Unlocking domestic demand

Initiatives to support Ireland's domestic economy

November 2011

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1. Executive summary[1]

Ireland's export sector has recovered very strongly since the global economic crisis of 2008 and will help grow GDP in 2011 for the first time since 2007. The domestic economy remains in recession, however, and with unemployment at over 14% the crisis remains acute. In such circumstances, most governments would introduce a package of stimulus measures to support enterprise and employment. Given the constraints of Ireland's public finance position and its international loan arrangements, an Exchequer-funded stimulus is not an option. Ambitious and innovative policy measures are therefore required to incentivise a non-Exchequer-funded stimulus for the economy.

Consumer spending and saving

Consumer spending and investment have fallen sharply since 2007 and while some of this is a structural or permanent loss, much of it is cyclical and will ultimately return once households have both the credit and the confidence to start spending again. As a result of unemployment and net pay reductions, many people do not have the capacity to invest or increase their consumption. The most indebted of households will also have reduced spending power for years to come. Many others, however, have significantly increased their savings and have the potential to return to a more normal spending and savings behaviour, thereby boosting demand in the domestic economy.

The 'new normal' for the domestic economy

Households are also currently postponing investment decisions. This is most evident in the housing sector. In 2006, some 80,000 homes were bought by first-time buyers and mover-purchasers. In 2011, the corresponding number will be less than 10,000. Both the housing construction sector and the transactions sector are effectively shut-down. This will not be a permanent state and normal transaction and investment activity will eventually return, most likely at a level somewhere between the current state and that experienced before the collapse. A 'new normal' will ultimately emerge right across the domestic economy and when it does activity will increase, the public finances will improve and many of those currently unemployed will find work again.

The importance of normal credit flow

In order to reach this 'new normal' household savings will need to return to something closer to their long-term average and consumers will need to have access to a reasonable flow of credit. In 2006, there was a net flow of credit of €30 billion from the banks to households – mainly to fund housing investment. By 2010, this position had been completely reversed and there was a net credit flow of €10 billion from households to the banks. While it is desirable for many households to deleverage, this needs to be balanced with a normal flow of new credit to people without debt who now want to buy homes and make other investments.

Many people have increased precautionary savings

While much of the surge in the savings ratio can be explained by debt repayment (including accelerated and discretionary debt repayment) rather than an increase in

[1] IBEC wishes to thank members of the Consumer Confidence High Level Group for their guidance and advice in producing this report. A list of members can be found in the appendix.

precautionary savings, many people have in fact increased their precautionary savings. Data obtained from the financial institutions show that deposit balances have increased sharply on accounts held by those aged under 35 and over 50. The 35-to-50 age cohort is the most financially distressed and their precautionary savings have not increased. Many of those aged under 35 are likely to be saving to buy a home while many older people could increase their spending if they were incentivised to do so.

Confidence and communications

An improvement in consumer confidence will ultimately be the main determinant of consumer spending and saving patterns. The eurozone crisis and other global economic developments will have a major bearing on consumer sentiment and these issues obviously remain outside of our control. There are a range of other important domestic issues which will also be important in determining consumer confidence levels. Many of these relate directly to how the economy is performing and the success of Government in addressing the difficulties in the public finances. It is also vital, however, that Government communicates effectively with households on the economic situation. Government and its agencies currently devote significant resources to communicate with external investors and stakeholders but consumers remain the most important set of investors in the Irish economy and require a targeted and tailored communications strategy.

What Government should do

Government could help boost domestic demand and accelerate a transition to a 'new normal' level of consumer activity by introducing a package of innovative measures. IBEC has identified the following triggers which could significantly increase domestic demand over the comings years:

- The release of a proportion of AVC and personal pension funds.
- Measures to create a 'window of opportunity' to purchase homes.
- Fiscal incentives to encourage additional home renovation activity and to ensure a transition in the sector from the informal economy to the formal economy.
- Roll-out of an electronic payment card for social welfare benefits such as child benefit in order to encourage the spending of these funds in the domestic economy.

The economic benefits of this package would be substantial and could be delivered at no cost to the Exchequer. We have estimated that over a three-year period domestic activity could increase by close to €6 billion, up to 25,000 new jobs could be created and the measures outlined above could yield €2.4 billion in additional taxes to the Exchequer.

The measures proposed in this paper provide practical solutions to stimulating domestic demand and creating much needed employment. Their delivery will require a level of fresh thinking and ambition in public policy but simply hoping for a recovery in the domestic economy is not an option. Government must now explore ways of making it happen.

2. Why Government must act

In 2011, Ireland's GDP will expand for the first time in four years, but the economy is one of two speeds. Exports are growing strongly and are leading the economy out of recession, but domestic demand remains muted. Ireland is unique in its capacity to achieve an export-led recovery. The value of exports accounts for over 100% of GDP and net exports are 25% of GDP – a much higher proportion than in most other countries. Significantly reducing the unemployment rate from its current high level is very difficult, however, in the absence of a recovery in domestic demand. Private-sector domestic demand – consumer spending and investment by firms and households – accounts for 60% of GDP and is by far the most labour intensive component of the economy.

A return to more normal spending and savings patterns would provide a significant boost to the domestic economy. While an improvement in consumer sentiment is the prerequisite for this to occur, there are a number of policies which Government could pursue to stimulate domestic demand. One way is to create a window of opportunity for a period of three years to encourage households to bring forward their consumption and investment decisions. The car scrappage scheme that ended in June 2011 was highly efficient in stimulating activity, demonstrating that Irish consumers are highly responsive to the right incentives. However, the import content of a car purchase is high and it is possible for Government to focus on areas with greater jobs benefit for the economy.

