BUDGET 2007

OVERVIEW

This year's budget has been framed with one eye on the political landscape and the impending general election, which has to be held by early summer. Fortunately for the government, the public finances are in excellent shape, with an unexpected and large government budget surplus of €4 billion in 2006. Thus, even after providing for an 8% increase in spending in the 2007 Estimates, the Minister still had an opening General Government budget surplus of €4.4 billion, before today's budget day changes.

Hence, **the Minister has been able to deliver a very generous and stimulatory budget today and still target a sizeable General Government budget surplus of 1.2% of GDP in 2007.** Indeed, by our estimates, the surplus could be even larger as the Dept's tax projections are likely to be overshot again next year. Thus, we expect that the eventual outturn will be a General Government budget surplus of close to 2% of GDP in 2007.

It makes sound economic sense to run large fiscal surpluses at present. Budgetary policy should allow sufficient scope for the operation of automatic stabilisers and avoid the need for restrictive fiscal measures when the economy slows. Indeed, there is a real risk of a sharp decline in property related taxes in the event of a slowdown in the housing market. Thus, it is even more imperative to keep the public finances in significant surplus at the present time.

Although this government has implemented large reductions in various tax rates over the past decade, the actual tax take at 36% of GNP in 2006 is one percentage point higher than when it came to power in 1997. The buoyancy of the economy, especially the labour and property markets, has greatly boosted tax receipts. Furthermore, many taxes have not been fully indexed to take account of rising inflation, especially property related taxes.

The sizeable increases in income tax credits and bands in this budget are particularly welcome. These were frozen in the 2003 and 2004 budgets, pushing low paid workers into the tax net and many middle income earners onto the top tax rate. The top rate of income tax was today reduced by 1% to 41%. Today's personal tax cuts are the most generous since 2001, costing €1.25 billion in a full year. There was also a doubling of mortgage interest relief for first time buyers. Stamp duties, though, were left largely unchanged. Meanwhile, the 50 cents hike on a packet of 20 cigarettes will add 0.4% to the CPI rate, which is now likely to average above 4% in 2007.

On the expenditure side, additional resources were allocated for the elderly, including generous increases in the old age pension. Indeed, the total increase in social welfare payments announced yesterday amounts to close on €1.5 billion in a full year.

Overall, the budget is positive from a business point of view as it should help ensure continuing robust economic growth. **It is likely to find particular favour with the construction sector.** The tax changes will help alleviate some of the recent deterioration in housing affordability, underpinning demand from first time buyers in particular. At the same time, as in the 2005 and 2006 budgets, this budget has quite an emphasis on social inclusion. **Overall, it is a generous and politically popular budget that it is likely to be broadly welcomed, while keeping the public finances on a firm footing.**

Oliver Mangan/Jenny Pollock - 6th December 2006

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BUDGET 2007: KEY FEATURES

2007 BUDGET TARGETS

* **Exchequer Deficit** of €546m (-0.4% of GNP) in 2007, compared with government expectations for a 2006 surplus of €1,854m (1.2% of GNP). **General Government Surplus** of €2.3bn (1.2% of GDP) in 2007 against an expected 2006 surplus of a €4bn (2.3% of GDP).

* The Exchequer Deficit is projected at €1.5bn in both in 2008 and 2009, with the General Government Surplus estimated at 0.9% and 0.6% of GDP, respectively, in both years.

* The General Government Debt as a percentage of GDP is projected to be 25% in 2007, falling to 23% in 2008 and 22.4% in 2009.

EXPENDITURE MEASURES

Current Spending

* Gross Non-Capital supply services expenditure figure for 2007 at €48.5 billion, up 11.5% on the 2006 level.

* Budget day Social Welfare measures totalling €1,467m in a full year.

Elderly

* Old age pensions increased by €16 per week, bringing the Old Age Contributory Pension to €209.30 per week, effective from January 2007. Non-contributory pension increased by €18 per week to €200 per week.

* Additional funding of €255m in a full year to provide: 2,000 more home care packages; further increases in home help hours; increase in numbers of day and respite places; and other measures.

Other Social Welfare Measures

* Personal social welfare rates increased with, for example, lowest adult rate up by €20 per week to €185.80.

