

The budget must outline a plan, which will be developed over the next six months for implementation in 2010 and beyond which involves,

On the expenditure side:

(1) a major focus on reducing expenditure levels in line with lower revenue yields through a thorough assessment of current expenditure, including public sector incomes, pensions and numbers

(2) the efficient delivery of essential public services; the elimination of inefficient or ineffective activities

(3) a review of the level of social welfare payments and their interaction with the labour market

(4) a capital expenditure programme that will be restricted to essential infrastructure projects and those designed to improve competitiveness of the economy generally and of the traded sectors in particular.

On the revenue side:

(1) raising additional taxes to make up for the permanent reduction in tax revenue following the bursting of the building and construction bubble in the least damaging way to the economy

(2) a restructuring of the tax base away from taxes sensitive to the economic cycle

(3) the retention or reduction in the 12.5% corporation tax rate

(4) the introduction of a property based tax

(5) the extension of charges for a greater range of public or local services

(6) the introduction of a carbon tax on households

(7) a thorough examination of income tax and social welfare codes to develop an income tax system that does not exclude 40% of income earners from paying tax; a system that taxes benefits such as childcare; a system that rewards work

(8) ensure that indirect taxes, VAT and excise, do not distort competition in terms of cost impositions on businesses and diversion of consumer spending to cross border or internet shopping.

(9) there should be no increases to employers' PRSI

The government should focus on eliminating the structural deficit by 2015. Some two thirds of this should be achieved by expenditure reductions and reduced funding of the capital programme from Exchequer resources. In our view the revenue gap resulting from the structural change to the economy that must be bridged out of taxation is of the order of 3% of GDP, or somewhat under €5 billion. Significant progress needs to be made in 2010 and 2011 not only to correct the financial imbalance and contain rising debt interest payments, but also to demonstrate to markets that steady corrective action is being taken.

If the necessary focus is placed on achieving tangible income and cost reductions in 2009 and 2010, then Ireland will be better placed to benefit from the lift from the global upturn which is anticipated in 2010.

Government must be mindful of the need to explain and deliver the necessary structural changes to the Commission and to the markets. The focus away from the immediate headline target of the general government deficit to the focus on the structural deficit must be understood by players outside the economy. It must gain the active support and endorsement of the European Commission. International investors must understand and have confidence in the corrective action. Failure to deliver cogent messages to the necessary players could put in jeopardy Ireland's ability to raise money at no premium. In this regard it is important that Ireland's relatively low debt/GDP ratio is known and understood.

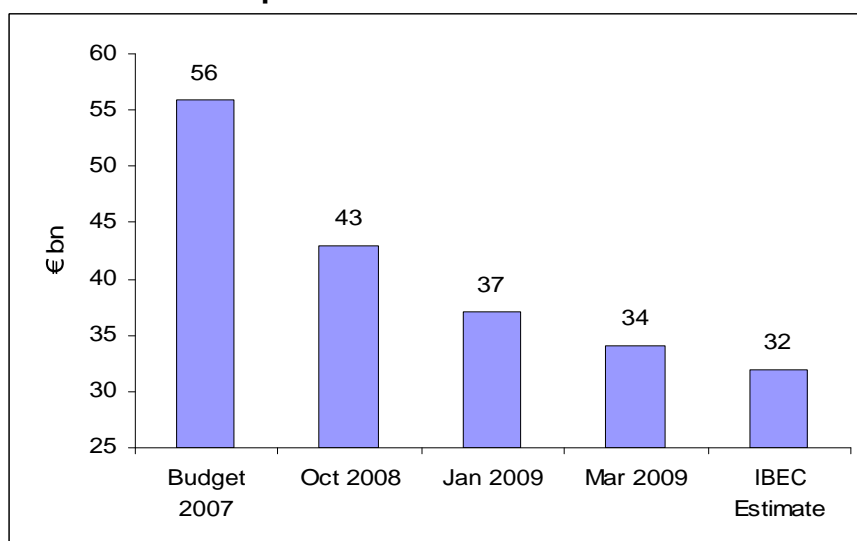
5. Recommendations for April Supplementary Budget

5.1 Overall approach

IBEC accepts the requirement for emergency fiscal measures to address the current difficulties in the public finances. The further deterioration in tax revenues in recent months necessitates immediate action. What is most difficult to determine is precisely how much of an adjustment is required, the pace of that adjustment, and how can this be achieved in a manner which limits negative socio-economic impacts.

