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Opening Statement on the Economic and Fiscal Position in the Context of Budget 2017

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I thank the Chairman for the opportunity to appear before the Committee today.

Economic Context

Following the recent upward revision to GDP the NERI's next set of macroeconomic projections are likely to forecast a 2016 general government deficit of close to 0.8% of GDP and a gross debt ratio of close to 75%. Our summer forecast was for real GDP growth of 4.6% this year 3.7% next year.

While the headline GDP figures give a misleading picture of economic activity in Ireland there is evidence that the real economy grew strongly in 2015 and continues to grow strongly.

Personal consumption increased 4.5% in volume terms in 2015 and 5% in the first quarter of 2016 compared to last year. The growth in spending is being driven by the strong growth in employment. Other factors boosting consumption include the reversal of fiscal austerity, the ongoing decline in household debt, pent-up demand, loose monetary policy, the fall in energy prices and Ireland's position within the economic cycle.

Employment increased by 2.6% in 2015 and is up 2.7% in the first half of 2016 compared to the previous year. Total employment is now above two million for the first time since the fourth quarter of 2008 although this is still over 130,000 below peak employment levels. All regions remain below their pre-crisis employment totals with recovery relatively strongest in

Dublin at 97% of second quarter 2008 employment and relatively weakest in the West at 89%.

The unemployment rate was 8.6% in the second quarter of 2016. Unemployment rates are lowest in the Mid-East at 6.9% and highest in the South-East at 10.8%. Long-term unemployment is below 100,000 for the first time since the third quarter of 2009 and now stands at 4.4%. However, long-term unemployment is three times as large as it was in the first quarter of 2008.

Average weekly earnings were up 0.5% in the second quarter compared to the previous year while average hourly earnings increased by 0.2%. Average hourly earnings are essentially unchanged over the last five years and have actually declined in nominal terms compared to the same quarter in 2009.

Consumer prices (CPI) in July were up 0.5% over the previous year and 1.3% excluding energy products. The CPI is now broadly at 2008 levels and is up almost 3% since the middle of 2011. This means that hourly earnings have declined in real terms over the last five years.

Fiscal Context

The parameters for Budget 2017 are set by the requirements of the *preventive* arm of the Stability and Growth Pact. Adherence to the fiscal rules limits the net fiscal space for new commitments to between €900 million and €1 billion in 2017. The recent upward revision to GDP will have minimal impact on the 2017 fiscal space.

The Irish Government estimates the net fiscal space available over the next five years at €11.3 billion. However, this estimate is based on an assumption that the economy is running a structural deficit of 2% of potential output in 2016 and that the economy is overheating.

A strong case can be made that the economy is not overheating. This analysis is based on the economy's still high unemployment rate; the evident lack of domestic price and wage pressure in the economy; the current account surplus even after correcting for multinational restructurings, and the low underlying investment ratio and lack of housing supply.

If this analysis is correct it implies scope for increasing fiscal space in 2018 as structural deficit targets will have been achieved.

The fiscal space is sensitive to the potential growth rate of the economy. The NERI's baseline estimate is for real GDP growth of close to 3% out to 2030. Potential GDP growth could well be higher than this in the short-to-medium term given the potential for above trend employment growth over the next five years.

However, a structural shock to the economy; a secular productivity decline, sustained under-investment, or an under-performance of employment growth, would damage the economy's growth potential. An average reference rate of real potential growth of 3% over the next five years, as opposed to 3.5%, would reduce the cumulative net fiscal space by around €1.8 billion over the next five years.

Not all fiscal measures have the same impact on potential output. In the long-run sustainable growth can only come from productivity gains.

Given Ireland's relatively low levels of spending by advanced economy standards on education, R&D and capital expenditure, there appears to be scope to use fiscal policy to enhance future productivity by:

1. Increasing per capita investment in education and skills.[1]

[1] Spending on education generates positive externalities for the wider economy to the extent that it represents genuine investment in human capital. Early years are the most important for human capital development. Despite Ireland having a comparatively young population, government spending on education on a COFOG basis was just 4.3% of GDP in 2014 compared to 4.9% for the EU, 5.2% for the UK, 6.5% for Sweden and 7.2% for Denmark.

2. Increasing per capita investment in R&D, in the production, diffusion and use of new knowledge and ideas, and the development of a strong innovation system.[2]
3. Increasing investment in productive infrastructure.[3]

Long-run investments in these three areas can actually increase the fiscal space available to government over the long-term because these types of investment increase the productive capacity of the economy.

The future of the Universal Social Charge (USC) has come under question in recent years. The USC has a simple and highly progressive structure.

Average rates of combined income tax and employee social security contributions in Ireland are significantly below OECD averages for both low and middle income earners. Dismantling of the USC would be regressive and extremely costly. While there would be a short-term boost to demand there would be no increase in the economy's productive capacity.

