Quarterly Economic Observer

Summer 2014

ISSN 2009-4663

Nevin Economic Research Institute

About NERI and this publication

The Nevin Economic Research Institute (NERI) has been established to provide information, analysis and economic policy alternatives. Named in honour of Dónal Nevin, scholar, trade unionist and socialist who gave a life of service to the common good, the Institute aims to undertake research that will be of relevance to the Trade Union movement and the general public across the island of Ireland.

This is the tenth Quarterly Economic Observer (QEO) of the Institute. The purpose of the QEO is to provide regular, accessible and timely commentary so as to equip trade unions and others in articulating and advancing a new economic paradigm where the old has failed. The QEO complements the NERI Summer 2014 Quarterly Economic Facts (QEF) which provides a set of statistical indicators to complement our analysis. Unless otherwise stated, the data cited in this Observer are the latest available as of early June 2014. The final draft of this document was completed on 20th June 2014.

This report has been prepared by staff of the Institute. We are grateful to external reviewers from the academic and research community who reviewed and commented on an earlier draft of this document. The analyses and views expressed in this publication are those of the NERI and do not necessarily reflect those of others including the Irish Congress of Trade Unions or the unions supporting the work of the Institute.

Further information about NERI may be obtained at our website www.NERInstitute.net

The Nevin Economic Research Institute

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Executive Summary

This edition of NERI's Quarterly Economic Observer (QEO) provides an overview of recent economic trends (Section 2) and outlines NERI's current expectations for the economic outlook in Northern Ireland and the Republic of Ireland (Section 3). The QEO also contains an analysis of the Republic of Ireland's public finances and considers fiscal policy options in advance of Budget 2015 (Section 4).

Economic Outlook

Our outlook for the Republic of Ireland is for continued improvement in employment and output in 2014 and 2015. A number of concerns remain including the still high level of private indebtedness, weak credit conditions and the very high levels of long-term unemployment and youth unemployment. Our projections are predicated on an improving outlook for GDP growth in the Republic's main trading partners in Europe and North America. There are a number of risks to the forecast including the threat of deflation in the Euro area and the potential for a supply side shock arising out of the political difficulties in Eastern Europe and the Middle East.

Economic prospects in Northern Ireland are unclear due to the potential impacts of the Scotland independence referendum in September and next May's general election in the UK. The result of the general election has implications for the UK's membership of the EU. Despite the uncertain outcome of the upcoming elections in the UK our outlook for Northern Ireland is generally positive.

For Northern Ireland we project that:

- Economic recovery will start to take hold with modest increases in employment and output.
- The pace of recovery will continue to lag that of the UK.

Based on the analysis outlined in Section 3, our current projections for the Republic of Ireland include:

- Growth in 2014 and 2015 of 2.1% and 2.9% respectively. The return to growth will mainly be driven by an increase in domestic demand.

- A return to growth in personal consumption in 2014 after a decline in 2013 and a strong return to growth in investment. Investment will increase by almost 10% in 2014, albeit from a very low base.
- Continued improvement in employment with the unemployment rate falling to 11.5% in 2014 and 10.7% in 2015.
- A decrease in government debt both nominally and as a percent of GDP in 2014 and 2015. The deficit figures will be helped by favourable revisions to the methodology used to calculate GDP along with the pace of the recovery in employment and growth. We anticipate a deficit of 4.7% of GDP in 2014 and 2.5% of GDP in 2015.

Fiscal Policy Options in the Republic of Ireland

The Republic's public finances remain fragile and a 'Do Nothing' stance in Budget 2015 will be insufficient to restore the public finances to a sustainable path. A number of points can be made:

- Government revenue as a percentage of GDP is very low by Western European standards and it is evident that there is no room for tax cuts in Budget 2015.
- On the other hand further cuts to public spending will put immense pressure on public services, public investment and social transfers. Primary (non-interest) public spending is already low by EU standards, and by modern historical standards in Ireland.
- On the balance of evidence it appears likely that Ireland's structural deficit is now close to zero, albeit still marginally in deficit. This implies there is minimal need for additional discretionary consolidation.
- However, the debt to GDP ratio is still too high and it is too early to claim the public finances are repaired. Some additional adjustments are needed to place the Republic's public finances on a sustainable path.

As important as the deficit is, it is just as important to avoid embedding a high level of structural long-term unemployment in the economy. As people's human capital degrades they find it increasingly difficult to return to work and this reduces the productive capacity of the economy. Too much, or poorly designed, austerity will reinforce the 'hysteresis effect' in the labour force whereby the economy becomes stuck in a lower output equilibrium over the long-term. The Republic's low level of public investment is a drag on employment and potential output. An 'off-book' investment stimulus funded from the Ireland Strategic Investment Fund (ISIF) would go some way to addressing this problem.

The budget is about choices. In this QEO we describe an alternative approach to achieving the 2015 EDP deficit target of less than 3 per cent of GDP. We find that a better outcome can be achieved in terms of equity, growth and employment by pursuing a three pronged strategy based on:

- A net discretionary fiscal adjustment of €800 million composed mainly of increases in government revenue. We identify revenue measures that are supportive of growth and equity objectives. These include reforms to tax expenditures and Capital Acquisitions Tax as well as the introduction of a Net Wealth Tax.
- The net fiscal adjustment includes a modest increase in social spending as part of a social emergency fund targeted at the most vulnerable individuals and communities. Part of this fund would be reserved for spending on social housing.
- The third prong is an accompanying 'off-book' investment package that restores public investment in the Republic to the EU average in 2015. The investment package can be funded through the Ireland Strategic Investment Fund. This off-book stimulus would not increase the Government's borrowing requirement.

The more growth friendly choice of fiscal consolidation instruments under the NERI plan, coupled with the proposed off-book programme of public investment, is estimated to deliver a more benign outcome in terms of GDP growth, employment, and the unemployment rate. The general government balance (the public deficit) would be the same as a percentage of GDP under both plans.

1 Introduction

Our economic outlook for both parts of the island of Ireland is for recovery to take hold gradually. In the Republic of Ireland we anticipate growth in output and employment in 2014, with more robust growth in 2015 and 2016. Unemployment will continue to fall. However the recovery remains fragile and is being hampered by high levels of public, corporate and household indebtedness, weak credit conditions, deflationary fears in the Euro area and an absence of wage growth. In the short-run the referendum on Scottish independence is contributing to a climate of economic uncertainty in Northern Ireland. Overall the economic outlook for Northern Ireland is mildly positive.

In this edition of the *Quarterly Economic Observer* (QEO) we update our expectations for both of the economies - North and South (Section 3). Complementing this, in Section 4 we assess the health of the public finances in the Republic of Ireland and consider fiscal policy options for Budget 2015.

The QEO is structured as follows. Recent economic trends in both parts of Ireland are reviewed in Section 2. Section 3 updates NERI's macroeconomic projections while in Section 4 we examine fiscal policy options in the Republic of Ireland. Section 5 concludes.[1]

The Nevin Economic Research Institute (NERI) offers this report as a contribution to public debate on policy making and formation on the island of Ireland. We welcome feedback, comment and suggestions. The precise data used and the specifics of any proposal/projections are constantly subject to review as fresh information and data become available.

[1] The analysis here complements a number of recent and forthcoming NERI research papers. These are cited throughout the report and can be accessed on the NERI website.

2 Overview of Recent Economic Trends

This section of the Quarterly Economic Observer (QEO) examines recent trends in a number of key economic indicators in both the Republic of Ireland and Northern Ireland. Recent economic developments are summarised in Table 2.1

Table 2.1 Key Economic Trends (2007-2013)

	2007	2008	2009	2010	2011	2012	2013
Total Employment (% of working-age population)							
ROI	69.2	67.6	61.9	59.6	58.9	58.8	60.5
NI	68.4	67.8	64.7	66.1	67.4	67.3	66.9
UK	71.5	71.5	69.9	69.9	69.5	70.1	70.8
Euro area	65.5	65.9	64.5	64.1	64.2	63.8	63.5
Unemployment (% of labour force)							
ROI	4.7	6.4	12.0	13.9	14.7	14.7	13.1
NI	4.0	4.5	6.5	7.1	7.2	7.5	7.6
UK	5.3	5.6	7.6	7.8	8.0	7.9	7.5
Euro area	7.5	7.6	9.6	10.1	10.1	11.3	12.0
Gross Domestic Product (% volume change over previous year) – *NI output refers to GVA*							
ROI	5.0	-2.2	-6.4	-1.1	2.2	0.2	-0.3
NI	8.8	-1.0	-3.2	1.8	0.4	1.2	N/A
UK	3.4	-0.8	-5.2	1.7	1.1	0.3	1.7
Euro area	3.0	0.4	-4.5	1.9	1.6	-0.7	-0.4

Sources: Labour market data are from Eurostat (2014b) Labour Force Survey Database (Updated 3 June 2014; Online reference code lfsi_emp_a and une_rt_a); GDP data for Republic of Ireland (ROI), United Kingdom (UK) and for the Euro area (Euro) are from Eurostat (2014c) National Accounts database (Updated 5 June 2014; Online reference code nama_gdp_k); Gross Value Added (GVA) data for Northern Ireland (NI) are taken from ONS Regional Trends Series (Office for National Statistics, 2013)

Notes: ROI, UK and Euro area labour market data refer to the whole year; NI labour market data are based on the average of the four quarters for each year with data taken from the Labour Force Survey
Total employment refers to all persons in employment (ILO definition) aged 15-64 as a proportion of all persons aged 15-64.
Unemployment is measured on the ILO definition basis and refers to persons aged 15-74.
n/a = not available

2.1 Recent trends in the World Economy

The Great Recession and its aftershocks have left their marks on the world economy. The recovery has been slow by historical standards. In many countries structural unemployment has increased while labour force participation has fallen. In addition, many advanced economies are now burdened by high public and private debt levels, large fiscal deficits and weakened banking sectors. The economic outlook for the Euro area remains fragile, albeit improving, with recovery likely to be uneven across countries. Economic activity decreased in the Euro area in 2012 and 2013 and both the IMF (April, 2014c) and the European Commission (2014) project that Euro area real GDP growth will be just 1.2% in 2014. Economic recovery is forecast to be sluggish throughout the region although only Cyprus is projected to remain in recession.

Prospects for recovery in the developed economies over the next two years will be assisted by a lessening of drag from fiscal austerity. EU domestic demand is likely to strengthen as the pace at which households and firms repay their debts continues to ease off. There is still much spare capacity (slack) in large parts of the Euro area. This suggests potential for above trend growth in the short to medium-term. On the other hand there are a number of ongoing impediments to growth including the high level of structural unemployment and falling potential output, the weakness of private and public balance sheets (that is assets in comparison to liabilities), and the general weakness of credit conditions. Low investment also remains a concern and risks becoming a drag on potential output. Unemployment will remain very high in the Euro area in 2014. Over half of the 18 Euro area countries will still have double digit unemployment a full six years after the economic crisis erupted. The IMF (2014c) projects a Euro area unemployment rate of 11.9% in 2014 falling to 11.6% in 2015.

The large amount of slack in the economy (underemployed resources) means there is little inflationary pressure. The European Central Bank (ECB) projects Euro area inflation will be well below target at just 0.7% in 2014 and 1.1% in 2015. Ongoing deflationary concerns will keep monetary policy loose or 'accommodative' and interest rates low. It seems likely that further monetary stimulus will be needed to support economic recovery and enable the ECB to hit its inflation target. The ECB has reduced interest rates, introduced a programme of Targeted Long Term Refinancing Operations (TLTROs), and may yet engage in quantitative easing. The threat of deflation continues to raise debt sustainability concerns in a number of countries, most notably Greece.

An increase in interest rates would be highly damaging to Euro area growth although the risk of this is low in the short-term given the lack of inflationary pressure. On the other hand the crises in Ukraine and Iraq may well manifest as a supply-side shock in the form of higher energy prices. Such an event would exert downward pressure on growth, particularly in Europe. There is further downside concern in the shape of ongoing uncertainty around the outcome of the comprehensive assessment of Euro area banks and the potential for further bank recapitalisation, or even resolution.

The comprehensive assessment of Euro area banks is key to restoring confidence in the banking system and to improving credit conditions in the Euro area. This process must be credible. The establishment of a banking union, despite its potential flaws, may help reduce financial fragmentation in the Euro area. However, it is as yet unclear how effective the new Single Resolution Mechanism (SRM) will be at decoupling the damaging link between sovereigns and their banks. The decision-making process seems too lengthy and complex to eliminate the possibility of bank runs. Progress in bank reform and improving credit conditions will help ease lending rates and assist growth.

The United Kingdom economy began 2014 with growth of 0.8% in the first quarter, up from 0.7% in the final quarter of 2013. Forecasters expect growth of up to 2.9% for the UK in 2014 which would be a marked increase from the 1.7% growth rate achieved in 2013 (NIESR, 2014). Overall UK GDP remains 0.7% below its 2008 Q1 peak, although it is likely to exceed this level in the second quarter of this year.

