



# Pre-Budget Submission on Behalf of IPAV

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## **ECONOMIC BACKGROUND TO BUDGET 2009**

The background against which Budget 2009 is being set is the most difficult in 20 years. The economy is currently in the midst of a serious economic slowdown, with GDP expected to contract by around 2% in 2008 and by up to 1% in 2009.

All indicators of economic activity are consistent with a sharp weakening of economic activity so far in 2008:

- The number of people signing on the live register increased by 73,178 in the twelve months to August;
- The unemployment rate increased to 6.1% of the labour force in August, up from 4.5% at the beginning of 2007;
- Employment increased by just 6,900 in the twelve months to the second quarter, but fell by 26,600 during the quarter. The construction sector shed 26,800 jobs over the year to the second quarter;
- The total value of exports in the first six months of 2008 was 4.1% lower than the first half of 2007;
- The total volume of retail sales in the first seven months of the year was 2.4% lower than the first seven months of 2007;
- The volume of manufacturing output in the first seven months of the year was 2.7% higher than the equivalent period in 2007. Manufacturing output increased by 7.5% in 2007;
- The Exchequer recorded a deficit of €8.4 billion in the first eight months of 2008, which compares to a deficit of €2.9 billion in the first eight months of 2007. The total tax take was €2.8 billion lower than expectations.

The boom in residential housing activity in recent years was a key driver of employment, tax revenues, consumer confidence, consumer spending, the Irish equity market and overall economic activity. Given this major contribution, a market adjustment was always going to be a painful experience for the economy and that is turning out to be the case. However, the pressures arising from the adjustment are being exacerbated by rising food and oil prices, the contraction in credit availability as a result of the escalating sub-prime crisis, the sharp slowdown in the US and UK economies, and adverse exchange rate movements.

## ECONOMIC IMPACT OF HOUSING MARKET SLOWDOWN

The sharp slowdown in the housing market over the past year has had a very negative impact on many aspects of the economy and economic activity in general. The key impact to date has been seen in the labour market, the Irish stock market performance, the Exchequer finances, consumer confidence, and consumer spending.

### THE LABOUR MARKET

The Irish economy is still creating jobs, but the pace of growth is slowing dramatically. Employment increased by 6,900 in the year to the second quarter of 2008, which is equivalent to growth of just 0.3%. This is down from 2.6% in the previous quarter. Over the past year construction and manufacturing have shed 35,600 jobs between them, with the construction sector accounting for 26,800 job losses.

**Table 1 Job Creation**

<b>SECTOR</b>	<b>CHANGE Q2 2007 to Q2 2008</b>
Agriculture, Forestry & Fishing	+7,500
Other Production Industries	-8,800
Construction	-26,800
Wholesale & Retail Trade	+16,200
Hotels & Restaurants	-3,700
Transport, Storage & Communications	-3,000
Financial & Other Business Services	+10,400
Public Administration & Defence	+1,400
Education	+2,300
Health	+10,700
Other Services	+700
<b>TOTAL</b>	<b>+6,900</b>

*SOURCE: CSO QNHS, August 2008*

## THE IRISH STOCK MARKET

The Irish equity market has lost 44.9% of its value so far in 2008 and has now shed over 62% of its value since the first quarter of 2007. This is having a very negative impact on receipts from Capital Gains Tax, on the value of pension funds, and on personal wealth holdings.

The Irish equity market has primarily fallen because international investors have become increasingly concerned about the Irish economy in general and the housing market in particular. Financial and construction stocks have been particularly badly hit, but the damage has been quite widespread.

## THE EXCHEQUER FINANCES

The sharp correction in the housing market has had a very serious impact on the public finances, with housing related tax revenues under serious pressure. In the first eight months of 2008 the Exchequer ran a deficit of €8.4 billion, compared to a deficit of €2.9 billion in the first eight months of 2007. Table 2 outlines the trend in tax revenues in the first eight months of 2008. The total tax take is €2.8 billion behind target and is 9.4% lower than the first eight months of 2007. The two main property related tax headings are under particular pressure. Stamp Duties are €480 million behind target, and are 45.1% lower than the first eight months of 2007. VAT is €1.2 billion behind target and is 6% lower than the first eight months of 2007.