Ireland is not a high tax or a high public spending economy. Given our aging population it is likely we will have to increase taxes in the future. Cutting taxes now is not a prudent long-term budgetary strategy.

I am happy to take questions.

[2] Ireland spent €166 per capita on public sector R&D in 2014. This compares to just over €200 in the UK, €462 in Sweden, and over €500 in Denmark and in Norway. While an economy's innovative capacity depends on far more than just the public spend on R&D it is evident that Ireland has significant scope to raise the R&D budget.

[3] Public capital investment has been hovering close to 2% of GDP since 2012, one of the lowest rates in the EU, and well below the EU average of 2.9%. Such a low rate of public investment, if maintained, will increasingly produce infrastructure bottlenecks and impede Ireland's long-run growth potential. Ireland already ranks poorly in terms of international rankings of infrastructural quality.

Reference Tables

Table 1 Dashboard of Macroeconomic Indicators, Ireland

	2011	2012	2013	2014	2015	Latest
	Percentage volume change over previous year					
Gross Domestic Product	0.0	-1.1	1.1	8.5	26.3	2.3 *(Q1'16)*
Domestic Demand	0.7	1.4	-1.9	7.7	9.9	1.8 *(Q1'16)*
Retail Sales	-3.0	-1.1	0.7	6.4	8.2	6.0 *(Q2'16)*
Industrial Production	-0.4	-1.5	-2.2	22.9	34.9	0.9 *(Q216)*
	Percentage annual average rate of change					
Employment	-1.8	-0.6	2.4	1.7	2.6	2.9 *(Q2'16)*
Average Hourly Earnings	-0.4	0.2	-0.3	-0.1	0.2	0.2 *(Q2'16)*
Inflation (HICP)	1.2	1.9	0.5	0.3	0.0	0.1 *(M7'16)*
	Percentage of gross domestic product					
Investment	17.2	19.4	18.2	20.5	21.1	17.9 *(Q1'16)*
Current Account Balance	-1.6	-2.6	2.1	1.7	10.2	14.3 *(Q1'16)*
Government Balance	-12.6	-8.0	-5.7	-3.7	-1.8	-2.3 *(Q1'16)*
Government Gross Debt	109.6	119.5	119.5	105.2	78.7	78.7 *(Q4'15)*
	Percentage of labour force					
Unemployment	14.6	14.7	13.0	11.3	9.4	8.3 *(M8'16)*
Long-term Unemployment	8.6	9.0	7.8	6.6	5.3	4.4 *(Q2'16)*
	Percentage of households					
Deprivation	24.5	26.9	30.5	29.0	n/a	29.0 *(2014)*
At Risk of Poverty	16.0	16.5	15.2	16.3	n/a	16.3 *(2014)*
	Percentage					
Gini Coefficient	31.1	31.2	31.3	31.8	n/a	31.8 *(2014)*

Notes: Quarterly data (e.g. Q1 is the first quarter) is compared to the same quarter of the previous year. Monthly data (e.g. M4 is April) is compared to the same month of the previous year. Rates of change represent the average value over the four quarters or twelve months. Average annual hourly earnings compares annual hourly earnings to the previous year. General Government Balance and Gross Debt are end-year figures as a % of annualised GDP or, in the case of the government balance, the latest quarterly figure as % of quarterly GDP. Unemployment and labour force are averages for the four quarters.

Sources: CSO National Income and Expenditure (2016), CSO Quarterly National Accounts (2016), CSO Retail Sales Index (2016), CSO Industrial Production and Turnover (2016), CSO Quarterly National Household Survey (2016), CSO Earnings and Labour Costs Annual (2016), CSO Earnings and Labour Cost Quarterly (2016), CSO Consumer Price Index (2016), CSO Balance of Payments (2016), CSO Government Finance Statistics (2016), CSO Monthly Unemployment (2016), CSO Survey on Income and Living Conditions (2015).

Table 2: Regional and Sectoral Employment Trends, 2008-2016 (Thousand)

	Q2 2008	Q2 2012	Q2 2016	Employment Ratio 2008 to 2012	Employment Ratio 2008 to 2016
Border	217.8	174.6	196.9	**80.2**	90.4
Midland	121.3	105.2	116.6	86.7	96.1
West	207.4	179.5	185.0	86.5	**89.2**
Dublin	637.7	547.4	617.5	85.8	**96.8**
Mid-East	252.9	222.7	242.2	**88.1**	95.8
Mid-West	174.2	150.1	157.6	86.2	90.5
South-East	227.0	186.0	213.8	81.9	94.2
South-West	309.1	270.7	285.4	87.6	92.3
State	**2147.3**	**1836.2**	**2014.9**	**85.5**	**93.8**
Selected Sectors (seasonally adjusted)*					
Construction	248.0	100.2	136.4	40.4	55.0
Wholesale/retail	315.3	269.3	275.4	85.4	87.3
Industry	292.8	232.9	257.3	79.5	87.9

Source: CSO Quarterly National Household Survey (August, 2016)
Note: On a net basis four out of every seven jobs lost have been recovered since the trough.
*All other sectors are at minimum within 7,500 of Q2-2008 employment levels. Seven of the fourteen sectoral categories have seen employment increase since 2008.