In relation to the scale of the adjustment required, it remains difficult to determine just how much further activity levels in the Irish economy will fall. Figure 5.1 shows the various tax revenue forecasts for 2009 published by the Department of Finance. The initial tax revenue forecast for this year of €56 billion was published in Budget 2007; by last October's Budget the forecast had fallen to €43 billion and had reached €37 billion in January's *Addendum to the Irish Stability Programme Update*. Following the publication of the Exchequer Receipts for February, Government acknowledged that the €37 billion target would not be reached. It currently estimates that tax revenue will total €34 billion this year. The risks to this estimate remain firmly on the downside, however, and IBEC estimates that the total tax-take this year could be as low as €32 billion. Difficulties are also emerging on the expenditure side as rising unemployment places increasing pressures on the social welfare budget. Unemployment assistance costs are likely to be at least €1 billion higher than the €3 billion estimated in October's Budget.

Figure 5.1 Timeline of Dept. of Finance tax revenue forecasts for 2009



April's Supplementary Budget must achieve the following objectives. It must provide the necessary fiscal adjustment to demonstrate to the international investment community that the public finances are stabilised for the remainder of 2009 and it must contain a cogent plan to show that they are on the path to

sustainable recovery over the coming years. It must ensure that for 2009 the tax and expenditure changes can be administered quickly and efficiently. It should not seek to pre-empt the work of the Commission on Taxation and should therefore postpone to 2010 any major changes to the existing tax mix and structure. Recent months have shown the difficulties associated with rushed and poorly thought out policy changes.

IBEC recommends that the Supplementary Budget should be based on the following set of principles:

- A series of temporary and emergency measures should be introduced in 2009 for the purpose of addressing the short-term fiscal problems
- The adjustment process can only be achieved through a mixture of taxation and expenditure reduction measures, with lessons from international experience indicating that there should be a greater focus on expenditure cuts
- Upon completion of the work of the Commission on Taxation, the Public Expenditure Review Group, a new working group on the social welfare system and further policy analysis during the year, a more fundamental and sustainable revision of the tax system and expenditure issues should be introduced in Budget 2010
- Recognising the structural shift in the economy and its implications for tax revenue, decisions regarding issues such as the introduction of a property tax; taxing of child benefit; or introduction of a carbon tax should be deferred until 2010, when a new comprehensive, cohesive and sustainable tax system should be introduced
- Government must balance the need to restore stability to the public finances, and thereby strengthen Ireland's reputation internationally, with the negative implications of tax increases and expenditure cuts on already rapidly declining activity levels. At the current juncture there is a real danger that an overly aggressive budget might contract the economy to such a degree that the shortfall in the public finances remains just as wide but at a much lower level of activity – thereby greatly accentuating the socioeconomic problems of the current recession
- On balance, IBEC supports an adjustment process in the region of €3 billion for eight months of 2009 but believes that measures in excess of this amount would ultimately prove counter-productive.

5.2 Current expenditure

International evidence indicates that fiscal consolidation processes are most effective when the balance of the adjustment occurs on the expenditure side rather than on taxation. IBEC recommends that the adjustment required during the remainder of 2009 should comprise of a two-thirds current spending reduction component with one-third coming from increased taxes.

The April Supplementary Budget should introduce a reduction in all discretionary (net) current expenditure. The cost of public sector pay and expenditure on current services should be cut by 9%. This would provide a gross saving of €2.1 bn over the eight months of 2009.

Government should establish a working group to examine the current structure and sustainability of the social welfare system. The group should take account of available resources; the impact of deflation; and potential difficulties in relation to welfare traps as wages decline. Recent OECD research shows that replacement rates in Ireland are very high by international standards. This and a range of

other dimensions of the Irish social welfare system must be fundamentally reappraised in light of the predicted decline in living standards.