**Table 2 Tax Revenue Jan-August 2008**

CATEGORY	COMPARED TO TARGET	YEAR ON YEAR GROWTH
Customs	-€26 m	-1.4%
Excise	-€258m	-4.7%
Capital Gains Tax	-€677m	-40.7%
Stamp Duties	-€480m	-45.1%
Income Tax	-€156m	-1.1%
Corporation Tax	-€190m	-7.6%
VAT	-€1,178m	-6.0%
Total	-€2,762	-9.4%

Source: Department of Finance

- In 2006, Stamp Duty from residential property transactions on a revenue net receipts basis totaled €1,311 million, or 36% of total net Stamp Duty receipts.
- In 2007, Stamp Duty from residential property transactions on a revenue net receipts basis totaled €1,018 million, or 31% of total net Stamp Duty receipts.

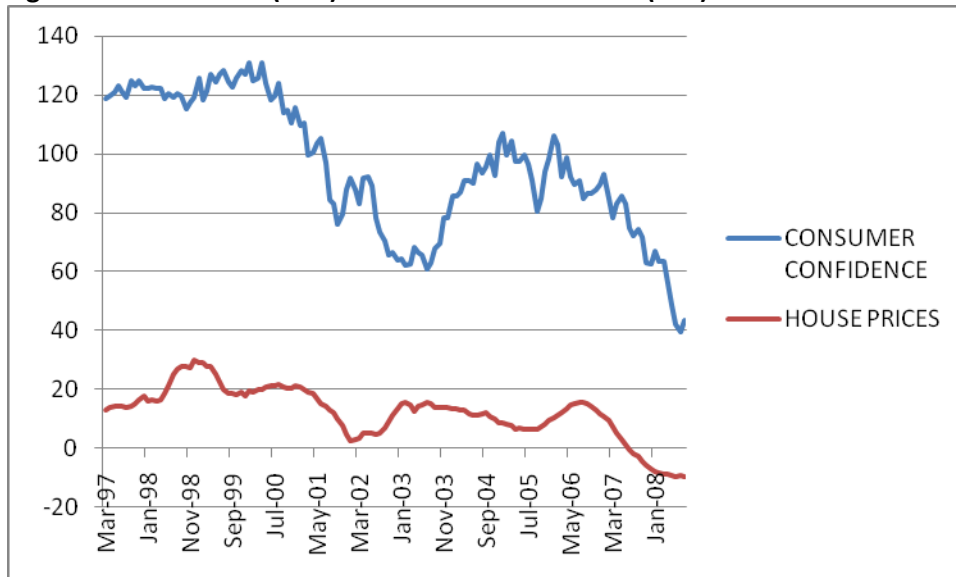
- In 2006, it is estimated that VAT receipts from residential property transactions totaled €2,727 million, or 20.3% of total VAT receipts.
- In 2007, it is estimated that VAT receipts from residential property transactions totaled €2,424 million, or 16.7% of total VAT receipts.

It is clear that the housing slowdown is having a serious impact on tax receipts, both directly and indirectly. VAT and Stamp Duty receipts on residential property transactions are falling sharply, but tax receipts relating to consumer spending, capital gains and general economic activity are also suffering.

### CONSUMER CONFIDENCE & HOUSE PRICES

Given the high level of home ownership in Ireland, house price movements have a significant consumer wealth effect and have a significant impact on consumer confidence and consumer spending power. In an environment of sharply rising house prices, consumer wealth increased on paper and this encouraged borrowing and spending. The converse is also true. In an environment of falling house prices, paper wealth is destroyed and consumer confidence and spending power are undermined. This has been demonstrated very clearly over the past 18 months and the trend is continuing.