People unemployed in the UK in the three months ending April 2014 fell by over 161,000 bringing the overall rate down to 6.6% from 7.2% in November-January. Once again there was a significant increase in part-time employment which grew 1.0% in the first quarter compared to an increase of 1.2% for full-time workers. Self-employment increased by almost 1.6% over the same period which represents an increase of over 8% from February to April of 2013. House prices rose significantly again in April this year.[2] While the significant increase in house prices led many to expect an early increase in interest rates, the inflation rate unexpectedly fell to 1.5% in the month of May giving a rather confused picture for policymakers.

The US economy contracted in the first quarter due to the severe winter weather. However, the economic outlook for the US is moderately positive. The IMF (2014c) projects real GDP growth will be 2.8% in 2014 and that the unemployment rate will fall to 6.4%. Improving labour market conditions are supporting an increase in private consumption while there will be less of a drag from fiscal contraction. The resolution of the debt ceiling crisis and the increase in the government spending cap has eased political uncertainty, at least for 2014. Growth in the US is also being driven by pent-up demand for business and residential investment after years of stagnation.

The Federal Reserve (Fed) now considers long-term unemployment, under-employment and the participation rate as part of its decision making process. There is still substantial slack in the US economy and this is contributing to the lack of inflationary pressure. However, inflationary pressures will increase as the economy

[2] Fears of a property price bubble are outlined in Section 3 of this publication.

reaches its potential level and this increase in inflation will be accompanied by a tightening of monetary policy. Interest rates are likely to start rising sometime in early 2015 while the Fed has already begun the process of tapering its asset purchases. The scaling down of monetary stimulus in the US is likely to generate negative spill-overs for the global economy.

Expansionary monetary policy is continuing in Japan. However, fiscal contraction will weigh on Japan's growth, particularly in 2015 when the fiscal contraction will be almost 2% of GDP and will include a large investment component. The OECD (2014) projects real GDP growth will be 1.2% in 2014 with fiscal tightening partially offset by improving labour market conditions. Consumer spending, industrial production and investment have all slowed in China and this may lead to a loosening of monetary policy. There are concerns (see OECD, 2014) about the rapid pace of growth of China's financial system. Policy induced slowdown in credit or financial collapse in the banking sector would hit domestic growth and would undoubtedly have spill-over effects on other countries via the impact on trade. The outlook for economies in Eastern Europe and the Middle East is particularly uncertain given the ongoing political tensions in Ukraine and the escalating conflict in Iraq.

2.2 Recent trends in the Republic of Ireland Economy

The Republic of Ireland's labour market continued its recovery during the last quarter (CSO, 2014g), albeit at a slower pace with seasonally adjusted employment increasing by just 1,700. The economy added 42,700 jobs in the year to Q1 2014 and total employment is now 1.89 million while there are 2.15 million people in the labour force. Seasonally adjusted employment has fallen by 257,500 between Q1 2008 and Q1 2014.

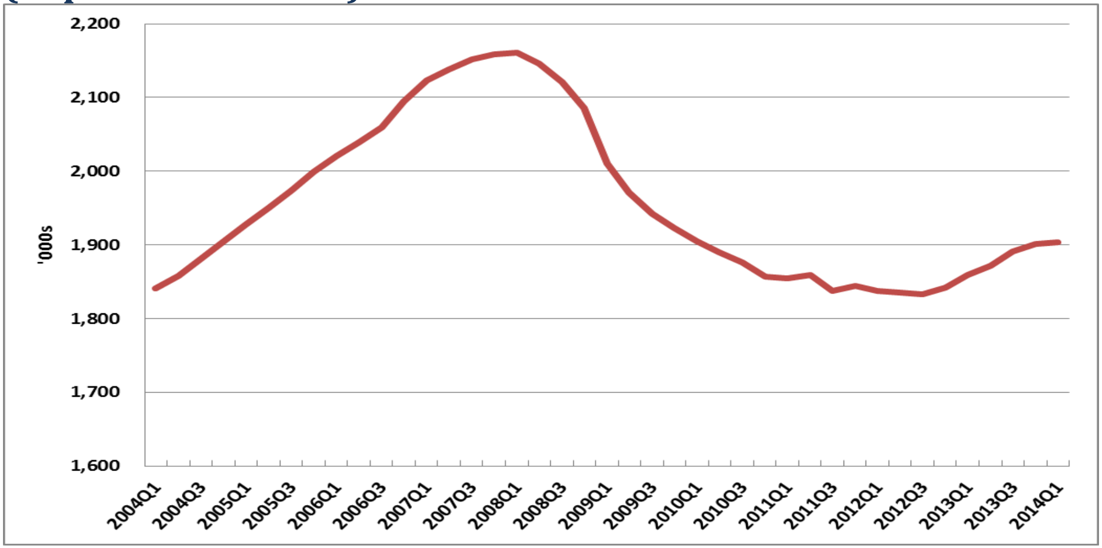
The current statistics for annual employment growth by sector are somewhat unreliable due to adjustments made to the sample of the Quarterly National Household Survey. With this caveat in mind, a*griculture, forestry and fishing* (+14,500); *accommodation and food service activities* (+14,000) and *professional, scientific and technical activities* (+12,000) all show large increases. The largest sectoral increases during Q1 2014 were in *education* (+2,300) and *financial, insurance and real estate activities* (+1,400). In terms of broad occupational group the biggest annual employment gain was in *skilled trades* (24,100), while the largest decline was in *sales and customer service* (-3,100). On an annual basis employment has fallen for females aged 25-34 (-5,000) and for females aged 15-24 (-8,800). Employment has also fallen for males aged 25-34 (-1,200). Total youth employment is down 7,500 in the year to Q1 2014.

The seasonally adjusted unemployment rate was 12.0% in Q1 2014.[3] There has been a steady improvement from 13.7% in Q1 2013 and 15.1% in Q1 2012. However the pace of improvement tapered off notably in Q1 2014. There are now 260,300 people unemployed (seasonally adjusted) compared to 295,600 in Q1 2013. The unemployment rate is 13.7% for males (164,700 people) and 10.0% for females (96,500 people), while the participation rate is 67.9% for males and 52.8% for females. Youth unemployment remains high at 25.3%. Underemployment fell from 155,800 to 141,700 in the year to Q1 2014. The long-term unemployment rate has fallen from 8.4% to 7.3% in the year to Q1 2014 but remains worryingly high. There are now 156,200 long-term unemployed representing 60.5% of the total unemployed. The Live Register showed a seasonally adjusted standardised unemployment rate of 11.8 per cent in both April and May of 2014.[4]

The recovery in employment has not been balanced over the eight NUTS regions. While total employment in the *Dublin* region increased by 25,800 in the year to Q1 2014, it actually fell by 3,600 in the *South-West* region; by 2,000 in the *Mid-West* region and by 1,600 in the *West* region. The *South-West* (Cork and Kerry) was the only region to see an increase in its unemployment rate in the year to Q1 2014. The unemployment rate is lowest in *Dublin* (10.4%) and highest in the *South-East* (15.7%). The *Dublin* region has the highest participation rate at 62.6% while the *Border* region has the lowest at 54.6%.

[3] Figures are based on ILO definitions of labour force status.
[4] See NERI's Quarterly Economic Facts for more details on recent labour market trends.

Chart 2.1 Quarterly Trends in Total Employment (Republic of Ireland)



Source: CSO (2014g) Quarterly National Household Survey (QNQ03)
Note: Numbers in employment, seasonally adjusted.

The Irish economy continues to operate well below potential output and the spare capacity in the economy is contributing to subdued wage and price inflation. Futures prices for oil suggest energy prices will remain low. Consumer price inflation is also being compressed by the strength of the euro. Inflation in 2013 averaged 0.5% as measured by the Harmonised Index of Consumer Prices (HICP), and averaged 0.4% as measured by the GDP deflator. Wages are still declining. There was a decrease in average hourly earnings of 0.9% in the year to Q4 2013. This was mainly due to a fall in hourly earnings of 3% in the public sector. Hours worked are broadly flat. Real income is at least being buttressed by low inflation.

Total domestic demand fell marginally in 2013. Ireland's long period of balance sheet recovery is still playing itself out and the process of private sector deleveraging continues to weigh on domestic demand and growth. Demand is also being held down by the ongoing fiscal contraction. Personal consumer spending is estimated to have fallen by 1.1% in 2013 while government consumption fell by 0.5%. GDP fell in volume terms by 0.3% in 2013 although this must be understood in the context of important patents expiring in the pharma-chem sector and the replacement of products by generic equivalents. The value of pharmaceutical products fell by 10% in 2013 (the volume fell by 3%). GNP, which was unaffected by the patent cliff effect, grew by 3.4% in volume terms in 2013.

Capital formation (i.e. investment) increased by 4.2% in 2013, albeit from an extremely low base. Investment levels, at around 11% of GDP, continue to sit close to record low levels. Public investment as a proportion of GDP is just two thirds of the EU average. Corporate indebtedness, credit constraints and the weakness of the banking sector all remain barriers to private sector investment. Increased investment in 2013 in machinery and equipment fed through into higher imports. There were also higher royalty and licence payments by the multinational sector and in volume terms imports increased by 1.0% in 2013. Exports rose by just 0.2% in 2013 – influenced by the patent cliff effect - while net exports declined overall by €1.03 billion. Industry declined by 3.3% in volume terms, and within industry, building and construction fell by 10.6% in volume terms.

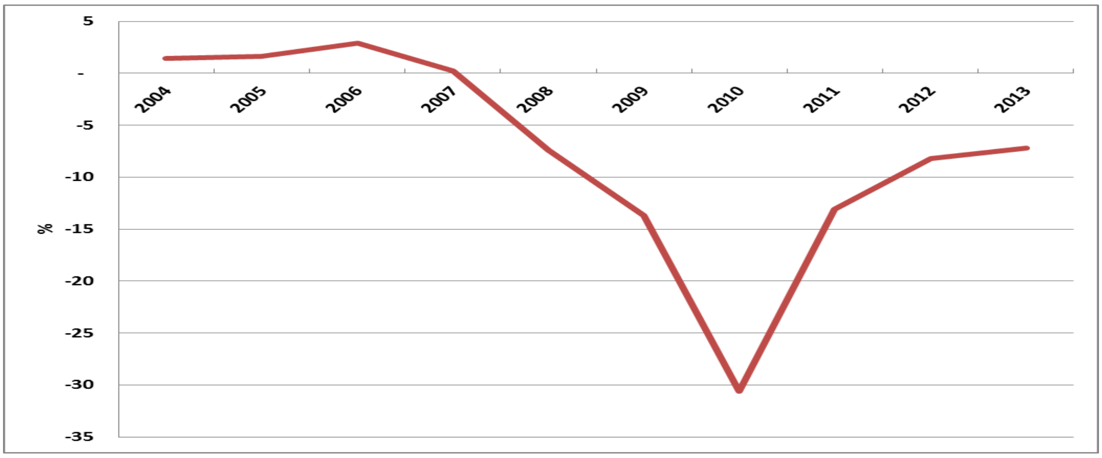
Seasonally adjusted constant price GDP declined by 2.3% in Q4 2013 compared with the previous quarter, while GNP increased by 0.2% over the same period. There was a decline in net exports (-10.5%) during the quarter, which was largely driven by higher imports. Consumption fell by 0.6% and investment increased by 3.1% in Q4 2013 compared to the previous quarter.

There are positive signs of recovery. The retail sales index is up 4.4% in value terms and 6.8% in volume terms in the year to April 2014. The industrial production index is up 11.5% in the year to March 2014. Construction activity is also starting to increase and sentiment appears strong. The composite Purchasing Manager's Index (Q1 2014) is at its most expansionary level for seven years - the construction PMI is at its highest for 10 years - while consumer confidence is close to a seven year high. Rising house prices are increasing net worth and in time this should feed through into greater confidence and demand. The number of mortgage accounts for principal dwelling houses in arrears fell for the second consecutive quarter in Q4 2013. A total of 136,564 (17.9%) of accounts were in arrears at end Q4 2013, a decline of 3.3% relative to end Q3 2013.

Gross Saving for the economy as a whole increased by €4.67 billion in 2013 to €28.38 billion although the contribution of the household sector decreased by €701 million to €8.15 billion. The gross saving ratio, as a percentage of gross disposable income, decreased from 10.2% in 2012 to 9.4% in 2013. Net borrowing by the rest of the world from Ireland was €10.87 billion in 2013 compared with net borrowing of €5.19 billion in 2012. The strong net borrowing position reflects the high level of gross saving in the Irish economy. Debt as a proportion of disposable income continues to decline and is now at 192% while household debt is now down to 2006 levels.

The General Government Balance (GGB) was in deficit to the tune of €11.78 billion in 2013, or 7.2% of GDP (see Chart 2.2). This marks an improvement on the 2012 position of €13.44 billion or 8.2% of GDP. Public expenditure increased from €69.84 billion to €70.37 billion reflecting an increase in interest payments and current and capital transfer payments. The overall increase in spending was ameliorated by reductions in other areas including expenditure on pay and on purchase of goods and services. Government revenue increased from €56.62 billion to €58.87 billion in 2013. At the end of 2013 the gross debt of General Government stood at €202.92 billion or 123.7% of GDP, while net debt amounted to €161.22 billion or 98.3% of GDP. The borrowing costs for 10-year bonds have fallen from over 14 per cent in 2011 to 2.5 per cent in June 2014.