* Free Fuel Allowance increased by €4 to €18 per week. Income threshold for eligibility increased from €51 to €100 per week.

Childcare/Maternity

* Child Benefit increased by €10 for all children bringing the rates to €160 per month for the first and second child and to €195 per month for each of the third and subsequent children, effective from April 2007.

* Increase in maternity leave by 4 weeks, as announced in Budget 2006, to be implemented.

* Back to School Clothing and Footware Allowances increased, plus other changes to reliefs and benefits.

* Tax free income for individuals providing child minding facilities increased from €10,000 to €15,000.

Carers

* Increases in grants and allowances to support carers.

Health

* 25% increase in charge for private beds in public teaching hospitals.

Disability Services

* Additional €100m to provide additional residential respite and day places plus other service improvements.

* Once-off grant of €2m for Special Olympics Ireland.

Capital Spending

* Additional €23m in capital expenditure measures.

* Gross voted capital expenditure is projected to rise to €7.6 billion in 2007, an increase of 13% on the 2006 level.

TAXATION MEASURES

PRSI

* Employee PRSI ceiling raised from €46,600 to €48,800, an increase of 4.7%.

* Employee weekly PRSI threshold increased from €300 to €339 (€17,628 p.a.).

Income Tax

* Top rate of tax cut from 42% to 41%, with commitment to cut the rate further to 40% in the next Budget, on the basis that the current economic strength is maintained. No change in standard rate.

* Basic single person tax credit increased by €130 to €1,760 (+8%). Married person credit increased by €260 to €3,520.

* The standard tax band to be widened by €2,000 to €34,000 (+6.25%) for a single person; for a married couple with one income by €4,000 to €43,000; for a married couple with two earners by €4,000 to €68,000, subject to a limit on the transferability of individual bands of €43,000.

* Employee PAYE tax credit increased by €270 to €1,760 (+13.5%).

* Health Levy threshold increased by €40 per week to €480.

* Health Levy rate increased from 2% to 2.5% on income over €1,925 per week (€100,100 per annum).

* Tax exemption rate for over 65s raised from €17,000 and €34,000 to €18,000 and €38,000 for single and married persons, respectively.

* Revenue to automatically credit tax relief where possible and to increase public awareness of reliefs available.

* Increases on range of other tax credits for persons in various circumstances.

VAT and Excise Duties

* 50c on pack of 20 cigarettes, with corresponding amounts on other tobacco products, with effect from 7/12/2006.

* No other changes in VAT or Excise Duties apart from abolition on kerosene and home heating LPG announced last year. Effective 1/1/2007.

Property

* Ceiling on mortgage interest relief for first time buyers doubled from €4,000 to €8,000 for a single person and from €8,000 to €16,000 for a married couple. Applies for the first seven years of a mortgage. Ceiling on mortgage interest relief for non first time buyers raised from €2,540 to €3,000 for a single person and from €5,080 to €6,000 for a married couple.

* Stamp Duty charge on mortgage documents abolished. Saving of up to €630.

* Level of rent paid for which tax relief can be claimed increased from €1,650 to €1,800 per annum for a single person and from €3,300 to €3,600 for a married couple.

Other Personal Taxation

* BIK rate increased from 3.5% to 4% in respect of home loans. Specified rate in regard to other loans increased from 11% to 12%. Effective 1/1/2007.

* Exempt individuals to receive income without deduction for DIRT.

Business Taxation

* Business Expansion and Seed Capital Schemes to be extended for a further seven years.

* BES ceiling for company investment increased from €1m to €2m.

* Annual investor limit for BES schemes increased from €31,750 to €150,000.

* Annual investor limit for seed capital schemes increased from €31,750 to €100,000

* New 10 year round of seed and venture capital funding.

* Package of VAT measures to reduce the charge and the administrative burden on small businesses.

* R & D tax credit to incentivise farms to engage in R & D.

Green Measures

* Vehicle Registration Tax ratings to be modified to relate to levels of carbon dioxide emissions. Following a public consultation process, measures to take effect from 1/1/2008.

* Annual motor tax rates also to be modified.

* Planned spend under Greener Homes Scheme increased by €20m from now to end 2009.