**Figure 1 House Prices (RHS) & Consumer Confidence (LHS)**



Source: IIB/ESRI & PermanentTsb/ESRI

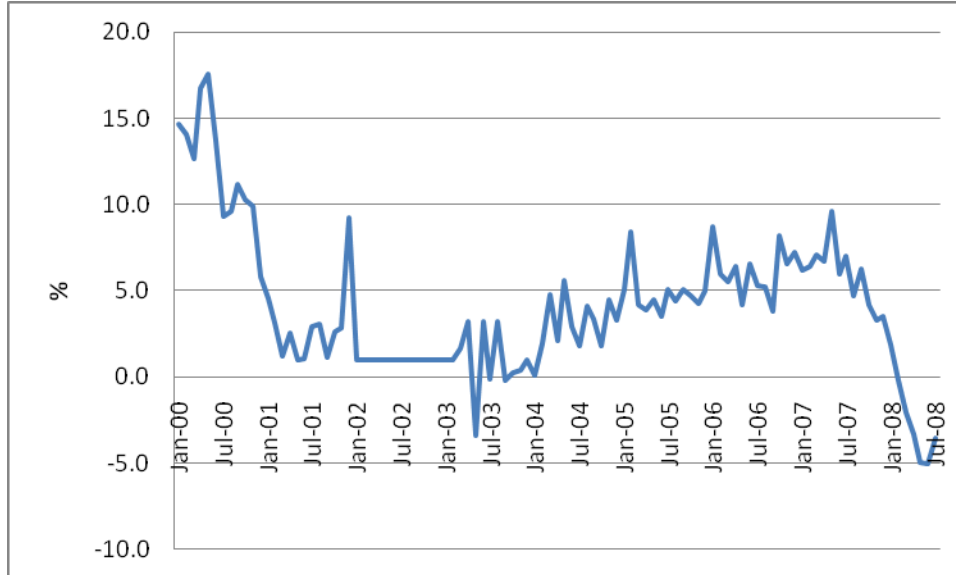
Consumer confidence has a strong relationship with house prices. It looks certain that based on unchanged policies; house prices will fall further over the coming months, so this is likely to maintain downward pressure on consumer confidence and on spending.

### CONSUMER SPENDING

Consumer confidence has been declining sharply since the beginning of 2007 and this eventually translated into a sharp slowdown in consumer spending towards the end of 2007 and this has continued

into 2008. The latest data show that in the first seven months of 2008 the volume of retail sales was 2.4% lower than the same period in 2007.

**Figure 2 Retail Sales Growth**



Source: CSO

An analysis of retail spending for the April-June quarter of 2008 shows that sales of Furniture & Lighting, and Electrical Goods have weakened sharply over the past year. If new houses are not being built and sold, associated retail spending will weaken as a result. This is exactly what is happening. However, the slowdown in spending is spreading to other areas of retail spending.

### Breakdown of Retail Sales Growth (April-June 2008 compared to April-June 2007)

CATEGORY	% CHANGE
Food, Beverages & Tobacco	-3.6%
Pharmaceuticals/Medical/Cosmetics	+2.0%
Textiles & Clothing	-2.1%
Footwear & Leather	-3.6%
Furniture & Lighting	-11.0%
Electrical Goods	-10.8%
Hardware, Paints & Glass	-5.4%
Books, Newspapers & Stationery	-8.1%
Bars	-5.1%
All Businesses excluding Motor Trades	-2.3%
All Business	-4.5%

Source: CSO

It is clear that the painful housing market adjustment is having a serious impact on the overall economy. The adjustment is being exacerbated by negative external developments and the slowdown is now becoming more broadly based.

The following growth outlook is suggested for the Irish economy, but is heavily predicated on an improved external economic environment and a freeing up of global credit conditions in the second half of 2009. If these do not materialise, the slowdown in the Irish economy will be more pronounced and of longer duration.

<b>(average)</b>	<b>2007</b>	<b>2008f</b>	<b>2009f</b>	<b>2010f</b>
GDP	6.0%	-2.0%	-1.0%	2.0%
GNP	4.1%	-1.2%	-0.5%	1.5%
Consumption	6.3%	1.0%	1.5%	2.5%
Investment	-1.8%	-18.0%	-8.0%	2.0%
Government	6.0%	3.5%	3.0%	3.0%
Exports	6.8%	4.0%	4.0%	4.5%
Imports	4.1%	3.0%	3.2%	3.5%
CPI	4.9%	4.6%	3.5%	3.0%
Unemployment	4.6%	6.3%	7.5%	7.8%
House Completions	78,027	45,000	30,000	35,000

F= forecast

## UPDATE ON HOUSING & MORTGAGE MARKET

All available evidence so far in 2008 continues to suggest very difficult housing and mortgage market conditions;