Chart 2.2 General Government Balance as a share of GDP (Republic of Ireland)



Sources: CSO (2014f) Quarterly National Accounts (QNQ03), Eurostat (2014a) Government finance statistics (gov_dd_edpt1) and NERI calculations

The current imbalances in the economy can be visualised through the lens of a series of charts. The General Government Balance (Chart 2.2) shows the amount to which the government is borrowing or saving money, while Gross Savings (Chart 2.3) show the amount being saved by the private sector. Chart 2.2 suggests there is no space for the Government to reduce its revenue intake. On the other hand Chart 2.3 shows that private saving is high and that there is potential for increased spending in the private sector.

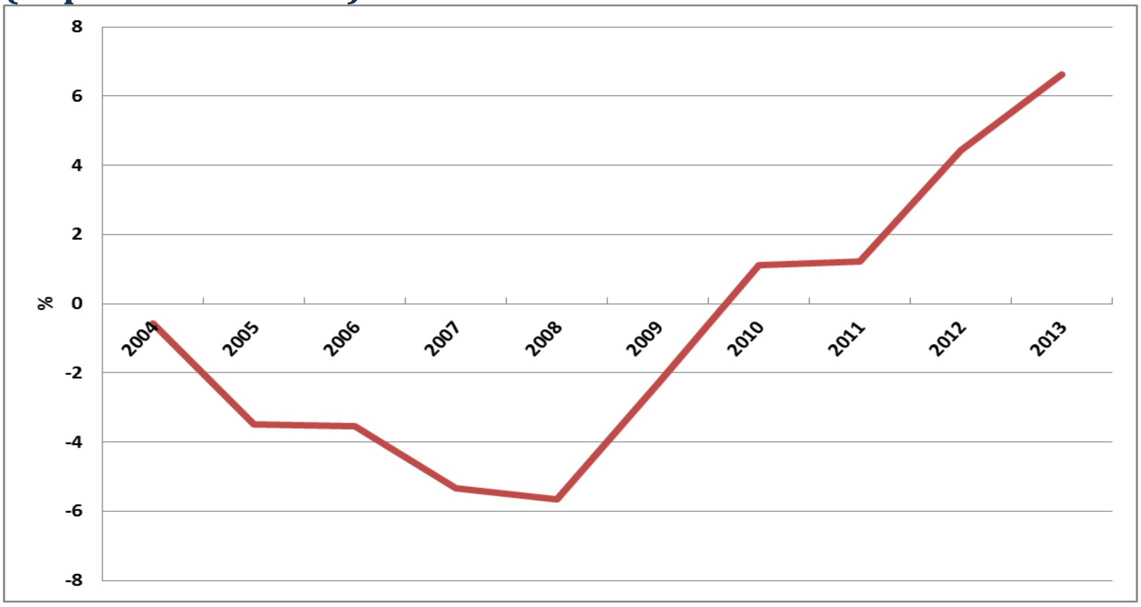
Chart 2.3 Private Sector Saving as a share of GDP (Republic of Ireland)

Sources: CSO (2014f) Quarterly National Accounts (NQQ21), CSO (2014d) Institutional Sector Accounts (ISQ03) and NERI calculations

Notes: Private sector saving is gross saving for households, non-profit institutions serving households, and non-financial corporations. Financial corporations are excluded.

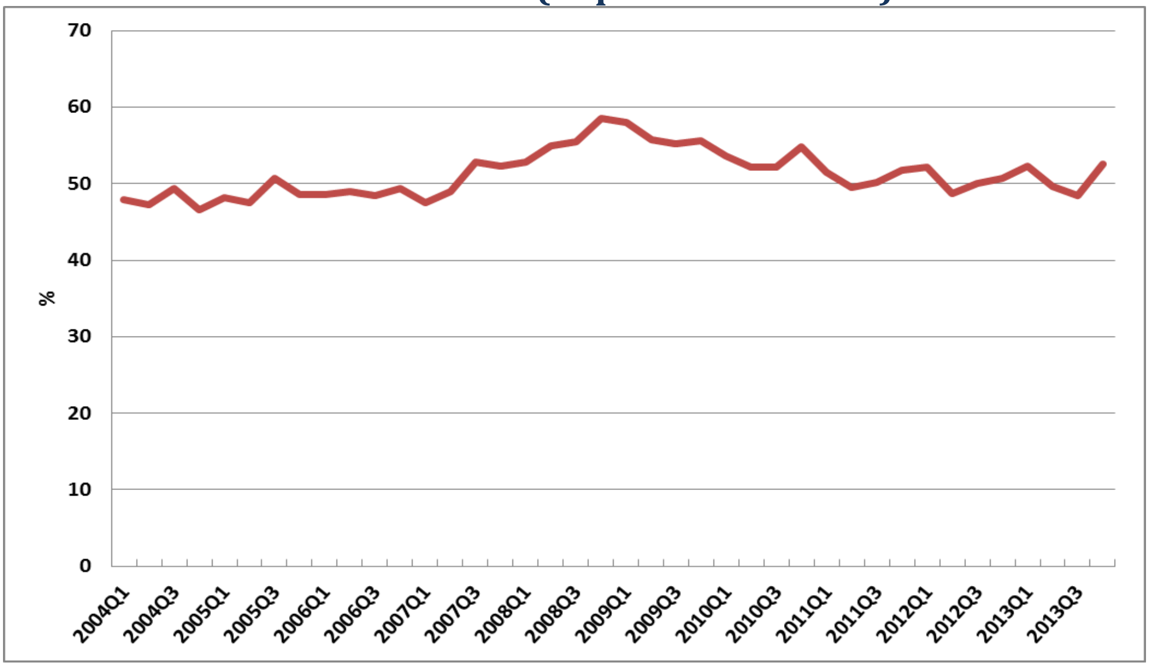
Chart 2.4 shows the 'current account balance'. This shows how much the country is borrowing or saving (including interest payments and repatriated profits of multinationals) with respect to the rest of the world. Since the 1960s Ireland has generally had small deficits in its current account. This is normal as a country borrows money to import machinery and capital equipment. The historically high current account surplus (6.6% of GDP in 2013) indicates that Ireland is paying down its loans, paying the interest, and also saving. The scale of Ireland's current account surplus suggests that Ireland has returned to a position of competitiveness and that there is scope to increase wages, which would eventually have the effect of reducing Ireland's current account balance to more normal levels. Chart 2.5 shows that the labour share of GDP has fallen from 58% of GDP in Q4-2008 to just 53% of GDP in Q4-2013. Finally, the large current account surplus suggests the economy is currently operating below potential output.

Chart 2.4 Current Account Balance as a share of GDP (Republic of Ireland)



Sources: CSO (2014f) Quarterly National Accounts (NQQ21) and CSO (2014a) Balance of Payments (BPCQ2)
Note: The current account surplus is the trade surplus (exports less imports) less 'current' payments abroad, such as interest payments and the repatriated profits of firms.

Chart 2.5 Labour share of GDP (Republic of Ireland)



Sources: Eurostat (2014c) National Accounts (namq_nace10_c and namq_nace10_e) and NERI calculations
Note: The labour share is worker compensation in the economy divided by GDP and adjusted for the number of self-employed in the economy.

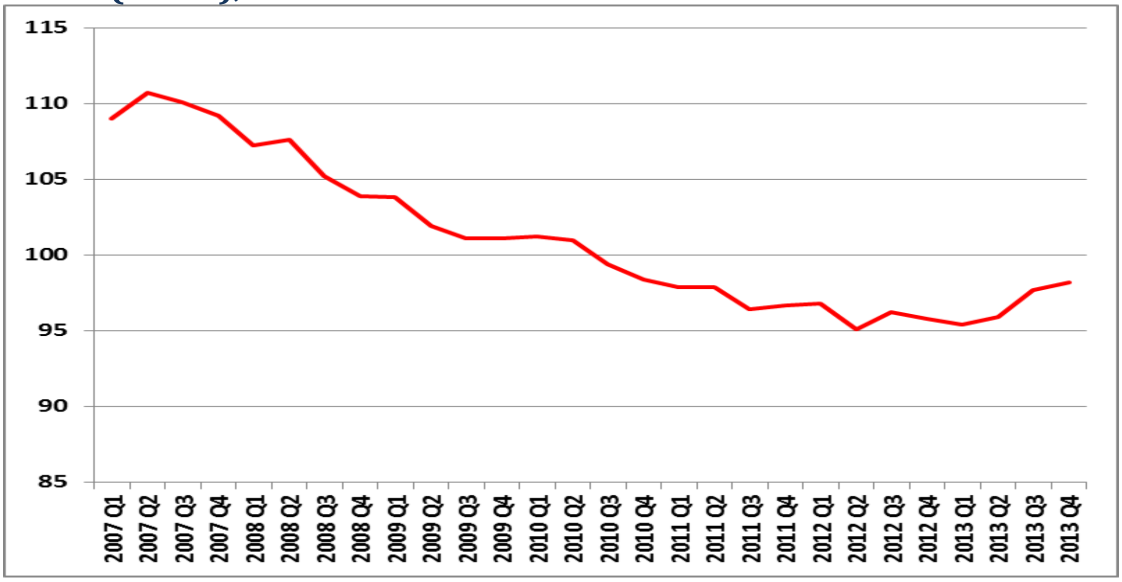
2.3 Recent trends in the Northern Ireland Economy

The latest Gross Value Added figures (GDP plus subsidies, less indirect taxes) for the Northern Ireland economy show a real terms decline of 0.5%. The Northern Ireland Statistics and Research Agency has developed a new indicator called the Northern Ireland Composite Economic Index (NICEI), to give a timelier picture of the state of the economy. Figures for the last quarter of 2013 indicate that economic output increased 0.6%, the third consecutive quarter of positive growth. The economy grew 0.9% over the year in 2013. This compares to a 1.3% decrease in 2012. While 2013 may have positive, the index has only returned to its 2010 level and is still 11.2% below its 2007 peak (see Chart 2.6).

Chart 2.7 shows that the modest increase in the construction sector in Q3 2013 has already been erased by a decline in the sector in Q4 2013. The Q4 data for the construction sector represents a new low and raises the concern that the sector may have further to fall. With the exception of a spike in the middle of 2012, the construction sector has been in consistent decline since the end of 2007. In that time it has lost almost half of its value. The production sector, which has been the best performing sector throughout the crisis, plateaued in the final quarter of 2013 following modest increases in the second and third quarters. The recent jobs data indicate that this sector could bring further growth in 2014. Small increases for the services sector in the second and third quarter of 2013 were sustained in the final part of 2013, but total growth in the sector has been modest. Overall the story continues to be one of modest growth held back by a declining construction sector.

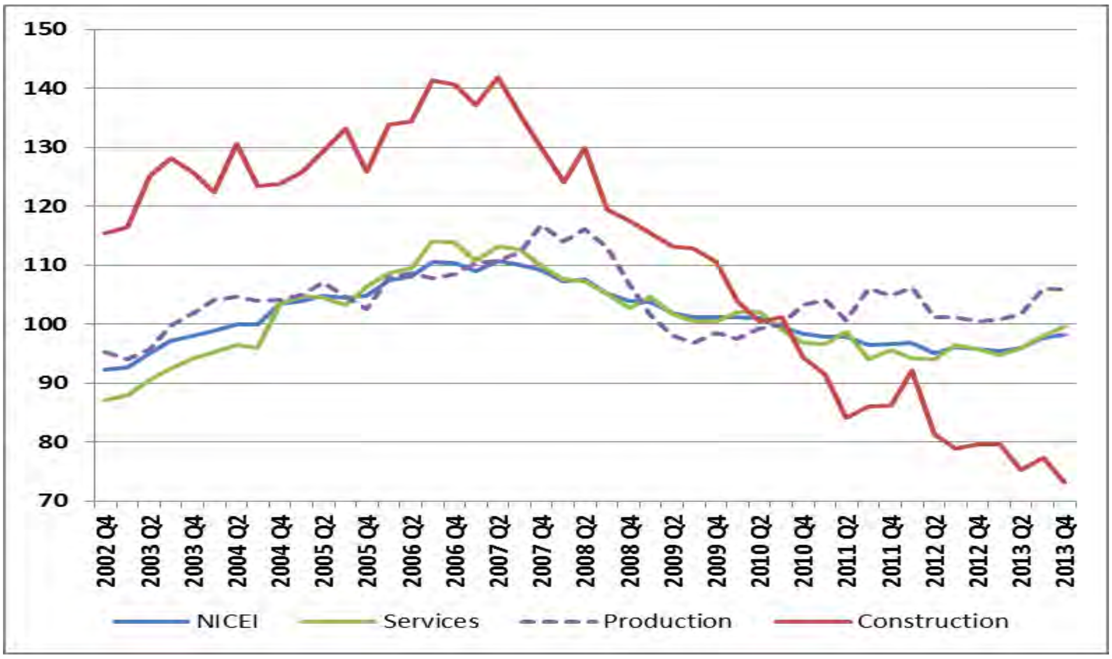
The public sector has been on a generally downward trend since late 2009 (Chart 2.8). The post-2009 trend has been similar for the public and private sectors. While the decline in the last two years has been slightly more severe for the private sector, the decline and subsequent growth in both sectors have tracked each other quite closely. Public sector output remains almost exactly where it was in 2005, with a moderate spike in 2008 the only substantial deviation. The story since 2004 is still that of the rise and fall of the private sector much of which can be attributed to the boom and bust in the construction sector. Public sector output has increased slightly over the last twelve months, but this growth has not been matched by the private sector. A further reduction in public sector output could arise if additional cuts in government expenditure materialise following the 2015 UK general election.