* Extension of grant aids for bio-heat schemes.

* Additional €3m funding to Sustainable Energy Ireland in 2007 to develop pilot programme to support SMEs in assessing energy usage and measures to enhance energy efficiency.

* Continuation of corporation tax relief for investment in renewable energy projects for a further 5 years.

* Grant aid for production of energy crops.

* Additional €270m fund for programme of purchases of carbon allowances up to 2013.

Capital Gains Tax

* No changes in capital gains taxes.

Other Measures

* VAT measure specifically for conferences to be introduced in Finance Bill to support tourism.

* Exemption from stamp duty for sporting bodies on purchase of land for promotion of sport to be introduced in the Finance Bill.

* Range of farm tax reliefs in areas of income and capital taxes to be renewed and extended.

BUDGET ASSESSMENT

Budget Surplus Forecast At €2.3bn In 2007

The table below sets out the principal features of the 2007 budget arithmetic. Net spending on current supply services is forecast to rise by 13% next year. On the other side of the balance sheet, tax receipts are forecast to rise by 8% in 2007. The tax changes announced in the budget will cost €1.1 billion in gross terms but just €445 million in net terms next year, when allowance is made for the impact on the buoyancy of tax receipts of the budget giveaways. Overall, the current budget surplus is projected to fall to €8bn in 2007, from €8.9bn in 2006.

On the capital side, net voted expenditure is forecast to rise by 13.3%. Capital receipts are expected to decline somewhat next year. As a result, the capital borrowing requirement is projected to rise to €8.6bn from €7bn in 2006. Overall, the government is forecasting an Exchequer deficit of €546m in 2007, compared to an Exchequer surplus of €1.85 billion in 2006. The Minister is targeting a General Government surplus of €2.3bn next year, or 1.2% of GDP. This compares to a surplus in 2006 of €4bn (2.3% of GDP).

Surplus May Be Even Bigger Than Forecast

How realistic are the Minister's budget targets? Current spending has come in under target in recent years. Capital spending has also undershot target in recent times. We do not see why these trends will not be maintained in 2007, with spending again somewhat below target. The main errors in budget forecasts, though, are on the revenue side, especially tax receipts.

BUDGET 2007

(€ Million)	2006 Projected Outturn	2007 Budget Target	% Change
Current Spending	**37,128**	**41,590**	**12.0**
of which			
(i) Central Fund	4,207	4,425	5.2
(ii)Supply Services	32,921	37,165	12.9
Current Revenue	**46,017**	**49,640**	**7.9**
of which			
(i) Tax	45,452	49,075	8.0
(ii) Non-Tax	567	565	-0.4
Current Budget Surplus	**8,891**	**8,050**	
Capital Borrowing	**7,036**	**8,597**	
Exchequer Bal.	**1,854**	**-546**	
(% of GNP)	(+1.2%)	(-0.4%)	
General Gov. Bal.	**3,980**	**2,276**	
(% of GDP)	(+2.3%)	(+1.2%)	

Tax receipts will overshoot target by €3.8 billion this year, having exceeded forecast by €1.75 billion in 2005. Much of these overshoots reflects a higher than expected take from property related taxes, namely capital taxes and stamp duties. These have been boosted by the exceptional buoyancy of the housing market. Corporation and income tax receipts also greatly exceeded target in 2006.

The Dept forecasts seem quite cautious again for next year in relation to capital taxes and stamp duties, which are forecast to rise by 7.5% and 6.6%, respectively, in 2007. At end November 2006, though, capital taxes and stamp duties were up by 62% and 40%, respectively. On a carryover basis, alone, these tax headings should record further strong growth in 2007. Meanwhile, corporation tax receipts are forecast to be unchanged in 2007.

Tax revenues have proven very difficult to forecast in recent years, but another sizeable overshoot of well over €1 billion seems likely in 2007. Overall, we think that the Exchequer balance could be in surplus to the tune of around €1 billion next year, beating the target by €1.5 billion. This implies that the General Government budget could be in surplus by around €3.8 billion in 2007, equivalent to 2% of GDP.