In the interim, welfare payments should be adjusted in line with changes in the cost of living. Consumer prices are forecast to fall by about 5% this year and the social welfare increases awarded in last year's budget, on the basis of a forecasted inflation rate of 2.5%, should therefore be revised downwards. All social welfare rates should therefore be reduced by 3% in the April Supplementary Budget resulting in an eight month saving of €400 mn.

5.3 Income tax

As tax revenue has fallen dramatically, income tax increases are necessary but should involve a significant broadening of the income tax base and any changes must take into account the need to maintain a strong incentive to work and ensure that Ireland remains an attractive location for high skilled mobile labour. While Ireland currently has one of the lowest tax wedges in the OECD, this is primarily to the benefit of those earning average and below average incomes rather than those on above average incomes. OECD data show that those on two thirds of average earnings face a tax wedge 6.7% below the OECD average; for those on average earnings the tax wedge is 6% lower, while for those earning 167% of average earnings the tax wedge is about the same as that across the OECD. Any changes to the income tax system should therefore involve a broadening of the income tax base, as it is unsustainable for 40% of income earners to remain outside the tax net.

For 2009, given the complexity involved in wholesale adjustments to the income tax system during mid-year, IBEC recommends an approach that does not alter tax rates or credits but is based solely on changes to the income levy structure. If changes are introduced to income tax bands or credits, or on tax reliefs, it would involve considerable cost to employers to implement these during a tax year. It is therefore recommended that the existing income levy system is restructured. All income earners should be subject to some levy and a number of new rates and thresholds should be introduced so that large step-changes do not emerge between rate bands i.e. the levy should not increase from say 2% on income under €100,000 to 4% on income over €100,000. An additional gross €1.2 bn should be raised via the income levy during 2009 – this would require a near tripling of the existing income levy. This would result in a 12% increase in the national income tax burden, which is at the limit of what could be borne in a single budget.

5.4 Indirect taxes

While it might be tempting for Government to consider some indirect tax increases, careful consideration must be given to the cross-border trade implications of such measures. IBEC estimates that between 2% and 3% of total retail spending was lost due to cross-border trade with the UK in 2008. The majority of this occurred in the form of cross-border shopping trips to Northern Ireland but a growing share is as a result of internet shopping. Irish consumers spent an average of €1,700 on internet shopping in 2008, a large portion of which is most likely to have involved out-of-state purchases². A recent report by the Revenue Commissioners and the CSO estimated that the value of cross border shopping was in the range of €350 mn to €550 mn in 2008. The report recognises

² iReach survey of consumer spending. March 2009.

the limitations of its own methodology and IBEC believes that the losses to both the economy and the Exchequer are much greater than those estimated. The report suggests that the total loss to the Exchequer in 2008 was in the range of €87 mn to €136 mn. These estimates take no account of the income tax and social welfare costs associated with the loss of employment in the retail sector occurring as a direct consequence of cross border shopping.

The feedback which IBEC has received from its members in recent months indicates that the volume of cross border shopping has increased substantially since last Autumn. The sharp deterioration in VAT and excise receipts over the past three months or so also reflects this. The real cost to the economy and the Exchequer of cross border shopping is well in excess of recent estimates prepared for Government. A much more comprehensive study of the issue, involving extensive primary survey work, is required in order to develop an accurate analysis of the situation. In the absence of such a study Government should postpone any further increases in either VAT or excise. Increases in indirect taxes at present would inevitably lead to higher levels of cross border shopping and further losses to the Exchequer. Indirect tax increases in the April Supplementary Budget could well prove to be counterproductive and ultimately result in lower tax receipts.