Chart 2.6 Trends in the Northern Ireland Composite Economic Index (NICEI), 2007-2013



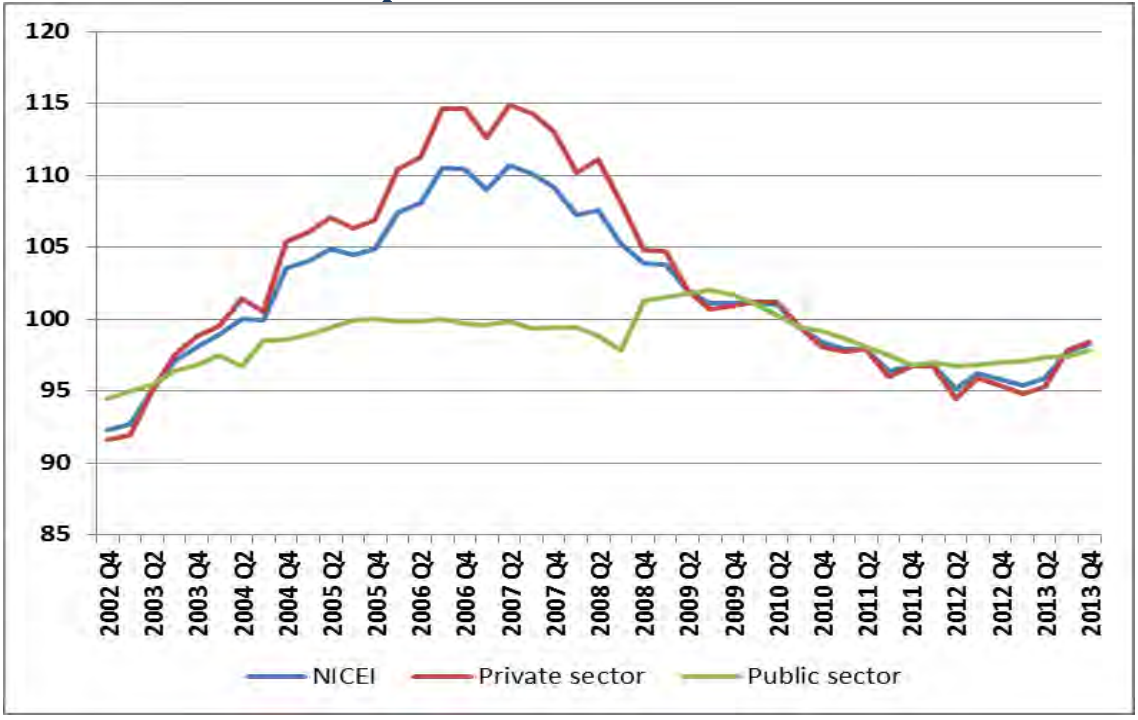
Source: Northern Ireland Statistics and Research Agency (2014b)

Chart 2.7 Sectoral changes in the Northern Ireland Composite Economic Index



Source: Northern Ireland Statistics and Research Agency (2014b)

Chart 2.8 Public and private sector performance in the Northern Ireland Composite Economic Index

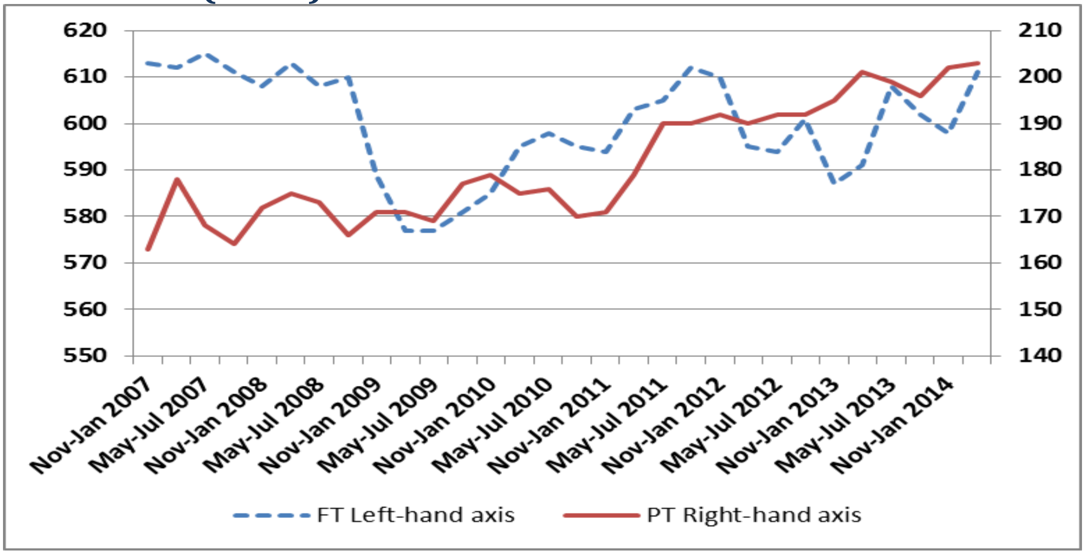


Source: Northern Ireland Statistics and Research Agency (2014b)

The Northern Ireland labour market has seen little change in recent months. Unemployment in the three months to the end of April was 6.9% showing a fall of 0.6% from the previous quarter (November to January). The rate is now back to where it was in the three months May to July 2013. The figures are also a reduction from the rate of 7.8% for the same quarter in 2013, and closer to the 7.1% and 7.2% rates recorded for the same quarter in 2012 and 2011 respectively. Data for the first quarter of 2014 shows a small increase for both full-time and part-time employees, but as shown in Chart 2.9 the trend since 2007 has been one of substantial increases in part-time employment and anaemic growth in full-time employment. Youth unemployment fell substantially to 19.62%, an almost 5% decrease from the 22.3% figure recorded in the previous quarter. However the youth Claimant Count only decreased by around 500 in the same period, indicating increased employment among those not claiming benefits. Long term unemployment measured as those out of work for 12 months or longer decreased by 2,000, but the percentage of the unemployed categorised as long-term increased.

The most up to date information we have on economic activity in 2014 is survey data from the Purchasing Managers Index (PMI) for Northern Ireland. The PMI reports the expectations and intentions of firms in various industries and sectors. The latest data for Northern Ireland indicate a continuing trend of increasing business confidence for the last ten months. Confidence levels are at their highest since March 2004 with most activity centred on the services sector. Employment expectations are buoyant despite a small month-on-month fall in the employment index. However many firms reported facing increased input prices particularly in the construction sector, although this is not expected to lead to any substantial increase in output prices among firms.

Chart 2.9 Full and Part-time Employment, Northern Ireland, 2008-2013 (000's)



Source: Northern Ireland Statistics and Research Agency (2014a) (LFS Quarterly Supplement)

The Northern Ireland jobs market presents a mixed picture in the second quarter of 2014 with some significant gains and losses across most sectors. The largest increase in jobs was in the financial services sector. This included the announcement of 500 new jobs by the accountancy and consultancy firm EY and 100 new jobs by Citi Group. Capita Managed IT solutions announced 400 jobs will be added to its existing work-force in Newtownabbey, while the financial services IT firm Spence & Partners announced it will be creating 100 new jobs. Significantly these jobs announcements represent high value added investments which have for many years eluded Northern Ireland. The manufacturing sector saw 241 jobs announced by Schrader Electronics operating in Carrickfergus while 130 jobs were announced by Wrightbus, which continues to expand its export market.

There have been fewer significant job losses in the same period, although the announcement by Northern Ireland Electricity that it is seeking 120 redundancies will have an impact in engineering and related skills sectors. BE Aerospace announced it is considering selling its operations. This endangers the ambitious plans announced earlier this year to create up to 4,000 jobs in Northern Ireland with an investment programme aimed at doubling turnover.

House prices increased by 3% in the first quarter of 2014 consolidating modest gains in 2013. The annual increase from the first quarter of 2013 to 2014 was 8% while the volume of residential sales increased by 21% over the same period (NISRA, 2014c). The overall index is still 52% below its peak in the third quarter of 2013. The modest increases in Northern Ireland are also dwarfed by substantial increases across the UK, but particularly in London and the South East of England. The level of increase in these regions is concerning. The threat posed to Northern Ireland by a property bubble is outlined in Section 3.

3 Future Economic Outlook

3.1 Introduction

In this section of the QEO we outline our basic assumptions for Ireland's main trading partners as well as our expectations for the economies of both parts of the island of Ireland. We also consider risks to the forecast.

NERI projections for economic growth, the labour market and the public finances are projected for the Republic of Ireland out to 2016. Overall our projections for economic growth in the Republic have improved since the previous edition of the QEO. However the economy will continue to operate below its potential level over this period, and the unemployment rate, although falling in each of the next three years, will remain well above pre-crisis levels.

For Northern Ireland we present a set of external projections for economic activity, employment growth and unemployment. As in previous editions our expectations are compared to the most recent macroeconomic projections from other agencies.

3.2 Macroeconomic Assumptions for the Global Economy

The level of growth in the Republic of Ireland's main trading partners has a major impact on growth in the Republic's economy. The Republic's most important trading partners are the Euro area, the UK and the US. For a number of reasons we expect recovery in the Euro area to remain sluggish over the short-term. Fiscal contraction is set to continue in most economies, albeit at a smaller level, and this will reduce domestic demand in the relevant countries. Elevated private sector debt burdens, both household and corporate, will weigh on consumption and investment as deleveraging continues. Finally, the slowdown in some emerging economies has implications for trade, capital flows and overall economic activity.

Real GDP in the Euro area rose 0.2% in the first quarter of 2014. Real GDP growth in 2014 is expected to be somewhat subdued overall but to marginally exceed 1% on an annual basis. Real GDP growth should be somewhat higher next year with annual growth expected to fall between 1.5% and 2%. Domestic demand will be supported by accommodative (stimulatory) monetary policy and by improvements in credit conditions, although financial fragmentation remains a significant concern for the Euro area periphery. Falling energy prices represent a gain in real disposable income. However, unemployment will stubbornly remain in double digit figures (11.7% as of April 2014), while unused capacity in the economy will remain at a high level. There are a number of downside risks to the baseline projection including geopolitical developments in emerging markets (e.g. Ukraine and Iraq) and weaker than expected demand.

The current strength of the Euro has negative consequences for exports and is pressing down inflation. Annual inflation (Harmonised Index of Consumer Prices - HICP) in the Euro area has fallen to 0.5%. This is well below the ECB's price stability mandate of just under 2%. The ECB's continued failure to fulfil its mandate has potentially adverse implications for debt sustainability in the periphery, raises concerns of a deflationary spiral, and is harmful to recovery in the Euro area. The ECB has responded by cutting all its main rates to record lows and has taken the innovative step of imposing a negative interest rate on overnight bank deposits. In addition, the ECB announced Targeted Long Term Refinancing Operations (TLTROs) which should help boost the supply of credit to Euro area SMEs. Inflation is expected to remain low throughout 2014 but to then gradually increase in 2015 and 2016. The ECB's 2% target is unlikely be achieved before 2017 at the earliest unless further policy steps are taken. In the current context of low inflation and weak credit growth we expect there will be further monetary policy accommodation, and that this will eventually include quantitative easing in the Euro area.

Economic prospects appear somewhat brighter for both the US and the UK than they do for the Euro area. We expect annual real GDP growth in the US to be about 3% in both 2014 and 2015. Real GDP growth will be slightly more subdued in the UK at between 2.5% and 3% in both 2014 and 2015. Improvements in the labour market will lead to tightening monetary policy and higher interest rates in both countries. The Euro will depreciate against both the US Dollar and the UK Pound over the next twelve to eighteen months as monetary policy gradually tightens in both the US and the UK.