The impact of consumer spending on growth and the public finances

As we detail in the next section, the past years have seen a dramatic increase in precautionary savings, which has been the most significant contributor to the sharp decline in consumer spending. It is logical for individual consumers to seek to repair their damaged balance sheets and to increase their precautionary savings at a time of economic uncertainty. The aggregate impact of these actions, however, is depressing economic growth and ultimately threatening the future prosperity of the very same consumers who are currently saving.

The next four years – 2012 to 2015 – will see a budgetary adjustment totalling €12.4 billion:

€ billion	2012	2013	2014	2015
Tax	1.6	1.25	1.1	0.7
Current expenditure	1.45	1.7	1.9	1.3
Capital expenditure	0.75	0.55	0.1	0.0
Total	**3.8**	**3.5**	**3.1**	**2.0**

Source: Department of Finance

Consumers tend to view the process of fiscal adjustment as a static exercise, similar to that of correcting a household's or firm's income and expenditure position. Adjusting the income and expenditure position of an economy, however, is much more complex due to the fiscal multiplier effect which reducing expenditure or raising taxes has on economic activity. This in turn has a knock-on effect on other Exchequer taxes – this effect is known as revenue buoyancy. Therefore, if Government attempts to reduce a budget deficit by €1 billion, for example, the taxation or expenditure adjustment required will be larger than this.

The size of the fiscal multiplier is influenced by a number of factors including an economy's openness to trade. While there is a lack of empirical data on fiscal multipliers for the Irish economy, most estimates have concluded that they are generally lower than average due to the exceptionally open nature of the economy – this has made the fiscal retrenchment process less painful. Nevertheless, an additional injection of cash into the economy in the form of higher consumer spending will have a significant impact on economic activity and ultimately on tax revenues.

Revenue buoyancy factors used in Budget 2011 estimated that, for example, a €1 billion reduction in social welfare spending would result in a tax loss of about €300 million. This means that reducing the deficit by €1 billion requires a spending cut of €1.3 billion. Using these figures it is possible to estimate the potential revenue impact of a consumer spending injection: each €3 billion additional consumer spending results in €1 billion accruing to the Exchequer[2].

The exact scale of revenue buoyancy would depend on the nature of purchases made by consumers with a lower import content leading to higher tax effects. In addition to short-term effects on tax revenue, a prolonged growth in spending will also get more people back to work and help kick-start a virtuous cycle for the Irish economy. Increased spending will also result in a higher nominal GDP and hence a less challenging adjustment in reducing the deficit-to-GDP ratio to the 3% target by 2015.

This logic is not to suggest that Government was wrong to embark on the austerity of recent years. The need to close the deficit through expenditure cuts and tax increases is inescapable. Crucially, however, an additional injection of spending into the economy from outside of the Government sector could greatly aid the fiscal adjustment process. If consumers could be influenced to reduce their savings somewhat and spend or invest more money in the local economy, the tax benefits for the Exchequer would be substantial and the future tax increases facing householders would be lessened.

The 'new normal'

During the peak boom years 2004-2007 consumer spending growth averaged almost 7% per year. Over the course of the recession the annual fall in the volume of private consumption has averaged almost 3%. At the peak in 2007, some 80,000 mortgages were issued to first-time buyers and mover-purchasers. In 2011, the number will be less than 10,000. In 2007, €30 billion flowed from the banks to consumers; in 2010 this was reversed and €10 billion flowed from households to banks.

It is clear that the domestic Irish economy was not in a normal state in the years immediately preceding the crisis and that some readjustment was necessary. The correction can usefully be broken down into a structural element (permanent changes) and a cyclical component (fluctuations arising from the economic cycle). It is wrong to assume that all of the decline in the domestic economy during the recession is structural or permanent. As often happens, the correction has overshot: consumption and household investment in the Irish economy are now below a medium-term equilibrium level.

Following a number of years of freefall, considerable pent-up demand has built up in the domestic economy. Weak confidence levels and lack of finance are holding people back from resuming more normal consumption and investment patterns. The housing market is at a virtual standstill and, as we detail in the next section, precautionary savings have increased substantially. We believe that a more normal savings ratio would be in the region of 5%, while a sustainable level of housing transactions for first-time buyers and mover-purchasers is in the region of 40,000 per year. The savings ratio returning to this more normal level would unlock some €4 billion consumer spending in the Irish economy, with significant knock-on benefits for the public finances. A normalisation of the housing market would generate about €600 million per year for the domestic economy and lead to the creation of nearly 10,000 jobs.

[2] This is an average for the economy and will be higher in some sectors such as construction.

Why the boost from the consumer is needed

Under normal circumstances, governments use fiscal policy to smooth over cyclical fluctuations in the economy. This is not possible in Ireland currently, given the scale of the deficit and the constraints of the EU-IMF loan agreement. In addition, though exports continue to perform well, the eurozone turmoil and a slowing global economy have undoubtedly made the landscape more challenging than even a few months ago.

The case for a non-Exchequer-funded stimulus in the current situation is compelling. The domestic economy will, eventually, recover to more normal savings, investment and consumption patterns. Getting closer to the 'new normal' in the next two to three years would provide powerful benefits for the Exchequer and nominal GDP, thereby easing the fiscal adjustment, and help bring down the unemployment rate. This would help the domestic economy break away from the vicious downward spiral in which it is locked and move onto a sustainable footing. For Ireland to return to balanced economic growth, it is essential that consumers play their part.