A Stimulatory Budget

The Minister started today with an opening Exchequer surplus of €1 billion. At a broader level, he had an opening General Government surplus of €4.4 billion. These large opening surpluses indicate that the Minister was in a position to deliver a generous package of budget giveaways today and still keep the public finances in large surplus. He did not disappoint.

On the current budget side, increases in social welfare benefits announced today will cost almost €1.5 billion in a full year A key component of this year's budget is additional spending on homecare for the elderly, costing €255m in a full year.

On the revenue side, there were generous cuts in income taxes costing €1.1 billion. However, some of the social welfare rises and tax cuts will flow back into the Exchequer coffers in higher tax revenues. Nonetheless, as the table below indicates, this was the most generous budget of recent years. Overall, as a result of today's measures, the Minister reduced his opening General Government surplus by €2.15 billion, pointing to an expansionary budget.

The increases in social welfare payments and reductions in income taxes total some €2.3 billion in 2007. This will boost household disposable income by close to 2.5%, providing a considerable fillip to household spending power. Furthermore, following today's budget, gross current voted government expenditure is set to rise by 11.5% in 2007. On the capital side, underlying voted expenditure will rise by 14.5%. Overall, these generous tax cuts and large spending rises point to a stimulatory budget.

The General Government budget surplus is forecast to fall from 2.3% of GDP in 2006 to 1.2% in 2007, also pointing to a stimulatory budget. Meanwhile, in cyclically adjusted terms, the Dept estimates that the General Government budget balance will fall by 0.9% of GDP in 2007, again suggesting an expansionary budget.

ANALYSIS OF MAIN BUDGET DAY CHANGES (€M)

	2003	2004	2005	2006	2007
Social Welfare	501	608	834	1,065	1,467
Other Current	3	65	37	446	388
Capital Expd.	209	50	334	469	23
Tax Changes	+944	-17	-578	-763	-1,107
Buoyancy Effect	227	181	333	488	662
Net Tax Change	+1,171	+164	-245	-275	-445

A Good Budget for Corporates

From a corporate perspective, the reaction to the budget is likely to be quite favourable. It should help ensure another year of robust growth for the economy, while keeping the public finances on a sound footing. Companies will welcome a lot of the tax changes in the budget. The Business Expansion Scheme is being renewed for a seven year period to end 2013. The BES company limit is to be increased from €1 million to €2 million. The Seed Capital Scheme is also being renewed for a seven year period to end 2013, with a €2 million limit also applying.

The VAT registration thresholds for small businesses are being increased from €27,500 to €35,000 in the case of services and from €55,000 to €70,000 in the case of goods. The annual VAT cash accounting threshold for small firms is being increased from €635,000 to €1 million. The changes take effect from 1 March 2007. Meanwhile, the frequency of VAT payments for small businesses, currently six per year, is being reduced to either two or four from July 2007.

Budget Should Help Underpin Construction Activity

The construction sector will welcome the sizeable increase in mortgage interest relief for first time buyers, which will help ease affordability pressures on this sector of the housing market, as will the boost to disposable income from the significant cuts in income tax. The impact of these changes on disposable income is quite significant.

For a two income couple on a combined average industrial/managerial wage of €80,000, the personal tax cuts announced in the budget will boost their take home pay by €1,722, equivalent to a rise of 2.5% in their disposable income. For a single person earning €40,000, the increase in take home pay amounts to €900 or 3% of disposable income.

The boost to disposable income is even greater for first-time home buyers as mortgage interest relief has been doubled in the budget to €16,000 for a couple and €8,000 for a single person (at the standard rate of 20%) for this category of home owner. This will boost the disposable income of a couple by up to €1,600 and by up to €800 for a single person. It also means that for a couple, all of their mortgage interest on a 35 year mortgage at the average house price of €310,000 will now qualify for tax relief.

This mortgage interest relief is available to all first-time buyers who are in the first seven years of their mortgage. Meanwhile, the ceiling for non-first-time buyers is also being increased, from €2,540/€5,080 for single/married to €3,000/€6,000, respectively.