3.3 Macroeconomic Projections for the Republic of Ireland

Gross Domestic Product

We are now projecting real GDP growth of 2.1% in 2014 and 2.9% in 2015 (see Table 3.1). While GDP fell by 0.3% in 2013 the 'patent cliff' effect had a large negative impact on production and exports in the pharmaceutical sector and this distorted headline GDP downwards.[5] It appears the patent cliff effect will be somewhat diminished in 2014. We expect that a gradual recovery in the Republic's trading partners will support export growth and a return to real GDP growth. Real GDP growth will also be supported by increased domestic demand. Improvements in labour market conditions in the next few years will lead to an increase in disposable income while investment is expected to increase substantially from its historically low level as a percentage of GDP. Qualitative indicators of performance are now robustly positive with the most recent Purchasing Manager's Indices (PMI) for Manufacturing and Services both suggestive of continued expansion for the rest of 2014. Finally, the high inflow of Foreign Direct Investment in 2013 will contribute to Ireland's real GDP growth performance in 2014.

In 2014, the European System of National and Regional Accounts (ESA 2010) will replace the current ESA that has been in use since 1995. The most important improvement introduced by ESA 2010 is the treatment of research and development (R&D). R&D has to date been recorded as intermediate consumption, but from 2014 will be recorded as capital formation. This change will increase recorded GDP and will lead to an upward adjustment of the estimated stock of GDP in previous years. As the change is a level effect it will have no impact on the rate of GDP growth. The increase in the stock of GDP will however matter for the calculation of the ratios of public deficit and debt in percentage of GDP under the Excessive Deficit Procedure (EDP). The size of the change to GDP will not be known until the summer of 2014. Preliminary estimates from Eurostat (2014e) suggest that the impact on the Republic's GDP from the methodological changes will be between +1% and +2% of GDP although the actual impact may well be higher.

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[5] In contrast to its effect on GDP the 'patent cliff' had very little impact on Gross National Product (GNP). Real GNP grew by 3.3% in 2013. GNP excludes the profits of foreign multinationals. One impact of the loss of patents was to reduce the outflow of profits arising in Ireland and this largely offset the drop in value added in the pharmaceutical sector.

Table 3.1 Projections for Output, the Public Finances and the Labour Market, (Republic of Ireland)

	2013 values	2013	2014	2015	2016
National Income		*Percentage real change over previous year*			
Gross Domestic Product	€164.1bn	-0.3	2.1	2.9	3.0
Personal Consumption	€83.1bn	-1.1	1.1	1.2	1.3
Investment	€18.4bn	4.2	9.9	8.0	7.0
Government Consumption	€25.1bn	-0.5	-0.9	-1.6	0.0
Exports	€177.1bn	0.2	2.3	3.2	3.3
Imports	€138.7bn	1.0	2.4	2.7	2.9
Government Finances		*Percentage of GDP*			
General Government Balance	€11.8bn	-7.2	-4.7	-2.5	-1.8
Gross Debt	€202.9bn	123.7	118.7	116.4	113.1
Labour Force		*Percentage change over previous year*			
Employment	1,881,150	2.3	2.2	1.9	1.9
		Percentage of Labour Force			
Unemployment	282,200	13.0	11.5	10.7	9.9

Notes: 2013 data are preliminary figures from CSO (2014f) National Accounts, CSO (2014g) Quarterly National Household Survey, Department of Finance (2014) Stability Programme Update and NERI calculations.
2014-2016 data are NERI projections.
General Government Balance for 2014, 2015 and 2016 reflects the expected upward adjustment to the stock of GDP caused by the adoption of ESA 2010. ESA 2010 will replace the current ESA 1995 in 2014. This is being done to bring the national accounts into line with the new economic environment and advances in methodological research.

Personal Consumption

Consumer spending fell by 1.1% in volume terms in 2013. This was the fifth consecutive year of decline and consumption is now down over 7% in real terms since 2008. However there are reasons to believe that the downward trend in consumption is finally coming to an end. We anticipate that higher employment and average real earnings, along with improving net worth, will facilitate growth in personal consumption of 1.1% in 2014 and by 1.2% in 2015.

Although the Retail Sales Index rose by 0.7% in volume terms in 2013 it actually fell by 0.2% in value terms. The 2014 data has been mixed but generally positive. While the volume of retail sales decreased by 0.9% in April 2014 the annual change to April 2014 shows an increase of 6.8%. The annual change in value terms to April 2014 was 4.4%, which indicates deflation is cutting into retail earnings. Increased motor trades have boosted the retail figures and if we exclude motor trades the year-on-year increase to

April 2014 is 4.6% in volume terms and 2.8% in value terms. The *KBC/ESRI Consumer Sentiment Index* (ESRI, 2014a) was at 87.2 in April 2014, representing the highest monthly value since 2007, before falling sharply to 79.4 in May. Despite the May result there has been a gradual and generally consistent improvement in consumer expectations and this improved confidence should eventually manifest in higher levels of personal consumption. Indications from exchequer VAT and excise returns are positive so far. The end-May 2014 outturn is 0.7% ahead of target for VAT and 4.9% ahead of target for excise duties.

Household debt declined by €2.4 billion to €166 billion during the fourth quarter of 2013 while household debt as a proportion of disposable income declined by 3.5 percentage points to 191.8% (CBI, 2014b). Debt has now fallen by 18.3% since its peak at the end of 2008. Debt and debt as a percentage of real disposable income are at their lowest levels in eight years. Although the ratio of household debt to gross disposable income remains high by international standards we expect the declining ratio will eventually feed through into a reduced rate of deleveraging and increased consumption. The *Nationwide UK (Ireland)/ESRI Savings Index* (ESRI, 2014b), which measures overall sentiment towards saving, was 102 in May, the same level as March. Household net worth rose by 2.9% during Q4 2013 and has been on an upward trend since Q3 2012. The increase in household net worth represents an increase in anticipated lifetime income. This too should eventually manifest in higher annual consumption.

Sustained improvements in the labour market will support a recovery in domestic demand. However the quality of these jobs is also important. The average weekly earnings for employees fell by 0.4% in the year to Q1 2014. Job growth without wage and income growth will not be sufficient to increase demand. The low inflation environment is helping to preserve the value of real incomes. Finally, the introduction of water charges will reduce disposable income and weigh on consumption in 2015.

Investment (Gross Domestic Fixed Capital Formation)

Investment increased by 4.2% in 2013 after five consecutive years of decline and we anticipate that investment will grow at an even faster pace over the next few years. The underlying growth in investment was even stronger in 2013 once the impact of aircraft purchases is excluded. Our expectation is for investment to grow by 9.9% in 2014 and by 8% in 2015. While these rates of growth may seem high they should be understood in the context of an investment to GDP ratio that was just 11.2% in 2013. This was the lowest ratio in the entire European Union and substantially below international norms for advanced economies. In addition, investment is by far the most volatile component of GDP in terms of year-on-year changes. In real terms total investment in 2013 was just half of total investment in 2007.

The Construction PMI shows a sharp increase in total construction activity. Building and construction output increased by 2.1% in the first quarter of 2014 and we expect that building and construction, and in particular residential investment, will increasingly drive the expansion in investment over the next few years. There is now an evident supply shortage in certain urban areas, most notably in Dublin. Housing completions are well below the number of needed units suggested by demographic pressures and employment patterns. The rise in house prices caused by the excess of demand over supply should eventually feed through into higher house completions. Expansion should also continue for machinery and equipment as investment responds to employment growth, an improved environment for exports, and solid growth of new orders. The Manufacturing PMI suggests a sharp improvement in business conditions and confidence in the sector.

Credit for SMEs is still very fragile and lack of availability of credit would reduce the potential for expansion in investment. However there is some evidence of growth in non-traditional sources of funding. The establishment of the Strategic Banking Corporation of Ireland along with the ECB's programme of Targeted LTROs should help channel credit to SMEs. Debt restructuring should also help investment. Finally, the potential deployment of the Ireland Strategic Investment Fund toward capital projects represents an upside risk to the 2015 and 2016 projections.

Government Consumption

Government consumption is a policy instrument. Our expectations for government consumption are based on the policy choices outlined in the Department of Finance's Stability Programme Update (SPU) which was published in April 2014 (DOF, 2014). Government consumption is scheduled to decline by 0.9% in 2014 and by 1.6% in

2015 before stabilising in real terms in 2016. There is some sentiment that the degree of discretionary fiscal consolidation will not be as high as previously anticipated but for now we assume the Department of Finance proceeds as outlined in the SPU.[6]

Exports

Exports rose by just 0.2% in volume terms in 2013. The weak performance of the export sector is largely attributable to the impact of the patent cliff and the fall in the measured volume of exports in the pharmaceutical sector. The patent cliff effect is expected to be diminished but not eliminated in 2014. The residual patent cliff effect will have limited impact on employment. Our expectation is that exports will increase by 2.3% in 2014 and by 3.2% in 2015 on the back of improved economic conditions in Ireland's key trading partners (the European Union and North America) and the expected depreciation in value of the Euro over the next eighteen months against the US Dollar and the UK Pound.

Services exports overtook goods exports for the first time in 2012 and growth in exports will continue to be driven mainly by the services sector. Business confidence is high. The *Investec Services PMI* (Investec, 2014b) has shown an expansion in new export orders from abroad for 34 consecutive months. The index for new exports has been strongest in the financial services sector. We anticipate some growth in the level of merchandise exports. According to the *Investec Manufacturing PMI* (Investec 2014b) the rate of expansion in new export orders accelerated in May to the fastest rate since last October. New export orders have now increased in each of the last 11 months. The UK was the main source of new business from abroad. The improvement in the international economy should lead to expansion in employment intensive tourism exports.

Imports

Imports rose by just 1% in volume terms in 2013.[7] The growth in imports is mainly attributable to the recovery in investment. We anticipate import growth to increase to

[6] We consider alternative budgetary adjustments in Section 4.

2.4% in 2014 and to 2.7% in 2015. The expected high rate of growth in investment will feed through into higher levels of merchandise imports while the more modest growth in personal disposable income and consumption will lead to a somewhat smaller increase in tourism imports and other services imports. Services and merchandise exports both contain a large import component and the expected increase in exports will be reflected in higher levels of imports.[8] The ESRI has noted that the trends in imports in the trade statistics have become increasingly hard to interpret in recent years (Duffy et al., 2014, for a more detailed discussion).

Labour Market

Total employment grew by 2.3% in 2013. However the latest results from the Quarterly National Household Survey (QNHS) were somewhat disappointing as seasonally adjusted employment grew by just 1,700 jobs (0.1%) in the first quarter of 2014. Employment is up 42,700 in annual terms, though the vast bulk of that increase happened during 2013. Despite the weak first quarter figures we are projecting employment growth of 2.2% in 2014. This will mainly be driven by the improvements in domestic demand. In particular the anticipated increase in investment will boost employment growth in the construction sector. We are projecting that steady employment growth will continue through 2015.

The latest results from the QNHS show that the seasonally adjusted unemployment rate decreased from 12.2% to 12.0% over the first quarter of 2014. The Live Register, which includes part-time workers, recorded a seasonally adjusted monthly decrease of 1,600 in May 2014, reducing the seasonally adjusted total to 391,800[9]. According to the Live Register the standardised unemployment rate was 11.8% in May 2014, identical to the rate in April, and 1.8 percentage points below the rate for May 2013. Compared to May 2013, the number on the Live Register fell by 32,973 while the

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[7] The underlying growth in imports was higher in 2013 if we exclude the impact of aircraft purchases. Imports of aircraft were much lower in 2013 than they were in 2012. In the national accounting statistics aircraft purchases increase imports and investment with no effect on GDP.

[8] Much of this import content is in the form of royalties and licenses. Some of this activity is allegedly related to aggressive tax arbitrage by multinational corporations. The outcome of the OECD's Base Erosion and Profit Shifting (BEPS) project may change international corporate tax rules from 2016 onwards. If it does so, and if the behaviour of multinationals is indeed driven by aggressive tax management as has been suggested, then the annual value of the Republic's service exports and service imports may be substantially reduced in future years.

[9] The Live Register is not designed to measure unemployment. Unemployment is measured by the Quarterly National Household Survey.

number of casual and part-time claimants fell by 11,181. We anticipate the unemployment rate will average 11.5% in 2014 and 10.7% in 2015. An expected increase in the size of the labour force will mean that not all of the employment gains in 2014 and 2015 will be reflected in a reduced unemployment rate.

The improvements in the labour market have yet to reap a dividend for workers in terms of weekly earnings. Average weekly earnings were €689.88 in Q1 2014, down 0.4% from €692.54 a year earlier. The decline is mainly attributable to a fall of 1.8% in weekly earnings in the public sector. Weekly earnings in the private sector were up 0.7% over the year and some sectors are seeing improvements in terms of weekly earnings. The largest increase was in the construction sector at 10.2%. Our unemployment and employment projections are mildly pessimistic relative to that of other forecasters. Table 3.2 shows a range of projections for unemployment in 2014 and 2015. The range of projections for 2014 is from 11.2% (European Commission) to 11.5% (NERI), while the range of projections for 2015 is from 9.9% (Investec) to 10.7% (NERI).