- Latest data from the Central Bank show that net mortgage credit growth slowed to 9.6% in July 2008, compared to a peak growth rate of 28.1% in March 2006. This is the lowest growth rate since 1987. In the first 7 months of 2008, mortgage credit outstanding increased by €6.46 billion, compared to €10.15 billion in the same period in 2007;
- House completions in the first eight months of 2008 were 28.6% lower than the same period a year earlier;
- New home registrations in the first eight months of 2008 were 66.9% lower than the same period a year earlier;
- House commencement notices in the first seven months of 2008 were 50.7% lower than the first seven months of 2007.
- Latest mortgage market data from the Irish Banking Federation (IBF) show that the total value of the mortgage market in the first half of 2008 was €13.83 billion, which is 16.4% lower than the first half of 2007. The First-Time buyer component declined by 28.2%, the Mover-Purchaser component declined by 26.1%, the Investor component declined by 17.3%, the Top-Up component declined by 23.5% and the Re-Mortgage component increased by 19.4%.

	FIRST TIME BUYER	MOVER PURCHASER	INVESTOR	RE-MORTGAGE	TOP-UP	TOTAL
MARKET SHARE	18.9%	23.1%	18.9%	25.5%	13.6%	100.0%
% CHANGE H1 2008/ H1 2007	-28.2%	-26.1%	-17.3%	+19.4%	-23.5%	-16.4%
VALUE €m	€2,616	€3,198	€2,612	€3,522	€1,884	€13,832

Source: IBF

- Data from PermanentTsb / ESRI show that average house prices fell by 9.9% year-on-year in August 2008. Prices declined by 7.3% in the year to December 2007;

The housing market correction has followed in the wake of a decade of exceptionally strong market performance, but is nevertheless proving painful for the economy, given the extent of the correction. Almost nine months into 2008, it is clear from all available evidence that the market is still very weak in terms of new home building, house prices, and sales activity.

From an economic and financial perspective, the sharp decline in housing activity is having and will continue to have a serious economic and financial impact, unless some measures are taken to restore confidence to the market.

## **WHAT CAN GOVERNMENT DO IN BUDGET 2009?**

In general terms, confidence in the housing market is still very poor and building and buying activity is very weak. Based on the latest data on commencements, registrations, and planning permissions, building activity is very weak and is likely to remain very weak in 2009 and very possibly in 2010. The Department of Finance is estimating 43,000 housing completions in 2008, which is down from over 93,000 in 2006. Based on current evidence, it is certainly conceivable that completions in 2009 could be as low as 30,000.

A number of factors are combining to weaken the market. These include;

- House buyers, but particularly first-time buyers, are not buying due to an ongoing decline in house prices and the expectation of further falls. Investor confidence is also very weak, as the rental market is now starting to weaken due to excess supply, and prospects for capital appreciation are poor;
- Affordability is under some pressure from rising interest rates. Since the end of 2005 the average variable mortgage rate has increased from 3.25% to around 6% at the moment due to a combination of ECB rate increases and the high level of interbank rates. Prior to the ECB's latest rate increase, mortgage rates had been edging up due to the difficult conditions in the interbank market. At the moment three-month interest rates are trading just over 5%, compared to an ECB base rate of 4.25%. This gap is exceptionally wide and is forcing mortgage lenders to increase rates where possible. The Irish housing market is particularly exposed to short-term interest rates due to the high percentage of the market that is on variable rates. At the end of 2007, 75% of mortgages outstanding were on variable rates;
- On the mortgage supply side the sub-prime crisis is seriously affecting liquidity in the financial markets and this is resulting in a sharp contraction in credit availability, and higher mortgage costs for existing clients who are not on a fixed or tracker mortgage, and for all new borrowers. In addition, credit standards are being tightened. Even if buyers want to buy at significantly lower prices, credit may not be attainable in many cases;
- Banks are unwilling to lend to developers because of existing financial exposures. Developers are in turn having difficulty selling because potential buyers are either unwilling to buy at existing prices, or are unable to buy due to a lack of credit availability;
- Against a background of poor buyer confidence and credit conditions, there is considerable excess supply in the market.

Any recovery in house building activity will be constrained by this overhang of supply, so any measure that would help restore confidence to the market and rid it of the excess supply would warrant consideration by government in Budget 2009. In 2007 the house buying market was accounted for by 30,469 first-time buyers, 32,864 mover purchasers and 20,861 investors.

Any measures introduced in Budget 2009 should aim to address first-time buyers and mover purchasers.