Table 3: Average Hourly Earnings and Inflation Trends, 2008-2016

	Q2 2008	Q2 2010	Q2 2012	Q2 2014	Q2 2016
Average Hourly Earnings (Euro)	21.51	22.05	21.98	21.82	21.93
Consumer Price Index (Base 2011 = 100)	102.8	97.0	101.4	102.2	101.9

Sources: CSO Earnings and Labour Costs Quarterly (2016) and CSO Consumer Price Index (2016)
Notes: CPI data is for M5 (May).

Table 4 Revenue and Expenditure Comparisons (% GDP)

	2015	2016	2017	2018	2019	2020	2021
Revenue							
Ireland*	32.8	30.9	30.3	29.9	29.7	29.5	29.4
Euro area**	46.5	46.2	45.9	45.9	45.8	45.8	45.8
United Kingdom**	35.7	36.5	36.7	36.7	37.1	37.0	37.0
Ireland (% GDP-GNP Hybrid***)	36.2	34.2	33.6	33.2	33.1	32.9	32.9
Expenditure							
Ireland*	35.1	32.0	30.7	29.6	28.6	27.5	26.6
Euro area**	48.5	48.1	47.4	46.9	46.5	46.3	46.1
United Kingdom**	40.2	39.7	38.9	38.0	37.0	36.5	36.4
Ireland (% GDP-GNP Hybrid***)	38.7	35.4	34.0	32.9	31.8	30.7	29.8

Sources: IMF World Economic Outlook (2016); Department of Finance Stability Programme Update (2016), NERI calculations

Notes: *Base projections for Ireland are from the Department of Finance's 2016 SPU and are before allocation of unused net fiscal space.
**Projections for Euro area and UK are from the IMF Fiscal Monitor.
***NERI estimates. The GDP-GNP Hybrid refers to the 'hybrid' measure of GDP and GNP developed by the Irish Fiscal Advisory Council as an estimate of Ireland's fiscal capacity (IFAC, 2012). It is calculated as GNP + 0.4(GDP-GNP).

Table 5: Comparison of Revenue by Type (% GDP)

		2010	2011	2012	2013	2014
Taxes on Consumption	Ireland	9.9	9.4	9.5	9.8	10.1
	EU	10.7	10.9	10.9	10.9	11.0
Taxes on Labour	Ireland	12.1	12.6	12.9	12.9	13.1
	EU	19.1	19.2	19.4	19.6	19.6
Taxes on Capital	Ireland	6.0	5.7	6.0	6.1	6.5
	EU	7.5	7.7	8.0	8.1	8.2
Breakdown of Labour Taxation						
Paid by Employers	Ireland	3.2	3.3	3.0	3.1	3.3
	EU	7.7	7.7	7.7	7.7	7.7
Paid by Employees	Ireland	8.8	9.2	9.6	9.6	9.7
	EU	9.5	9.5	9.8	9.9	9.8
Paid by Non-employed	Ireland	0.1	0.2	0.2	0.2	0.2
	EU	1.9	1.9	1.9	2.0	2.0

Sources: European Commission (2016): DG Taxation and Customs Union; NERI calculations

Notes: Data for EU represents weighted averages. Taxes on labour includes social contributions.

Table 6: Implicit Tax Rates, (% of potential tax base)

		2010	2011	2012	2013	2014
Consumption	Ireland	22.2	21.5	22.0	22.7	23.7
	EU26* (Unweighted)	20.9	21.2	21.3	21.5	21.8
Labour	Ireland	29.0	31.5	32.5	33.2	34.4
	EU28	35.4	35.8	36.1	36.5	36.4
Capital	Ireland	13.0	13.0	-	-	-
	Euro area**	27.4	28.9	-	-	-

Sources: European Commission (2016): DG Taxation and Customs Union; Eurostat (2015): Taxation Trends in Europe Annual Report 2014; NERI calculations

Notes: *Unweighted country average. Excludes Ireland. Data for Croatia not available.
** Not all EU countries reported the ITR on capital. More recent data is expected in 2016.

Table 7: Public Spending on R&D (GERD - Higher Education and Government), Capital Formation and Education, % GDP, 2014

R&D*		Fixed Capital Formation		Education	
Ireland	0.4	Ireland	2.1	Ireland	4.3
EU	0.7	EU	2.9	EU	4.9

Sources: Eurostat (2016): Total R&D Expenditure, (GERD) by Sectors of Performances; European Commission (2016) Statistical Annex of European Economy

Notes: *Higher Education and Government.
Education spending is on a Classification of the Functions Of Government (COFOG) basis.