5.5 Capital investment and National Development Plan

IBEC has previously argued that Government should preserve for as long as possible the funding committed to the National Development Plan (NDP). Expenditure under the plan is providing a much needed stimulus to the domestic economy and is also helping address a range of existing infrastructure deficits. It is now clear, however, that the Exchequer position has deteriorated to such a degree that the capital investment envelope can no longer be fully preserved. While accepting that the majority of funding allocated for 2009 is already subject to contract commitments, IBEC recommends that the bulk of the uncommitted funding be reallocated to an enterprise support programme. A minimum of €1 billion is required to help otherwise viable businesses survive the short-term impacts of the currency, credit and economic crises. A summary of the measures to be supported is set out in Section 5 of this submission.

Alternative options to secure funding for investment in the public capital investment programme should be explored. A National Infrastructure Bond aimed at pension funds and private investors could raise substantial resources to continue an ambitious programme of capital investment. A range of capital projects from building new schools to roads and rail could be funded through such a scheme. Funding structures of this nature would help cut Government debt and its servicing cost and could also reduce the budget deficit without any downside for activity levels in the real economy.

Maintaining an ambitious capital investment programme is the most appropriate form of counter-cyclical fiscal policy for a small open economy such as Ireland's. The target of delivering a public capital programme of about 5% of GNP should be maintained, using non-Exchequer funding sources in order to maintain investment levels. Irrespective of issues relating to the availability of funding, however, the NDP should be fully reassessed during 2009 in order to take account of the changing economic environment and associated infrastructure demand factors. The cost-benefit associated with all projects will have changed considerably since the NDP was first planned and project priorities should now be re-ordered in order to reflect changes to the external environment.

5.6 Summary of adjustments in April Supplementary Budget

The April Supplementary Budget is the first in a series of budgets required in order to address the structural deficit in the public finances. Government must not over-react to the current deterioration in tax revenue by introducing measures which will excessively contract economic activity. In summary, IBEC recommends:

- The April Supplementary Budget should be a holding position for 2009 in advance of a more comprehensive appraisal of tax and expenditure policy in Budget 2010 following the publication of the work of the Commission on Taxation and that of the Expenditure Review Group
- An adjustment of €3 bn in net terms is the maximum which the Irish economy could bear at the current point in the business cycle. Two thirds of this should come from expenditure reductions and one third from taxation increases
- The existing income levy should be adjusted so that it yields an additional €1.2 bn in gross terms over the remaining eight months of 2009
- Expenditure on public sector pay and pensions and on the provision of current services should be cut by 9% - yielding a gross saving of €2.1 bn for the remainder of 2009
- Social welfare rates should be adjusted in line with changes in the cost of living and should therefore be reduced by 3%, resulting in savings of €400 mn during 2009
- There should be no increases in corporation tax, employers' PRSI, excise levies or VAT. IBEC strongly believes that any increases in VAT or excise would further incentivise cross-border shopping and would be counter productive from a tax revenue perspective
- A reallocation of €1 bn should be made from the NDP to a programme to support employment in enterprise
- Off-balance sheet options should be explored in order to maintain the existing volume of infrastructure activity under the public capital investment programme

The total gross savings for eight months of 2009 arising from the above adjustments would therefore be €3.7 billion, with €1.2 billion coming from income tax and €2.5 billion from reductions in current expenditure. Negative revenue buoyancy would of course limit the final savings to the Exchequer as the adjustments would directly and indirectly result in lower tax revenues. Given the substantial increase in the savings ratio over recent months it is difficult to accurately estimate the current negative revenue buoyancy factor. If large numbers of households have already increased their savings ratio on the basis that tax increases were imminent then the consumption impact of the adjustments might not be as large as in normal circumstances. We have therefore estimated that the gross adjustment of €3.7 billion would result in a net Exchequer adjustment of about €3 billion.

6. Supports for enterprise

IBEC continues to recommend that a suite of temporary business supports which would ensure that hitherto viable companies survive the next two very difficult years and sustain employment, is urgently required³. The Exchequer has the resources to fund such supports if Government proves flexible enough to redirect existing commitments under the National Development Plan (NDP) into more urgent short-term relief measures.