Government communications

Uncertainty about the economic outlook greatly reduces consumer confidence and spending. This uncertainty is exacerbated by inaccurate and misleading claims made by a range of commentators on the Irish economy. Government has, quite rightly, put a great deal of effort into communications with external investors. It has, however, to a large extend neglected its most important audience: the domestic consumer.

At the time of writing, Government had begun the process of explaining its four-year austerity plan, which will give consumers much needed certainty. As a first step, it is crucial that the plan clearly sets out the detailed household budget impacts of all planned fiscal policy measures. Government must, however, go much further: it needs to have a clearer strategy and operational process for targeting communication on the economy directly at the concerns of consumers. In particular it needs to be more effective in countering the often very damaging inaccuracies of some domestic and international economic commentators. At a time of greater uncertainty about the global economy, Government can least afford to neglect domestic consumers in its economic communications strategy.

Summary:

The strong export performance will lead Ireland's GDP to grow in 2011 for the first time in four years. Domestic demand, however, remains muted and the economy is one of two speeds.

Closing the budget deficit is not a static exercise. For each additional €3 billion consumer spending, €1 billion accrues to the Exchequer, easing the burden of adjustment and obviating the need for further tax increases.

Considerable pent-up demand has built up over the last few years, as the domestic economy has over-corrected following the excesses of the Celtic Tiger years. A return to more normal consumption, savings and investment patterns is essential for a return to sustainable, balanced growth and for making serious inroads into the current very high level of unemployment.

3. Savings and debt dynamics

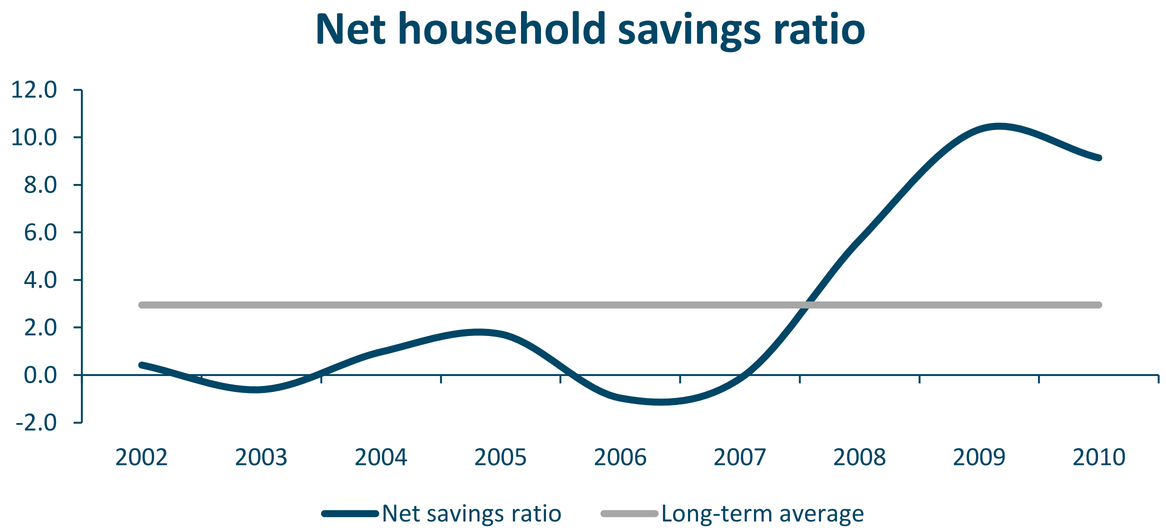
Which households have the capacity to spend and invest?

During the boom years, Ireland's household debt grew rapidly. At the end of 1998, before Ireland entered monetary union, household loans were exactly matched by household deposits of €26 billion. In the new low-interest environment, a gap between the two rapidly emerged. In 2002, the household loan stock outweighed deposits by nearly a third; at the height of the boom households loans were more than double household deposits.

Many commentators claim that a period of very weak demand in the domestic economy is inescapable, given the high debt burden on households and the consequent need to deleverage. This is not the case. As we show in this section, net wealth levels in Ireland remain high in an international context. The savings ratio has over-corrected as a result of the crisis and a normalisation of savings behaviour has considerable upside potential for consumer spending. Finally, it is important to look beyond the macro-level data to get a true picture of households' capacity to spend and invest. Some age cohorts are faced with a period of having to pay down debt. These are likely to be those who entered the housing market in the period 2004-2008. Younger age cohorts who have not yet bought a home and older age cohorts who have already paid off their mortgage are in an entirely different position. It is essential that public policy recognises these differences.