Table 3.2 Range of Projections for Unemployment as a Per Cent of the Labour Force, (Republic of Ireland)

	2014	2015	2016	2017	2018
NERI	11.5	10.7	9.9		
Department of Finance (April 2014)	11.5	10.5	9.7	8.9	8.0
Central Bank of Ireland (April 2014)	11.3	10.4	-	-	-
European Commission (May 2014)	11.4	10.2	-	-	-
IMF (April 2014)	11.2	10.5	-	-	
OECD (May 2014)	11.4	10.4	-	-	-
ESRI (April 2014)	11.4	10.1	-	-	-
Investec (April 2014)	11.3	9.9	9.0	-	-

Sources: DOF: Ireland's Stability Programme April 2014 Update, (DOF 2014); CBI: Quarterly Bulletin, (CBI 2014a); European Commission: Spring 2014 Forecasts, (EC, 2014); IMF: World Economic Outlook April 2014 (IMF 2014c); OECD: Economic Outlook, (OECD 2014); ESRI: Quarterly Economic Commentary, Spring 2014, (Duffy et al. 2014); Investec: Irish Economy Monitor, (Investec 2014a).

Public Finances

The headline government deficit improved from 8.2% in 2012 to 7.2% in 2013. This was within the Excessive Deficit Procedure (EDP) ceiling of 7.5%. Based on our estimates for economic growth and employment creation we are projecting further improvement in the deficit in 2014 and in 2015. Reductions in the numbers unemployed mean reduced expenditure on social transfers while increased employment will generate additional direct and indirect revenue flows. The exchequer deficit up to end May 2014 had fallen to €3.47 billion, compared to €5.30 billion for the same period last year. We estimate the borrowing requirement will fall to 4.7% of GDP in 2014 and to 2.5% of GDP in 2015. General government debt was 123.7% of GDP in 2013 (€202.9 billion). We estimate gross debt will fall to 118.7% of GDP in 2014 and to 116.4% of GDP in 2015. These estimates assume there will be a reduction in precautionary cash balances of the scale described in the April 2014 SPU and take into account the methodological shift from ESA 1995 to ESA 2010.

Our 2015 estimate assumes the Department of Finance will undertake a discretionary fiscal adjustment of the scale described in the April 2014 SPU.[10] If our projections for the public finances are borne out, Ireland will comfortably fall within the EDP ceilings for 2014 and 2015. However the deficit projections are highly sensitive to growth and employment outcomes. If growth disappoints relative to the projections the EDP ceiling may well be breached in 2015 under the current budgetary plan. The EDP targets can be achieved using a variety of alternative fiscal strategies. NERI's analysis of the public finances is discussed in much greater depth in Section 4.

Risks to the Outlook

Macroeconomic projections come with a high degree of uncertainty. Table 3.3 compares our projections to those of other agencies. Projections of GDP growth in 2014 vary between a low of 1.7% (European Commission and IMF) and a high of 2.6% (ESRI), while the 2015 projections for GDP growth vary between 2.2% (OECD and Investec) and 3.5% (ESRI). Even this variation fails to catch the true range of feasible outcomes in 2014 and 2015.

There are a number of risks to our projections. An increase in the savings rate would reduce the outlook for consumption while continued weak credit growth would delay recovery in investment. If there is higher than expected hysteresis in the labour market it could manifest as slower than anticipated improvements in both the unemployment rate and employment growth. Questions remain about the efficacy of

[10] This discretionary adjustment is €2.0 billion and is composed of €0.7 billion in revenue measures (net) and €1.3 billion in expenditure measures (net).

activation strategy and the sustainability of the Government's proposed expenditure adjustment, particularly in the areas of health and social protection.

Table 3.3 Range of Projections for Annual Change in Real GDP, (Republic of Ireland)

	2014	2015	2016	2017	2018
NERI	2.1	2.9	3.0		
Department of Finance (April 2014)	2.1	2.7	3.0	3.5	3.5
Central Bank of Ireland (April 2014)	2.0	3.2	-	-	-
European Commission (May 2014)	1.7	2.9	-	-	-
IMF (April 2014)	1.7	2.5	-	-	-
OECD (May 2014)	1.9	2.2	-	-	-
ESRI (April 2014)	2.6	3.5	-	-	-
Investec (April 2014)	2.0	2.2	2.2	-	-

Sources: DOF: Ireland's Stability Programme April 2014 Update, (DOF 2014); CBI: Quarterly Bulletin, (CBI 2014a); EC: Spring 2014 Forecasts, (EC 2014); IMF: World Economic Outlook April 2014 (IMF 2014c); OECD: Economic Outlook, (OECD 2014); ESRI: Quarterly Economic Commentary, Spring 2014, (Duffy et al. 2014); Investec: Irish Economy Monitor, (Investec 2014a).

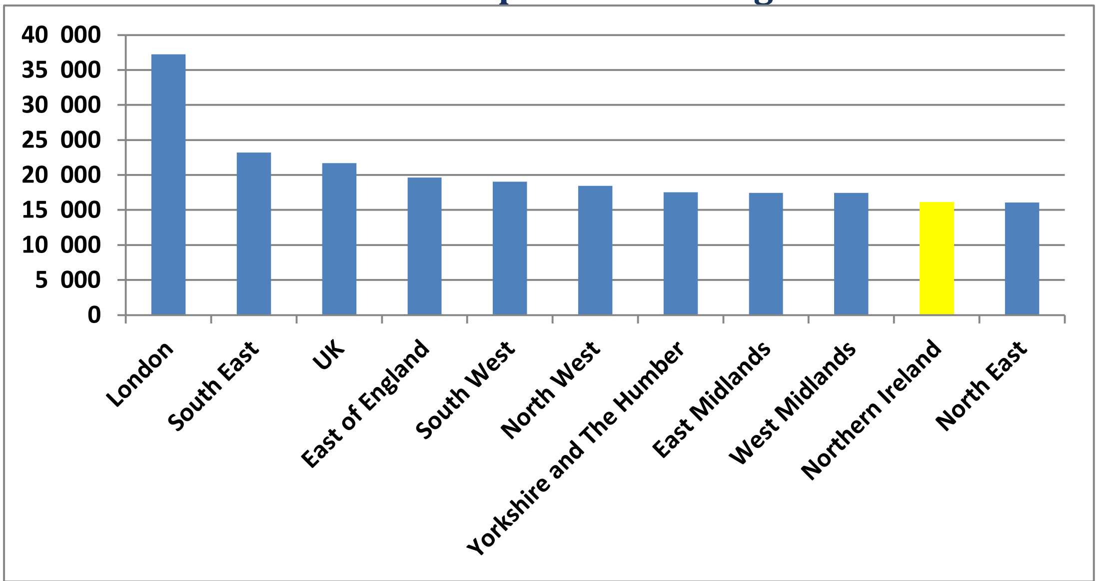
International growth remains fragile and there are deflationary concerns in the European economy. A slowdown in emerging economies would have a knock on effect on growth in Europe and North America. Weaker than expected output growth in our trading partners would impact on the Irish economy's recovery. Exchange rate movements represent a further source of uncertainty while an increase in interest rates would be highly damaging to recovery. A boiling over of geopolitical tensions, for example in Ukraine, or a further deterioration of the situation in Iraq, could precipitate an energy crisis. An energy price increase would be a major shock to the European economy. The Euro area crisis is itself not resolved and further bank bailouts arising from the results of the bank stress tests would put further pressure on public finances in the Euro area. There is also a danger that the eventual banking union will be inadequate to address the fragmentation in the European banking system or to sever the pernicious links between sovereigns and their banks. Finally, Scotland's independence referendum represents a further source of uncertainty to the outlook.

3.4 Macroeconomic Outlook for Northern Ireland

Macroeconomic Outlook

Northern Ireland saw three consecutive quarters of positive output growth in the final three quarters of 2013 suggesting economic recovery may be taking hold. Growth is still far below that of the UK which grew 1.7% in 2013 compared to an estimated 0.9% in Northern Ireland. Labour market indicators are more volatile in Northern Ireland but employment growth has been stronger at the UK level. This indicates that while the UK economy is on a recovery trajectory, Northern Ireland remains a lagging region that shows no signs of convergence to UK levels of productivity or prosperity.

Chart 3.1 Gross Value Added per head UK regions 2012



Source: Office for National Statistics (2013)

Northern Ireland has an output level which fluctuates around three quarters of the UK average and the productivity gap widens every year output growth falls below that of the UK. The regional imbalance in the UK is nothing new, but it is becoming more pronounced. The heart of the current recovery is in London and the South East and unless there is a significant alteration in policy at regional level it would seem that Northern Ireland will remain on a lower growth path while parts of the UK move forward.

At regional level, the Northern Ireland Executive still looks to a reduction in corporation tax (equalling the 12.5% rate in the Republic) as the key policy to stimulate the economy and begin to bridge the productivity gap. Serious questions remain over this policy, chiefly in relation to the effect it will have on the public finances in Northern Ireland and changed attitude toward multi-national corporations and their tax affairs internationally. Moreover at a time when the Northern Ireland Executive is still negotiating a deal on welfare reform it seems implausible that public money could be found for corporate tax relief with highly uncertain economic benefits.

Table 3.4 Overview of recent projections of Economic Activity and employment/unemployment (Northern Ireland)

	2013 (Outturn)	2014	2015	2016
Economic Activity	**n/a**			
Ernst & Young (GVA)		2.0	2.0	-
PWC (GVA)		1.9	2.0	-
Danske Bank (GVA)		2.3	2.4	-
Employment	**-0.4**			
NERI		1.0	0.2	
Ernst & Young		0.3	0.3	-
Unemployment % Labour Force	***7.6***			
Danske Bank		7.1	6.7	-
Ernst & Young		7.8	7.7	-

Sources: Ernst and Young: Economic Eye, Winter (2013); PWC: Northern Ireland Economic Outlook April (2014); Danske Bank Quarterly Economic Overview Q1 2014 (May 2014) Danske Bank (2014)
Note: Gross Value Added differs from GDP by the difference between taxes and government subsidies.

Risks to the Outlook

The main risks to the Northern Ireland economy over the medium term are economic and political. The main economic risk arises from the health of the UK economy and in particular the emergence of worrying trends in the property market. There has been a modest recovery in house prices in Northern Ireland from a very low base, but this has been dwarfed by the sudden resurgence of property prices within the UK. UK house prices grew 8% in the year ending March 2014 although the figures at regional levels are much more mixed. Prices in Northern Ireland grew 0.3% compared to 6.6% for the East of England and 17% for London (ONS, 2014). The emergence of a property bubble is not a concern for Northern Ireland at present but it is for the UK. In the event of a negative event in the UK property market, Northern Ireland will not be immune from the wider economic impacts of such a shock.

The other uncertainties to Northern Ireland's economic outlook are political. There are three events over the next three years which have the capacity to significantly alter the trajectory of the economy. The first is the referendum on Scottish Independence this September. While the debate may seem remote the economic consequences (whether positive or negative) of such a significant secession would be felt in every part of the UK. It may threaten the continuance of the current method of apportioning public expenditure in the UK., the Barnett formula. It might also lead to a further marginalisation of Northern Ireland within the UK both economically and politically. Current opinion polls do not indicate success for the independence proposition.

Following the referendum there will be a British general election in May 2015 the results of which may have a significant impact of government policy in Northern Ireland. A change of government could see a rethink on fiscal consolidation across the UK and this would be particularly significant for Northern Ireland. Beyond this the prospect of a referendum on the UK's membership of the European Union poses a substantial risk for the Northern Ireland economy. Structural funds for regional development and EU support for the agriculture industry would be the main concerns if the UK decided to withdraw from the EU. The loss of the common market could impact Northern Ireland's comparatively small export market and serious problems could arise with cross border trade and enterprise with the Republic.

4 Fiscal Policy Options in the Republic of Ireland[11]

4.1 Introduction

The Irish Government is required to reduce the deficit in the public finances to no greater than 3% of GDP in 2015. To achieve this goal the Government indicated in Budget 2014 and in the April 2014 Stability Programme Update (SPU) that it is planning a €2 billion fiscal consolidation in October's budget based on a range of tax increases and cuts in public spending.[12] Yet the deficit is just one of many considerations relevant to fiscal policy. Employment and poverty outcomes and the impact on the economy's long-term potential output are also important considerations and they help repair the public finances through growth in revenue and lower social spending. The scale of the adjustment is important but so too is the composition of the adjustment. This section considers the appropriateness of the Government's fiscal stance and explores NERI's alternative approach to reducing the public deficit. This approach consists mainly of a revenue-based fiscal consolidation alongside an off-the-book investment stimulus and a social emergency fund targeted at the most vulnerable people and communities in Irish society.

The more growth friendly choice of fiscal consolidation instruments under the NERI plan, coupled with the proposed 'off-book' programme of public investment, is estimated to deliver a more benign outcome in terms of GDP growth, employment, and the unemployment rate. The NERI plan is estimated to yield over 34,000 more jobs than the Government's plan and over 18,000 more jobs than a 'Do nothing' approach. GDP in 2015 is estimated to be 1.9% higher under the NERI plan than under the Government's plan while unemployment is estimated to be 1.7 percentage points lower under the NERI plan. We estimate that the general government balance (the public deficit) would be the same as a percentage of GDP under both plans.