## STAMP DUTY REFORM

Despite significant changes to the residential property stamp duty regime in recent years, the regime is still penal and acts as a major disincentive to property transactions. It is still acting as an impediment to labour mobility in the economy, which is a big problem in an environment of rising unemployment where workers may be forced to re-locate to find alternative employment. The regime also creates a significant disincentive for domestic investment and continues to result in investment funds flowing out of Ireland into foreign property markets.

Under the existing stamp duty regime the following costs apply to the buyer:

PURCHASE PRICE	STAMP DUTY CALCULATION	€	TOTAL STAMP DUTY PAYABLE
€100,000	<€125,000	NIL	NIL
€325,000	€125,000	NIL	
	€200,000 @7%	€14,000	€14,000
€650,000	€125,000	NIL	
	€525,000 @7%	€36,750	€36,750
€1,100,000	€125,000	NIL	
	€875,000 @7%	€61,250	€70,250
	€100,000 @9%	€9,000	

**The IPAV proposes that the current exemption limit from stamp duty should be doubled to €250,000 and that a flat rate of 5% should apply above €250,000.**

Under the proposed new stamp duty regime the following costs would apply to the buyer:

PURCHASE PRICE	STAMP DUTY CALCULATION	€	TOTAL STAMP DUTY PAYABLE
€100,000	<€125,000	NIL	NIL
€325,000	€250,000	NIL	
	€75,000 @5%	€3,750	€3,750
€650,000	€250,000	NIL	
	€400,000 @5%	€20,000	€20,000
€1,100,000	€250,000	NIL	
	€850,000 @5%	€61,250	€42,500

**The IPAV proposes that the current exemption limit from stamp duty should be doubled to €250,000 and that a flat rate of 5% should apply above €250,000.**

**In relation to stamp duty on commercial property transactions the IPAV proposes that the existing rate of 9% on commercial property transactions should be reduced to 5%. In an environment where commercial activity is very weak, a reduction could stimulate interest amongst domestic investors. Furthermore, it could help attract foreign investors into the Irish commercial property market. Under the existing regime, foreign investment in the Irish commercial property market is negligible.**

## **BRIDGING THE FUNDING GAP**

For buyers who are prepared to buy, the availability of credit is now a major impediment. Lending criteria and LTVs are being tightened so many buyers are now finding it difficult to bridge the gap, between the loan obtained and the purchase price of the house. In 2008, the Government is due to divert around €1.6 billion into the National Pension Reserve Fund. By amending the legislation it should be possible to divert this money temporarily into alleviating the pressure on house buyers who cannot bridge the funding gap.

A loan of for example €50,000 could be given to the potential house buyer, interest free for the first 5 years. Thereafter the loan would be paid back, but would attract an interest rate 1% higher than the normal mortgage interest rate. This would represent a reasonable return for the NPRF, given that at the moment most of the monies in the fund are invested in international equity markets and are currently making a very poor return. Using the suggested mechanism, the fund would be making a meaningful contribution to the domestic economy, through working the overhang of unsold housing out of the system. After the 5-year period, this mechanism would provide a reasonable return to the fund. The NTMA, which manages the fund, would have to get a second charge on the property.

## **CONCLUSIONS**

The housing market is currently in the midst of a very severe downturn. This is impacting very negatively on employment, tax revenues, consumer confidence, consumer spending, the performance of the Irish equity market and hence of Irish pensions, and economic activity in general. It is estimated that for every 10,000 decline in house building, up to 1% is taken off economic growth.

The housing market is still showing no signs of recovery in terms of either prices or building activity, and based on rising interest rates, tight credit conditions and a general lack of buyer confidence, the market could weaken even further in 2009. Based on unchanged policies, housing completions next year could fall as low as 30,000. This level of activity would cost at least 50,000 jobs in construction and other housing related areas, and put further serious pressure on tax revenues and Exchequer spending.

Given that there is still strong fundamental demand in the market, which is not materializing for a variety of reasons, some form of intervention would now be warranted. Intervention in the housing market is always risky and is not always the optimal solution, but on this occasion the ailing economy and the public finances need to see some recovery in housing activity.

The measures suggested should help to restore confidence in the market and help potential buyers overcome the barriers to house purchase. The important point is that the increased activity would generate significant tax revenues and end up revenue positive.