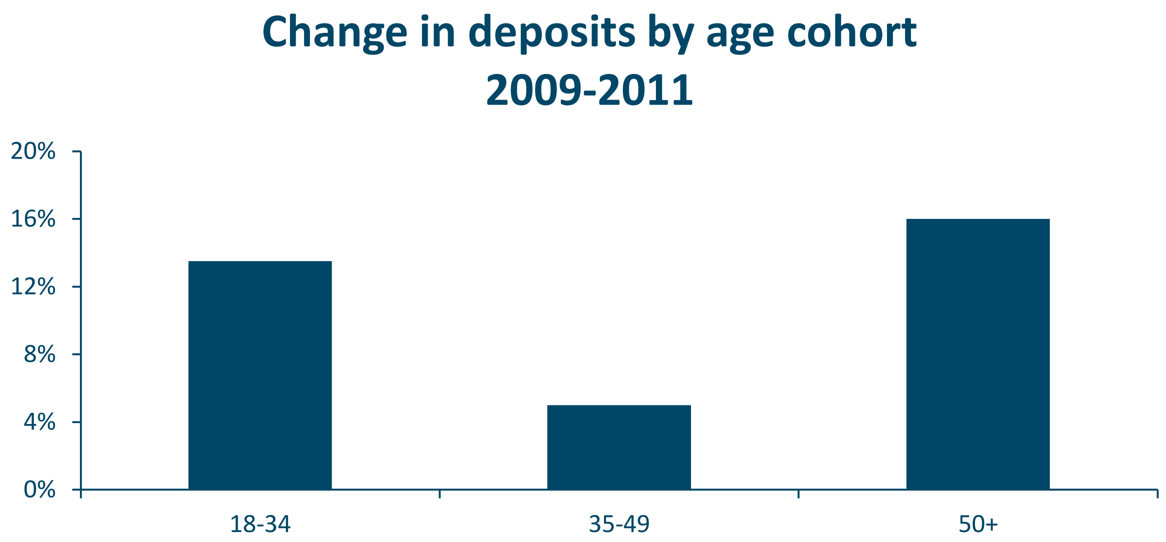
What the savings data tell us

The difference between what households could spend and what they actually spend in the economy is the savings ratio. The savings ratio has increased rapidly over the course of the economic crisis, growing from an annual average of 0% in the four years prior to the crisis to over 9% in 2010. This increase equates to close to €8 billion annually.



Source: CSO

Although some of the increase in the savings ratio can be explained by debt repayment (including accelerated and discretionary debt repayment), many householders have also increased their precautionary savings. Data provided by the main financial institutions and compiled by IBEC, show that on average deposit account balances have increased since the start of the recession. Increases were mainly recorded in the younger age cohorts (18-24 and 25-34) and older age cohorts (55-64 and 65+), while balances in the middle age cohorts remained largely flat. The data confirm the view that the most financially pressurised households are in the 35-49 age group as these are most likely to have the highest debt levels. The younger age groups are in many cases likely to be saving to buy a house.



Source: Financial institutions in IBEC membership

Separate data from the ESRI/Nationwide monthly savings index show that 40% of those saving are doing so for precautionary reasons. The proportion of people saving more than €200 per month jumped from 15% in April 2011 to 25% in July 2011 and has remained at that level since. In the October survey (most recent at time of writing) 56% intended to use cash for debt repayment, 33% would save any surplus and only 8% intended to spend any spare cash.

Finally, international comparisons show that Irish households' net wealth levels remain high, despite the sharp fall in house prices over the last few years. With total net wealth close to 500% of disposable income, Irish households have more wealth than those in Austria, or Finland and about the same as those in the United States[3].

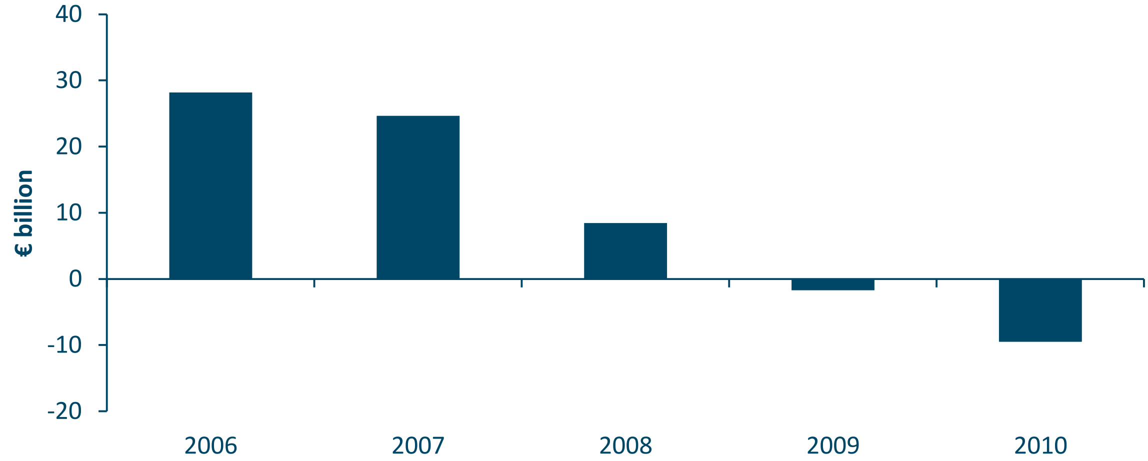
Households and banks

The onset of the recession led to an abrupt reversal of credit flows from banks to households. At the peak, the net flow from banks to households was nearly €30 billion. By 2010 this had been reversed and nearly €10 billion flowed from households to banks as consumers paid down debt and banks deleveraged. The impact has been a €40 billion shift in the flow of funds between banks and households in a very short period of time.

Under the EU-IMF plan, the guaranteed banks must meet a 122% loan-to-deposit ratio by the end of 2013. This is to be met by a combination of deleveraging and sale of non-core assets. There is considerable research both in Ireland and internationally showing that deleveraging can have a pro-cyclical impact on economic growth[4]: in other words, choking off credit will make the downturn steeper than would have been necessary.

[3] O'Leary, D and Walshe, D. Deleveraging the banks and economic recovery. A paper presented to the Dublin Economics Workshop (October 2011).
[4] See for instance Central Bank of Ireland: Decomposition of Irish house prices: 2000-2010 and Netherlands Central Bank: Credit and economic recovery.