4.2 Overview of the Public Finances

The context for Budget 2015 is a still high deficit in the public finances and a highly elevated debt to GDP ratio which we forecast will be close to 119% of GDP by the end of 2014 (see Table 3.1). A substantial component of the deficit is 'cyclical' meaning it is

[11] Fiscal policy options in the Republic of Ireland are discussed in greater depth in McDonnell (2014b).
[12] It is unclear whether these measures will be entirely new or inclusive of estimated 'carry-over' effects into 2015.

a function of the economic cycle and the operation of the automatic stabilisers.[13] The residual component is the structural deficit. The structural deficit is the deficit when the economy has returned to normal, is in long run equilibrium, and there is no output gap. It is this structural component that needs to be closed in the long-term.

We estimate the general government deficit will be close to 4.7% of GDP in 2014 based on our current projections for growth and the exchequer finances. This falls within the 5.1% ceiling allowed under the Republic's Excessive Deficit Procedure (EDP). Based on current budgetary plans and our projections for growth we expect the deficit will be close to 2.5% of GDP in 2015. This is within the EDP ceiling of 3%. The underlying deficit is projected to fall between €4 billion and €5 billion in 2015 with the final amount sensitive to the pace of growth in 2014 and 2015. The primary balance will move into surplus from 2015 onwards and it is possible a primary surplus will be achieved as early as 2014.

Table 4.1 Public Finances in the Republic of Ireland: IMF Estimates and Projections

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Overall Balance – per cent of GDP													
Ireland	2.9	0.1	-7.3	-13.8	-30.5	-13.1	-8.2	-7.4	-5.1	-3.0	-2.4	-1.7	-1.2
Euro area	-1.3	-0.7	-2.1	-6.4	-6.2	-4.2	-3.7	-3.0	-2.6	-2.0	-1.4	-0.9	-0.5
Overall Balance (excluding financial sector supports) – per cent of GDP													
Ireland				-11.3	-10.5	-8.9	-8.2	-7.4	-5.1	-2.9	-2.3		
Primary Balance – per cent of GDP													
Ireland	3.7	0.7	-6.6	-12.4	-27.9	-10.4	-5.2	-3.4	-0.7	1.6	2.4	3.0	3.4
Euro area	1.2	1.9	0.5	-3.9	-3.7	-1.5	-1.0	-0.4	-0.1	0.5	1.2	1.7	2.1
Cyclically Adjusted Balance – per cent of potential GDP													
Ireland	-4.2	-8.7	-11.9	-9.9	-8.3	-7.0	-6.1	-5.0	-4.0	-2.3	-2.2	-1.6	-1.2
Euro area	-2.3	-2.3	-3.3	-4.8	-5.1	-3.8	-2.8	-1.5	-1.4	-1.1	-0.7	-0.5	-0.2
Cyclically Adjusted Primary Balance – per cent of potential GDP													
Ireland	-3.4	-8.0	-11.1	-8.5	-5.8	-4.3	-3.2	-1.0	0.3	2.3	2.5	3.1	3.4
Euro area	0.3	0.4	-0.6	-2.4	-2.6	-1.2	-0.2	1.0	1.1	1.4	1.8	2.1	2.3

Source: IMF: Fiscal Monitor April 2014 (IMF 2014a).

Notes: IMF estimates are for general government and include financial sector supports. See IMF (2014a) for further details
The primary balance is defined as the overall balance excluding net interest payments.
Cyclically adjusted balances exclude financial sector support, and correct for real output, equity, house prices, and unemployment.
The cyclically adjusted primary balance is defined as the cyclically adjusted balance excluding net interest payments

[13] Cyclical fluctuations in the economy (upswings and downturns) influence a number of public sector income categories (personal taxes, social security contributions, corporate taxes, and indirect taxes such as VAT and excises) as well as one major expenditure category (unemployment and income related social benefits). These income and expenditure categories are known as the automatic stabilisers. They reduce the severity of downturns but also temporarily worsen the public sector balances for as long as the economy is operating below its long-run potential.

The OECD (2014) projects the Republic will be operating at 6.8% below its full capacity (potential output) in 2015 given underemployed resources. IMF (2014a) public finance estimates and projections imply Republic of Ireland will be operating below potential output until 2018 (see Table 4.1) while the Department of Finance's (2014) own projections imply the economy will have returned to its potential output level by 2017 (see Table 4.2). On the other hand the EU Commission (2014) projects the Republic will have a zero output gap as early 2015 meaning actual output will be equal to potential output. The Republic's well-above-trend unemployment rate, combined with its high current account surplus and the evident lack of domestic inflationary pressure, cumulatively suggests that actual output remains below potential output i.e. that Ireland has a substantial negative output gap.

Table 4.2 Public Finances in the Republic of Ireland: Department of Finance Projections, (Per cent of GDP unless stated)

	2013	2014	2015	2016	2017	2018
General Government Balance	-7.2	-4.8	-3.0	-2.2	-1.2	0.0
Underlying General Government Balance	-7.2	-4.8	-2.9	-2.2	-1.2	0.0
General Government Primary Balance	-2.5	-0.1	1.8	2.6	3.7	4.8
Underlying General Government Primary Balance	-2.5	0.0	1.9	2.7	3.7	4.8
Structural Balance	-6.2	-4.7	-2.8	-2.1	-1.2	0.0
General Government Balance €m	-11,780	-8,090	-5,135	-3,950	-2,265	-85
Underlying General Government Balance €m	-11,755	-8,040	-5,135	-3,950	-2,265	-85
Underlying General Government Primary Balance €m	-4,075	-75	3,315	4,885	6,985	9,485
Revenue	35.9	36.2	36.3	35.7	35.2	35.0
Expenditure	43.1	41.0	39.3	37.9	36.3	35.0
Of which Interest Expenditure	*4.7*	*4.7*	*4.8*	*4.9*	*4.9*	*4.8*
Gross Debt	123.7	121.4	120.0	115.9	112.0	107.2
Net Debt	98.3	100.8	100.9	97.6	94.6	90.6

Source: DOF: Ireland's Stability Programme April 2014 Update, (DOF 2014).
Notes: Projections are based on the most current budgetary plans. See Table 4.1 for definitions. Underlying balances exclude once-off or temporary measures e.g. bank recapitalisations or privatisation receipts.

The Commission's methodology for estimating the structural budget balance has recently been critiqued by Bergin and Fitzgerald (2014).[14] Bergin and Fitzgerald note that applying the Commission's methodology to Ireland would imply a huge current account surplus over the medium-term which they argue would not be sustainable. The Commissions' methodology also implies that the equilibrium (structural) rate of

[14] See Klär (2013) for a critique of how the European Commission estimates structural parameters (including the structural balance).

unemployment in Ireland is in excess of 10%. This figure is likely to be a substantial overestimate. Bergin and Fitzgerald's own model estimates for the evolution of the general government deficit (shown in Table 4.3) largely attribute the current deficit in the government's finances to the economy producing well below its long-run equilibrium – i.e. they attribute the deficit to mainly cyclical factors related to the automatic stabilisers. They estimate Ireland's structural deficit will be close to zero percent in 2014. If this estimate is broadly correct then it suggests there is minimal need for additional discretionary fiscal consolidation provided growth rates consistent with steady convergence on Ireland's potential output are achieved over the medium-term.

Table 4.3 General Government Balance: ESRI Projections, (Per cent of GDP)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
General Government Balance	-8.2	-7.0	-4.5	-2.8	0.2	1.0	1.7	2.2	2.6

Source: Bergin and Fitzgerald (April 2014).
Note: Estimates are modelled using the HERMES macroeconomic model of the Irish economy.

The Republic's gross debt was 123.7% of GDP (Table 4.2) and 146% of GNP in 2013. This was the fourth highest debt to GDP ratio, and the second highest debt to GNP ratio, in all of the European Union.[15] While these ratios are projected to gradually decline from 2014 onwards, it is clear debt sustainability remains uncertain and highly vulnerable to an increase in the cost of borrowing. The Central Bank of Ireland should, at a minimum, not push forward its timetable for offloading the portfolio of floating bonds it acquired in a swap for Irish government promissory notes. Doing so would have negative consequences for the cost of borrowing and ultimately for employment and growth. The gross debt figure is somewhat misleading as a barometer of sustainability as it is partially offset by significant cash reserves and other assets. The net debt to GDP ratio was 98.3% of GDP in 2013 and is expected to peak at just under 101% of GDP in 2015. The sustainability of the debt burden is very much contingent on an acceleration of growth and a continuation of accommodative monetary policy by the ECB. A negative shock to the European economy would put Ireland's debt sustainability under serious question.[16]

[15] Table 7.3.1 compares IMF estimates and projections for general government debt in Ireland and the Euro area.
[16] The maturity profile of Irish sovereign debt is shown in Table 7.3.2.

The medium-term sustainability of the public finances is not yet secure and is contingent on an acceleration of economic growth from its present rate. Sufficient acceleration of economic growth is conditional on faster growth in the wider European economy combined with a pick-up in domestic demand. Such an acceleration of economic growth is certainly feasible over the medium-term given the degree of slack in the Irish and European economies. On balance the exchequer figures up to end May 2014 coupled with the prospects for growth suggest scope for a smaller fiscal adjustment than that being signalled for Budget 2015. The chosen fiscal stance should first and foremost be guided by the short, medium and long-term needs of society (e.g. sustainable growth, low unemployment, poverty reduction and well-being) and not solely by an arbitrarily set threshold for the government deficit in a particular year.

4.3 Irish Fiscal Policy

The Department of Finance's April 2014 SPU describes its immediate and cornerstone fiscal policy objective as the correction of the excessive deficit by 2015, and its medium-term budgetary objective as a balanced budget in structural terms. The budgetary outturn for 2013 was a deficit of 7.2% of GDP or €11.8 billion and the underlying primary deficit was 2.5% of GDP or €4.1 billion. The Government projects the underlying primary deficit will have virtually disappeared by 2014 but that the overall deficit will still be 4.8% of GDP or €8.1 billion. According to the SPU a consolidation effort of €2.0 billion in the October 2014 budget (€0.7 billion in revenue raising measures and €1.3 in public spending cuts) will be sufficient to keep the deficit below the 2015 EDP ceiling of 3%. Following correction of the excessive deficit the fiscal rules require annual progress towards the medium-term budgetary objective of a balanced budget in structural terms.

In addition to the basic goal of a structurally balanced budget the Government's medium-term budgetary strategy is evidently to maintain Ireland as a very low tax and spend country compared to other EU states. Table 4.4 shows IMF projections for government revenue and expenditure in both Ireland and the Euro area based on current fiscal policies. The Government's own figures tell a very similar story (see Table 4.2). Structural balance is as consistent with high levels of revenue and spending as it is with low levels of revenue and spending and therefore the Government's fiscal model is essentially a conscious political economy choice.[17] The Irish Fiscal Advisory Council points out that the budgetary plans imply considerable pressures on government services, public investment and social payments, that public spending in Ireland is already at the lower end of the spectrum, and that budgetary projections will leave the primary (i.e. non-interest) expenditure share of economic output at a very low level historically (IFAC, 2014).

Table 4.4 General Government Revenue and Expenditure: IMF Estimates and Projections, (Per cent of GDP)

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Revenue													
Ireland	37.3	36.7	35.4	34.5	34.9	34.1	34.5	35.7	36.0	36.1	35.8	35.6	35.5
Euro area	45.3	45.3	45.0	44.9	44.8	45.3	46.3	46.9	46.9	47.0	47.0	47.0	47.0
Expenditure													
Ireland	34.4	36.7	42.7	48.3	65.4	47.2	42.7	43.1	41.1	39.1	38.1	37.2	36.6
Euro area	46.6	46.0	47.2	51.2	51.0	49.5	50.0	49.9	49.5	49.0	48.4	47.9	47.5

Source: IMF: Fiscal Monitor April 2014 (April 2014a).
Note: IMF estimates for Ireland are based on current fiscal policies

Yet it is the high tax and spend economies of Europe that are actually the most competitive countries. Table 4.5 shows the ten countries in the EU28 ranked higher than Ireland in the World Economic Forum's 2013 Competitiveness Index. All ten of these countries raise substantially more government revenue (measured as a proportion of GDP) than the Republic of Ireland, while nine of the ten countries raise more revenue as a proportion of GDP than is raised in the Republic as a per cent of Irish GNP.

Table 4.5 Competitiveness Rankings and Government Revenue, 2013, (Per cent GDP)

Global Ranking	Country	Government Revenue	Global Ranking	Country	Government Revenue
3	Finland	56.0	17	Belgium	52.0
4	Germany	44.7	22	Luxembourg	43.6
6	Sweden	51.5	23	France	52.8
8	Netherlands	47.3	-	**Top ten**	**49.9**
10	United Kingdom	41.3	28	Ireland (GDP)	35.9
15	Denmark	56.2	28	Ireland (GNP)	42.4
16	Austria	49.7			

Sources: World Economic Forum (2013); European Commission (2014)
Notes: Competitiveness rankings are global rankings. Tables shows the top ten ranked EU countries and Ireland. Average for top ten is unweighted. Total revenue is for general government as a percentage of GDP.