The aim of these business supports should be to sustain as high a level of enterprise activity and employment as possible by mitigating the adverse impact of the lack of access to finance and the crippling impact of currency movements. Failure by Government to implement an immediate suite of emergency support measures for those businesses affected by the recent economic, financial and exchange rate difficulties will result in a damaging and irreversible erosion of Ireland's enterprise base. The single greatest challenge facing the economy and society at present is to halt the recent surge in unemployment. The measures proposed in this submission would be instrumental in achieving this.

Summary of Recommendations (from IBEC Submission made to Government in February 2009³)

Temporary Enterprise Support Programme

- A new Enterprise Development and Sustainability Programme should be established within the framework of the National Development Plan (NDP). This programme should have an annual budget of €1 bn for both 2009 and 2010 and should be resourced through a reallocation of funding available to other programmes funded under the NDP
- Through this new programme a suite of strategic support and productivity enhancing measures should be targeted at those enterprises most affected by the exchange rate, credit access and market demand challenges which have intensified since July 2008

Regional Aid issues

- Government should seek approval from the EU Commission for a temporary suspension of the existing Regional Aid Guidelines with a view to providing higher grant rates for enterprises in all regions
- In order for enterprises to deliver essential productivity enhancing improvements to their manufacturing processes capital grants of 40% must be available to firms of all size in every geographical area

Supports for enterprises exposed to adverse currency movements

- Employers' PRSI payments should be suspended for a period of two years (subject to six monthly review) for companies in sectors where exports to the UK account for more than 40% of total exports
- A special marketing compensation grant should be available to these companies to overcome exceptional market distortions where they can demonstrate that loss of market share or loss of income due to exchange rate fluctuations is threatening their viability

³ A Programme for Enterprise Development and Sustainability. IBEC Submission to Government. February 2009.

Measures to address energy costs

- Given the unprecedented competitiveness challenges facing enterprise and the exceptionally high level of energy prices in the Irish market, Government must introduce a number of immediate measures to reduce energy costs for business
- IBEC recommends that an emergency review of the structure and level of all consumer electricity and gas tariffs be undertaken
- Strategic energy infrastructure must be identified, prioritised and progressed in a timely, efficient and cost-effective manner. Alternative funding mechanisms such as the NDP or EU funding for this infrastructure should be considered by Government. This would result in an immediate price reduction for consumers of about 13%
- Windfall carbon rebates for businesses should be extended to the 2009 to 2012 period
- Tax revenue from a possible carbon tax must be hypothecated towards helping businesses with energy efficiency initiatives.

New grant schemes for energy efficient equipment and machinery

- Within the context of the EU Recovery Programme and the EU Climate and Energy Package, Government should seek approval for a new grant aid programme to support investment in energy efficient machinery, plant and buildings

Measures to address credit shortage

- A loan guarantee scheme is needed to support working capital for firms of any size through which Government provides guarantee covering 50% of the risk
- New risk capital investment programme to be developed to provide investment of up to €2.5 mn per enterprise
- Dedicated loan guarantee scheme for SMEs should be introduced
- SME loan subsidy programme to be introduced
- Firms experiencing liquidity difficulties to be allowed to postpone payment of three months' worth of PRSI and income taxes to Revenue for a period of up to 2 years

Trade Credit Insurance

- Government should work with private sector insurers with a view to developing a state-backed guarantee scheme for trade credit insurance. This would level the playing field with other countries for Irish companies that currently cannot obtain affordable trade credit insurance

General State Aid issues

- Government must adjust its enterprise support programme in order to fully avail of the following temporary state aid measures introduced by the EU Commission in December 2008:
 - The individual enterprise limit for *de minimis* aid grants has been increased from €200,000 over three years (equivalent to €66,666 per annum) to €500,000 over 2009 and 2010 (equivalent to €250,000 per annum).
 - Subsidised loan guarantees for a limited period of time will be permitted in order to improve access to finance for firms.
 - Public and private loans can now be granted to enterprises at lower interest rates than previously permitted under State aid rules.
 - Subsidised loans are permitted for firms engaged in the production of 'green products'
 - The threshold for risk capital investments for SMEs has been increased from €1.5 mn to €2.5 mn and the percentage of minimum private investor participation has been reduced to 30%.