Credit flow from banks to households



Source: CSO

The pro-cyclical impact of debt deleveraging can be ameliorated by slowing the pace. This can have a significant impact on domestic demand. We are by no means advocating a return to boom-time banking, when private sector credit growth was in double digits each year. We are, however, concerned that the highly ambitious deleveraging targets cannot be met without further substantial damage to the domestic economy, at a time when Ireland can least afford it. While it is clear that the situation immediately preceding the crisis was unsustainable, neither is the current position tenable in the medium term. For the domestic economy to return to normalcy, it is essential the banking sector performs its functions in providing finance to creditworthy borrowers.

Summary:

It is neither likely nor desirable that the savings ratio would return to the particularly low levels seen during the boom years but a more sustainable savings ratio for the Irish economy would be in the region of 5%. If the savings ratio was to return to this more normal level, some €4 billion consumer spending could be unlocked in the Irish economy, with significant knock-on benefits for the public finances and employment.

Data from the main financial institutions show that younger (19-34) and older (50+) age cohorts have increased their savings over the past two years. The younger age cohorts are in many cases likely to be saving to buy a house; in the older age cohorts the increase in savings is likely to have a precautionary motive.

The flow of credit from Irish banks to households has reversed from a positive net flow of €30 billion in 2006 to a negative €10 billion in 2010. Both domestic and international research has shown the flow of credit has a pro-cyclical impact on the economy, amplifying both up and downturns. Slowing the highly ambitious pace of deleveraging of the domestic banks would help ameliorate the risk for the domestic economy recovery.

4. Allowing access to AVCs and personal pension funds

In addition to household savings, pension funds represent the other major wealth stock component of Irish households. Occupational group pension schemes are currently worth about €70 billion. These funds are predominantly invested outside of the country and while there has been some debate as to how a greater share of these funds might be put to work in the Irish economy, the issue remains largely unresolved. Government should therefore look at this issue again with fund managers and pension scheme trustees in an effort to incentivise greater investment of funds in Irish infrastructure and through domestic venture capital funds.

Government has also examined the possibility of allowing individuals with mortgage debt difficulties to draw down some of their pension funds. The group examining the issue concluded that it would be complex from an administrative perspective and those with the most acute debt problems were unlikely to hold significant pensions wealth. IBEC agrees that it would not be a practical policy initiative to allow widespread early drawdowns of defined benefit (DB) and defined contribution (DC) schemes. However, there is a further significant pensions wealth stock in additional voluntary contributions (AVCs) and other personal pension schemes, which would be more suitable for an early drawdown option.

The current value of funds in AVCs is estimated at about €4 billion. These funds are in addition to the standard pension contributions already made by employees in either DB or DC schemes. These additional contributions were largely made to supplement the basic income provided through occupational schemes. Many of the people who would have made these additional contributions would have done so at a time of higher earnings or from bonus payments. Their earnings could now be much lower and they would welcome the opportunity to draw down a proportion of their AVCs to fund their living expenses. If individuals were allowed to draw down a proportion of their AVCs it would not effect their basic income adequacy on retirement and would provide a much needed stimulus for both the domestic economy and the Exchequer.

There is also a substantial wealth stock in personal pension schemes. Such personal pension schemes would have been widely used by the self-employed and small business owners, many of whom increased their pension contributions during the Celtic Tiger period. A large share of these people have now either seen their businesses fail completely or have vastly reduced incomes. They may well have provided for an income on retirement which is now much greater than their current earnings. In addition to the benefits for the economy, allowing holders of such schemes to draw down a share of these funds would help alleviate financial pressures. It would be important to agree a code of practice with financial institutions to ensure that such early drawdowns are not excessively used for debt repayment. Unlike group schemes and AVCs, there is no definite valuation method for the value of pension assets in personal schemes, but industry estimates suggest the value could be up to €15 billion.

Economic impact

The current value of funds invested in AVCs and personal pension schemes combined could be as high as €20 billion. If Government were to allow a quarter of this to be drawn down over three years, there would be substantial benefits for the domestic economy. While it is impossible to know and difficult to stipulate on what the funds would be spent on, it is likely that they would be used to finance living expenses, repay some debt and to buy assets in the Irish economy which many might consider now offer good value. Like any demand-led initiative it is difficult to accurately forecast what the level of take-up would be but if even one in four people were to draw down one-quarter of their funds, the value of the stimulus would be €1.3 billion or about 1.5% of the annual value of consumer spending. If the drawdown was taxed at 20% there would be an immediate and direct injection to the Exchequer of €260 million. The State would also benefit from the revenue buoyancy of additional spending in the domestic economy amounting to a further €260 million[5], giving total revenue benefit to the Exchequer of about €520 million. Additional activity in the economy would create and sustain over 3,100 jobs for the three-year period.

Rationale:

Irish pension funds are a substantial wealth stock, currently largely invested outside of the State. For a number of reasons it is unlikely to be practical to allow drawdown of occupational group schemes but there are no significant obstacles in facilitating early access to AVCs and personal pension funds. IBEC estimates that about €20 billion is currently invested in AVCs and personal schemes and by allowing early access to these funds there would be a substantial stimulus for the domestic economy and a significant revenue injection for the Exchequer. Early drawdown of a proportion of these funds would not have a significantly negative impact on pensions adequacy and would greatly assist many individuals currently experiencing financial distress.