The annual interest repayment on a 35 year 90% mortgage at the average house price currently stands at around €13,500. The boost to annual disposable income for a first-time buyer couple on an average industrial/managerial wage from the budget tax changes is €2,800 per annum. For a single person who is a first- time buyer, it amounts to €1,700. Thus, the budget changes represent a significant easing of the burden on first time buyers of their mortgage interest repayments.

As a result, it should help to underpin demand and prices in this sector of the housing market. It also shifts the balance in terms of housing demand more in favour of the first time buyer and away from the investor. Indeed, it creates a more level playing field as investors can write off all their mortgage interest costs against rental income.

Meantime, it is to be welcomed that the Minister did not opt for a radical reduction in stamp duty in today's budget as this could have triggered a renewed acceleration in house price inflation across the market, at a time when house prices are already very high.

The doubling of mortgage interest relief is a much more targeted measure and as such should have a more muted impact on prices than a major change in the stamp duty regime. However, the ending of the recent uncertainty in relation to stamp duty should lead to a pick up in housing activity in the early part of the 2007, especially at the upper end of the market, and may lead to some upward pressure on prices.

Finally, the Public Capital Programme provides for another substantial rise in capital spending in 2007. A total of €1.5 billion in additional capital spending was contained in the Estimates. This puts the projected underlying rise in public capital spending in 2007 at 14.5%.

5.0 - 5.5% GDP Growth Forecast For 2007

There is a striking consensus amongst forecasters that the Irish economy will perform impressively again next year and grow by between 5.0 - 5.5%. The external environment is expected to remain reasonably favourable, with solid growth forecast for Europe. On the domestic front, fiscal policy will be expansionary again next year. Although interest rates have risen, monetary policy is still accommodative. Meanwhile, the bulk of SSIA accounts will mature in early 2007, providing a major boost to household disposable income.

Not surprisingly, then, consumer spending is expected to be the main engine of growth in the economy next year, rising by 6.5-7.5%. Solid growth is also expected in government spending and fixed investment. Exports are forecast to rise by around 5%. What is also notable about all the forecasts in the table below is that growth is expected to be well balanced in 2007, with a significant contribution from all the main components of GDP. Although there has been much comment about the economy becoming lopsided and overly dependent on construction, the fact is that GDP growth has been well balanced to date in this decade.

2007 IRISH MACRO ECONOMIC FORECASTS (%)

	AIB	D/Finance	ESRI	Central Bank	EC	OECD
GDP	5.5	5.3	5.0	5.5	5.3	5.1
GNP	5.5	5.3	4.9	5.5	NA	NA
Private Cons	7.5	7.3	6.8	6.5	7.0	6.8
Gov Expd.	5.0	3.7	4.1	3.5	4.2	5.4
Fixed Inv.	5.0	5.4	6.5	5.25	5.4	4.8
Exports	5.5	4.9	5.1	5.25	5.2	6.0
Imports	6.5	6.2	7.2	5.75	6.0	7.3
CPI	4.3	4.1	3.6	3.75	NA	NA
HICP	2.6	2.6	NA	2.75	2.7	2.8
Employment	4.0	3.5	3.5	3.75	3.0	NA
Unemployment Rate	4.4	4.4	4.4	4.25	4.5	4.4

A notable feature of the economy has been the strong growth in employment, which is likely to increase by around 4.5% this year. Forecasters expect a slowdown in employment growth to 3-4% in 2007. AIB is the most optimistic, expecting employment to rise by 4% next year. Meanwhile, the unemployment rate is forecast to remain low at around 4.25-4.5%.

Turning to inflation, there is a risk that the expansionary budget could aggravate the price pressures evident in the economy at present. Indeed, the hike in excise duty on cigarettes will add close to 0.4% to the CPI rate. Most forecasters expect that the Irish HICP rate will average around 2.75% in 2007, with the CPI rate at 3.75%. AIB's 2007 CPI forecast of 4.3% is somewhat above other forecasts. This may reflect the fact that we have built in two further 0.25% hikes in ECB rates in December and early next year into our CPI forecasts.

Meanwhile, it is comforting to note that the Dept of Finance is forecasting that the General Government Budget will remain in surplus in 2008 and 2009, at 0.9% and 0.6% of GDP, respectively. Indeed, these surpluses may be even larger, given that we expect the budget surplus will exceed target in 2007.

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