Government should:

- Allow early drawdown of up to 25% of AVCs and personal pension schemes over a three year period. The drawdown could be limited to 8% or 9% for each year.
- Tax the drawdown at the standard rate of tax but apply no further penalties or charges.
- Work with the financial institutions to develop a code of practice which would limit the degree to which any drawdowns would be used for debt repayment.
- Explore with the pensions industry, trustees and employers options to incentivise greater investment by Irish-owned pension funds in the domestic economy, through either infrastructure bonds or venture capital funds.

[5] This assumes that about a quarter of the money drawn down would be spent on debt repayment.

5. Social welfare retail and services payment card

Government can have a significant impact on domestic demand by correctly calibrating the manner in which it reduces public expenditure. The allocation of the very substantial budget for child benefit payment is a good case in point. The scheme currently costs the Exchequer €2.2 billion and is a universal payment made to almost 600,000 families.

Government has already reduced the payment rates under the scheme but it has done so in a very untargeted way. Flat rate across-the-board cuts in schemes such as this are unnecessarily damaging to domestic demand. Due to the fact that many middle and high-income families save some or all of their child benefit payments, while lower income families are likely to spend all of the benefit, a flat rate cut will impact sharply on domestic spending.

A means-testing approach or taxing of child benefit could achieve similar savings for the Exchequer without damaging consumer spending. For various reasons, however, it appears that Government believes that neither of these options is deliverable. IBEC is therefore suggesting an alternative approach to reform the scheme which would save money for the Exchequer, protect payments to those most in need and increase the impact on domestic demand.

The child benefit scheme is a poorly designed and blunt measure with unclear policy objectives which does not target resources at those most in need of assistance. In many ways it is a clear example of the inefficient policies which were commonplace in the Celtic Tiger era. The Government solution to the high childcare costs faced by working parents was to increase payments for everyone irrespective of need.

While we have not been able to compile data to prove the case, we believe that a large proportion of the total €2.2 billion payment made by the State ends up in the savings accounts of many middle and upper income families. While some families are likely to have reduced their savings in response to income reductions and job losses, it is still likely that significant numbers of families save the payment. There is also an issue in relation to the repatriation of child benefit payments. EU nationals working in Ireland are eligible to claim benefits for children living elsewhere in the EU and these payments are often directly repatriated. It is therefore clear that Government is spending substantial scarce resources on this scheme, without maximising the benefits for the domestic economy.

IBEC believes that there is considerable merit in moving to an electronic payment model which would incentivise recipients to spend their money in the domestic economy. Electronic payment card models for social welfare payments have been rolled out right across the world, including in some underdeveloped countries. The technology is already widespread in the Irish retail sector – almost every store in the country now has the facility to accept a laser card or equivalent. This means that there would be no restrictions in choice for beneficiaries and the payment card could be used to pay for a wide range of goods and services.

While there would be some costs in the transition to a payment card model, preliminary discussions with a number of private sector providers indicate that the project timescale should be no more than three to six months. A payment card model would not require beneficiaries to have a bank account as it would not involve a credit transfer to a bank account but would operate more like an electronic voucher model.

The overall purpose of the new payment model would be to change the 'default setting' on how recipients use the payment. While it would of course be possible for those using a payment card model to continue to put a cash equivalent amount into savings accounts or to repatriate it, evidence from behavioural economics shows that this would only happen in a proportion of cases. Many people would therefore repatriate and save less and spend more on goods and services in the domestic economy. In order to encourage take-up of the electronic card option, we propose that the cash payment should be reduced by 25%. Those using the payment card would also benefit from discounts which some retailers could provide through the scheme.

Economic impact

The budget for child benefit at €2.2 billion is equivalent to almost 3% of total consumer spending in the Irish economy. If an alternative payment option could incentivise the spending of a greater share of this in domestic businesses, the economic benefits would be substantial. The Department of Social Protection estimates that payments to non-nationals whose children are not resident in the State are less than €20 million. We have not been able to source data to show the proportion of child benefit payments which are saved but it is likely to be substantial. If 25% of benefits are currently saved then the total loss to domestic demand is about €600 million. A change in the default payment option could result in about 50% of this money being spent on domestic goods and services rather than put into savings accounts. This could result in an increase in domestic spending of about €300 million, leading to the creation of about 3,600 jobs. The benefit to the Exchequer would be about €100 million.

Rationale:

Government is currently spending €2.2 billion on child benefit payments but there is considerable 'leakage' from this as some payments are repatriated and, more significantly, a large share is saved by middle and upper-income families. Meanwhile, Government is under pressure to make savings from this scheme but sees difficulties in either means testing or taxing child benefit payments. IBEC believes an electronic payment card option would result in savings for the Exchequer, greater value benefits for recipients and would boost the domestic economy. The scheme would not be difficult to administer and the technology platform is already widespread in retail throughout the country.

Government should:

- Introduce the option of receiving child benefit payments in an electronic voucher card model to be used to purchase a range of goods and services within the State.
- Allow beneficiaries to still receive the normal cash payment but at a 25% reduction on the current payment level.
- Negotiate with retailers to deliver a discount for consumers using the electronic payment card on a range of goods and services.
- Achieve savings for the Exchequer as not all recipients would opt to use the payment card model and would therefore receive a lower payment.

6. Home improvement works

The home improvements sector is currently valued at about €2.2 billion per year – about the same as the new home building sector. Higher unemployment among construction workers and recent tax increases have seen activity move into the informal or 'shadow' economy, leading to a substantial loss of revenue for the Exchequer. Although we have no specific estimates for home improvement works, it is likely that informal-economy activity in the sector has seen a particularly sharp increase.

International evidence suggests that a home renovation tax credit can generate significant additional activity in the economy. In Canada, the home renovation tax credit was a temporary non-refundable tax credit and was a key component of Canada's Economic Action Plan in 2009. The credit was viewed as a success with residential renovations increasing by 18%. The total cost of the credit was $2.3 billion. However, the total boost in spending from the credit was $4.5 billion, exceeding the $3 billion target. As a result, renovation investment was one of the first components of the Canadian economy to fully bounce back from the economic downturn.

Canada has been largely insulated from the financial crisis with employment in the construction sector remaining relatively stable since 2007. The extent of the informal economy for home improvement works in Ireland is likely to be far higher given that construction employment has fallen by over 60% from the peak. As a result the benefits of a tax credit have the potential to be far higher.

Economic impact

The introduction of a home renovation tax credit (or a grant of equivalent value, which has the benefit of having a capped budget) has important economic impacts given that works are labour intensive and goods used generally have a low import content allowing any investment to be re-circulated within the economy. As a result a rise in activity would bring further substantial indirect multiplier benefits. A 30% increase in the formal economy activity would result in €660 million of additional spending in the economy and would generate would generate over 9,200 jobs. The Exchequer would gain more than €260 million in additional tax and reduced social welfare spending.

Rationale:

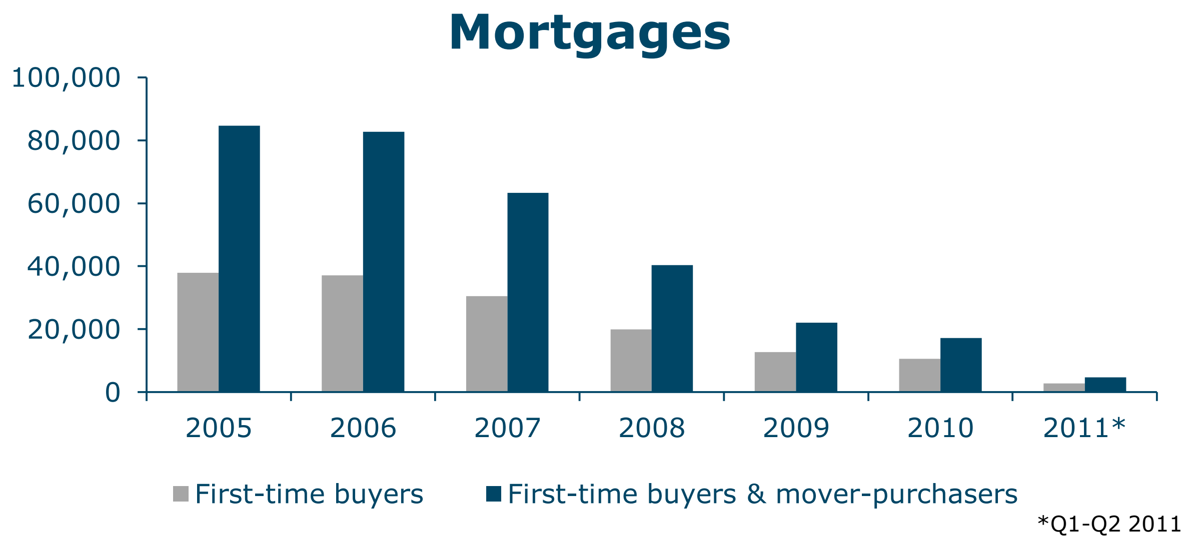
A targeted suite of policy measures would bring a considerable portion of the home improvements sector back into the formal economy and incentivise older age cohorts with high savings levels and younger age groups who are unable to move house due to negative equity to invest in formal-economy home improvement works.

Government should:

- Introduce a home improvement tax credit or grant for a period of three years. Such a scheme could involve a refundable tax credit or a grant of 20% of approved home improvement between the value of €3,000 and €20,000, carried out by tax compliant contractors. The cost of the scheme would be funded by a reduction in informal economy activity.

7. Property transactions

The property market has effectively frozen over the past few years, as prospective buyers expect prices to fall further and potential vendors are either unwilling or unable to sell at current prices. The number of mortgages for first-time buyers and mover-purchasers has dropped from about 80,000 per year at the peak to less than 10,000 in 2011.



Source: Irish Banking Federation

A recent survey by MyHome.ie, the property website, shows that considerable pent-up demand has now built up in the market, particularly among first-time buyers[6]. Of those living at home, almost 75% want to buy within the next three years and close to 45% intend to wait less than a year. Of renters, nearly 85% plan to buy a home – with two-thirds hoping to buy within the next three years and a third within the next 12 months. However, 44% expect prices to fall further and over a quarter are most concerned about securing a mortgage.

Barriers to market normalisation

A number of issues are preventing the market from returning to more normal activity levels:

Market structure: A normalisation in housing market activity will greatly help domestic recovery, but is not likely to occur until a price floor has been reached. In a textbook case this would happen through prices being driven down by an oversupply of housing stock. In Ireland, however, the National Assets Management Agency (NAMA) controls much of the newly built unsold housing stock. NAMA at present operates in a very opaque manner and it is far from clear that it is actively bringing stock to market at realistic prices. NAMA's operational model can be improved by introducing a competitive framework using private sector bidders to dispose of properties more rapidly.

Access to finance: Difficulties in securing mortgages, particularly for first-time buyers, continue to hamper recovery in the housing market. Transactions volumes cannot return to more normal levels until an adequate supply of finance is available for credit-worthy

[6] MyHome.ie Consumer Sentiment Survey, October 2011.

buyers. Government must analyse the underlying level of pent-up mortgage demand and ensure that State-supported financial institutions meet this demand.

Price transparency: Potential buyers continue to worry about further house price falls and the prospect of falling into negative equity. The inability to access reliable information on current and historical prices is delaying the return of more normal market transactions. The previous government put forward the Property Services (Regulation) Bill in 2009, which provides for a national house price database. The new Government should give effect to this as a mater of priority. The database should contain information on sale prices, addresses and dates of sale, in line with international best practice and contain data of property transactions since 2005 to give buyers an appropriate benchmark.

Economic impact

Each property transaction results in spending of about €20,000 in ancillary items such as professional services, furnishings and home improvements. This is particularly important for the employment intensive retail and wholesale sector which has shed almost 50,000 jobs since the beginning of 2008. A normalisation of transactions in the market to about 40,000 per year would generate €600 million per year for the domestic economy. If the market were to gradually normalise by the end of 2014, this would support about 5,600 for the three-year period and lead to an average gain of €160 million per year for the Exchequer.

Rationale:

While it is not in the economic interest of the country for house prices to increase, a return to more normal transaction volumes would bring substantial economic and employment benefits. Government can help the housing market return to normal by introducing a suite of policy measures that would create a two-year 'window of opportunity' for home purchases to encourage those prospective buyers who are 'on the fence' to bring forward their purchasing decisions. In addition, IBEC believes that the stamp duty regime has swung too far and that the current 1% rate is too low.

Government should:

- Exempt homes purchased before end-December 2012 from any new property taxes for a period of six years and those purchased during 2013 for three years.
- Pre-announce an increase in the flat rate of residential stamp duty on purchases after December 2012 to 2% and to 3% after December 2013.
- Ensure the state-controlled financial institutions commit to an adequate supply of mortgage credit, based on proper quantification of pent-up demand.
- Restructure NAMA's operational model by introducing a competitive framework using private sector bidders to dispose of properties more rapidly.
- Immediately roll out a national house price database to improve market transparency and reduce buyer uncertainty.

8. Access to credit

We have demonstrated in this paper that Irish consumer spending has fallen due to a combination of disposable income reductions (caused by unemployment and tax increases), an increase in precautionary savings and a collapse in credit provided to households. A recovery in consumer spending and investment, and to a large extent the success of the housing related measures suggested in this paper, will be dependent on sufficient availability of credit. Unless the financial institutions meet the funding needs of creditworthy customers, it will be exceptionally difficult for domestic demand to recover.

Under the EU-IMF loan agreements, Ireland has committed to reducing the loan to deposit ratio of the covered financial institutions to 122%. This will place considerable pressure on the banks to reduce their loan books. While the exceptionally low level of credit provision is a function of both weak demand and supply constraints, it is clear that the financial institutions will need to continue to constrain their loan books even if consumer confidence recovers and demand for credit increases.

The reversal of the credit flow position from a €30 billion net inflow to households in 2006 to the 2010 position which saw a net outflow of €10 billion from households to the banks, explains much of the collapse in investment and domestic demand. While many individual households need to deleverage over the coming years, there will be a large number of creditworthy households which will require access to mortgages, car loans and other credit in order to fund normal investment and consumption behaviour.

Government must ensure that the correct banking policy is in place to meet these sustainable credit needs of households. In particular, it should complete a comprehensive bottom-up analysis of expected household credit demand over the coming years. If this analysis shows that the deleveraging targets for the covered institutions are inconsistent with the likely credit demand of the economy then the pace of deleveraging will need to be reassessed.

9. Total economic impact

No single measure will, on its own, stimulate sufficient activity to make up for the nearly 30% fall in the value of domestic demand that has taken place over the past three years. However, a targeted package of measures aimed at incentivising consumers to return to more normal savings, consumption and investment patterns could provide a substantial non-Exchequer-funded stimulus for the domestic economy.

The table below presents IBEC's estimates of the likely impact over the three-year period 2012 to 2014 on economic activity, the Exchequer and employment from each proposed measure. For some, such as the home improvement tax credit and child benefit, the measure is likely to yield full benefit in the first year of implementation. In other cases, such as normalisation of savings and property transactions, the full benefit will take up to three years to accrue. However, given the level of pent-up demand in the economy, a virtuous circle can develop quite quickly.

Over a three-year period, IBEC estimates that the measures have the potential to create up to €5.7 billion in additional activity in the Irish economy. This would support almost 25,000 jobs for the three-year period and yield benefits to the Exchequer totalling €2.4 billion[7]. There would also be substantial further employment and economic gains from the reduction in the unsold housing stock for the construction sector but these benefits have not been counted here as much of them would occur after the initial three-year period.

Economic impact and jobs supported for 2012-2014

	Expenditure	Exchequer benefit	Jobs impact
AVCs and personal pensions	€780 mn	€520 mn	3,150
Child benefit payment card	€900 mn	€300 mn	3,630
Home improvements	€2.0 bn	€790 mn	9,200
Property transactions	€1.2 bn	€480 mn	5,600
Normalisation of savings	€820 mn	€270 mn	3,300
Total	**€5.7 bn**	**€2.4 bn**	**24,880**

[7] This calculation assumes that a normalisation of the savings ratio and housing transactions volumes takes place in the three-year period and that the injection from reduced savings is invested on home improvements or housing transactions, with the remainder spent in the domestic economy. A normalisation of bank lending conditions would lead to further additional benefits and jobs creation.

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