[17] Table 7.3.3 shows the cumulative fiscal adjustment from 2008 to 2015. Two thirds of the adjustment to date has been on the spending side.

Managing the public finances is a delicate balancing act and there is unquestionably a strong public interest in controlling the deficit and the national debt. Important reasons include sustainability, creditworthiness and stability, and intergenerational fairness in terms of the burden of future debt interest repayments (IFAC, 2014). A large debt overhang also has the potential to act as a drag on the economy's long-run growth and output potential by diverting resources away from productive uses. On the other hand, the larger the budgetary adjustment, the greater the impact in terms of reduced domestic demand, lower short-run growth, and higher unemployment. Usable capital and labour that lies idle for a period of time is wasted and the lost output and employment cannot be recovered once foregone through lack of use. There are also 'hysteresis' effects which can become structural within the economy and which can permanently reduce potential output and destroy lives. Hysteresis is associated with long-term unemployment, the deterioration of human capital, and the loss of skills, confidence, work habits and labour market contacts. There is also hysteresis effects associated with the loss of potentially viable businesses during a recession.

Insufficient fiscal consolidation may undermine debt sustainability and high debt interest repayments could create a permanent drag on economic output and employment. Yet the economy is a complex system and excessive discretionary consolidation carries its own risks. Short term losses can be 'sticky' and there is no reason why an economy need automatically bounce back to a given equilibrium point. Instead, the future trajectory of Ireland's economy could follow a number of different paths. Consider a business that is 'hanging on' and eventually goes under during a prolonged recession. Such a business cannot easily be restored from scratch once the economy recovers. Accumulated damage in terms of lost human capital, business closures, a reduced capital stock, emigration, job losses, etc. can permanently reduce the long-term potential output of the economy.

4.4 Fiscal Consolidation with Equity and Growth

The purpose of fiscal consolidation is to reduce the public debt and in so doing reduce the burden of the State's annual debt interest repayments. Debt reduction is just one public goal. We are also interested in maintaining short-run economic growth, generating sustainable long run economic growth, creating decent employment, reducing income and wealth inequality, eliminating poverty, protecting communities, and enhancing well-being. A wide range of fiscal instruments are employed to achieve these goals. Recent work by the OECD (Cournéde, Goujard and Pina, 2013) has considered the impact of consolidation strategies on economic growth and equity and with these objectives in mind constructed a hierarchy of seventeen fiscal consolidation instruments (see Table 4.6).

The instrument with the least damaging welfare outcome is a cut to business subsidies. Unless introduced to correct a market failure a production subsidy will distort resource allocation and competition and reduce productive potential (OECD, 2001). Consolidation through increasing or introducing taxes on property (inheritance, gift and wealth taxes) also scores highly in terms of overall welfare effects. Such taxes are highly redistributive with minimal impact on growth. However careful policy design is crucial to prevent tax avoidance by wealthy households. Other high scoring instruments from a welfare perspective include: recurrent taxes on immovable property, personal and corporate income taxes, environmental taxes and cuts to unemployment benefits. However cuts to unemployment benefits will further increase poverty at a time when 16% of the population of the Republic of Ireland were already suffering from income poverty by 2011 while 130,000 children were experiencing deprivation (ESRI, 2014c).

The most damaging fiscal consolidation instruments are cuts to education and cuts to childcare and family supports. Cutting childcare and family supports increase the risk of child poverty. This hampers the formation of human capital resulting in lower output per capita in the long-term. Cuts to education also hamper the formation of human capital and education spending is generally progressive, at least for primary and secondary education. These positive welfare effects are strongest for early childhood education. Cuts to government investment are particularly damaging to welfare in the long-run because government investment has a positive effect on capital accumulation, productive capacity, and long-term output. There is a strong case for increasing public spending in all of these areas.

Table 4.6 Balancing Equity and Growth: Hierarchy of Fiscal Consolidation Instruments

Generic Ranking	Instrument	Generic Ranking	Instrument	Generic Ranking	Instrument
1	Business Subsidies	4-8	Environmental taxes	13	Public investment
2-3	Pensions[18]	4-8	Unemployment benefits	14-15	Health services (in kind)
2-3	Other property taxes	9-10	Other government consumption	14-15	SSCs
4-8	Recurrent taxes on immovable property	9-10	Sales of goods and services	16	Childcare/family
4-8	Personal income taxes	11-12	Sickness and disability payments	17	Education
4-8	Corporate income taxes	11-12	Consumption taxes (non-environmental)		

Source: Cournéde, Goujard and Pina (2013)
Notes: Hierarchy considers impact of consolidation strategies on growth and equity objectives. **Rank 1** represents the fiscal instrument with the *least* damaging welfare outcome arising from consolidation. **Rank 17** represents the fiscal instrument with the *most* damaging welfare outcome arising from consolidation

In order for Ireland to stabilise gross public debt at 60% of GDP in the long-term, Cournéde et al. (2013) argue that Ireland would require an additional package of post 2012 fiscal consolidation measures equivalent to 5.8% of potential GDP. In terms of which instruments to use, and given the expected impact on the growth and equity objectives, Cournéde et al. (2013) found public spending measures should make up 27% of the total consolidation effort. Spending measures actually made up 60% of the total adjustment over budgets 2013 and 2014 (see Table 4.7). This suggests the entirety of any future consolidation effort should be made on the revenue side.

Table 4.7 OECD Estimate of Post 2012 Short-to-Medium-Term Consolidation Needs, (Percentage of potential GDP)

	Total	Expenditure	Revenue
Consolidation needs post 2012	**5.8**	**1.6**	**4.2**
Budget 2013 consolidation	2.0	1.2	0.8
Budget 2014 consolidation	1.5	0.9	0.6
Remaining consolidation needs (Post 2014)	**2.3**	**-0.5**	**2.8**

Sources: Cournéde, Goujard and Pina (2013); NERI calculations
Note: The composition of needs is extrapolated using the OECD estimates of consolidation needs; the OECD hierarchy of fiscal instrument, and Ireland's relative spending and revenue profile.

[18] Reductions in public pension spending scores highly in the hierarchy of consolidation instruments. However this ranking refers to an increase in the retirement age which keeps productive workers in the labour force and increases output. Reducing the pension rate (payments to individuals) does not score highly from a welfare perspective mainly because such a measure would be highly regressive.

Table 4.8 Tax Revenues (including Social Security Contributions), Ireland and the EU, (Percent of GDP)

		2007	2008	2009	2010	2011	2012
Total Tax and SSC	Ireland (GDP)	31.5	29.5	28.1	28.0	28.2	28.7
	Ireland (GNP)	36.6	34.3	34.1	33.6	35.1	35.5
	Ireland (HYB)	34.4	32.2	31.4	31.1	32.0	32.4
	EU	39.3	39.2	38.3	38.3	38.8	39.4
	Euro	40.0	39.6	39.1	39.0	39.5	40.4
Main Categories							
Taxes on Consumption							
	Ireland	11.3	10.9	10.1	10.3	9.8	10.0
	EU	11.0	10.8	10.7	11.1	11.2	11.2
Taxes on Labour *(includes employer PRSI)*							
	Ireland	10.7	11.2	11.7	11.5	12.1	12.2
	EU	19.1	19.5	19.9	19.7	19.8	20.1
Taxes on Capital							
	Ireland	9.4	7.4	6.3	6.2	6.3	6.5
	EU	9.3	8.9	7.8	7.7	7.9	8.2
Selected Sub Categories							
Taxes on Capital Stock/Wealth	Ireland	2.8	2.2	1.9	1.9	2.2	2.2
	EU	2.8	2.8	2.7	2.5	2.6	2.8
Taxes on Corporate Income	Ireland	3.5	2.9	2.4	2.5	2.3	2.4
	EU	3.4	3.1	2.3	2.4	2.6	2.6
Taxes on Capital and Business Income	Ireland	6.6	5.2	4.3	4.3	4.1	4.3
	EU	6.4	6.1	5.1	5.2	5.3	5.4
Taxes on Property	Ireland	2.3	1.7	1.4	1.5	1.4	1.4
	EU	2.3	2.3	2.1	2.1	2.2	2.3
VAT	Ireland	7.6	7.3	6.4	6.4	6.0	6.2
	EU	7.0	6.9	6.7	7.0	7.1	7.1
Environmental Taxes	Ireland	2.5	2.4	2.4	2.6	2.5	2.5
	EU	2.4	2.3	2.4	2.4	2.4	2.4
Social Security Contributions (SSCs)	Ireland	5.0	5.4	5.7	5.7	4.8	4.4
	EU	12.2	12.5	12.8	12.6	12.7	12.7
Employee SSCs	Ireland	1.7	1.9	2.3	2.4	1.2	1.1
	EU	3.7	3.8	3.8	3.8	3.9	3.9
Employer SSCs	Ireland	3.1	3.3	3.3	3.1	3.4	3.1
	EU	7.1	7.2	7.4	7.3	7.3	7.3

Sources: Eurostat, Taxation Trends in Europe Annual Reports 2013 and 2014 (2014 and 2014d); NERI calculations

Notes: Data for EU (28 EU countries) and Euro (18 Euro area countries) represents weighted averages. Ireland (HYB) refers to the 'hybrid' measure of GDP and GNP developed by the Irish Fiscal Advisory Council as a more appropriate estimate of Ireland's fiscal capacity.

Ireland is a low tax economy by European standards. The most recent data from Eurostat (Eurostat, 2014d) shows that Ireland's overall tax take, including social security contributions, is the sixth lowest in the EU as a proportion of GDP. Ireland's take was just 28.7% of GDP in 2012.[19] This was well below the 39.4% weighted average for the EU (see Table 4.8). Ireland's low level of social contributions explains most of the gap with the EU. In 2012 social contributions amounted to just 4.4% of

[19] Ireland's tax take was 35.5% in GNP terms and 32.4% when measured using the Irish Fiscal Council's hybrid measure of fiscal capacity.

GDP and 15.3% of tax revenue in Ireland. The EU weighted averages were 12.7% and 32.4% respectively. Employer social contributions are particularly low in Ireland. Ireland also stands out for its low tax take from property and from labour.

The Implicit Tax Rate (ITR) provides a good measure of the effective average tax burden on different types of economic income or activities. The ITR expresses aggregate tax revenues as a percentage of the potential tax base. Ireland has a comparatively high ITR on consumption but low ITRs on labour and on capital (Table 4.9). The ITR on labour was just 74.5% of the Euro area average in 2012. These facts belie the assertion Ireland is a high tax country for workers. The current debate about marginal tax rates misses the point that it is the effective tax rate that actually matters for workers and that effective rates are not high in Ireland. A single person on a gross income of €35,000 has a baseline theoretical effective tax rate of just 21.0% (Table 4.10). In practice the actual effective rate for such a person will be lower due to entitlements to tax expenditures. Effective tax rates for couples are lower than effective tax rates for single persons.

Table 4.9 Implicit Tax Rates (ITRs) in Ireland and the EU, (Percentage of potential tax base)

		2006	2007	2008	2009	2010	2011	2012
Consumption	Ireland	26.0	25.2	22.8	21.9	22.1	21.4	21.9
	EU	19.8	20.0	19.6	19.1	19.7	19.9	19.9
	Euro area	19.6	19.8	19.2	18.8	19.2	19.3	19.3
Labour	Ireland	25.3	25.5	24.5	25.1	25.9	28.2	28.7
	EU	35.6	35.8	36.0	35.4	35.4	35.8	36.1
	Euro area	37.5	37.9	38.0	37.4	37.4	37.7	38.5
Capital	Ireland	21.5	19.0	16.7	15.0	13.0	13.0	13.0
	Euro area	30.4	30.9	29.2	28.3	27.4	28.9	-

Sources: Eurostat, Taxation Trends in Europe Annual Report 2014 – Preliminary Estimates and Eurostat, Taxation Trends in Europe Annual Reports (2013 and 2014d)

Notes: Data for EU (28 countries) and Euro area (18 countries) represents weighted averages. Not all EU countries report data for the ITR on capital.

Table 4.10 Baseline Effective Tax Rates for Single PAYE Workers, 2013 (Percentage of gross income)

Gross Income (€)	Single Person (%)	Gross Income (€)	Single Person (%)
20,000	11.1	60,000	33.9
30,000	17.7	70,000	36.5
35,000	21.0	80,000	38.4
40,000	24.8	90,000	39.9
50,000	30.3	100,000	41.1

Source: Collins (2013)

Notes: Baseline effective rate is the combined income tax, USC and PRSI as a percentage of gross income with a deduction for income tax credits. The baseline effective rate is a maximum rate. Entitlements to tax expenditures will reduce these figures. See Collins (2013) for additional methodological notes.

Finally, consideration of the Irish tax system's progressivity is often misleadingly focused only on income taxes, or income related taxes. A full analysis of the progressivity of the tax system also requires consideration of the impact of consumption taxes. Consumption taxes are more regressive than direct taxes on income. Indirect tax contributions, as a percentage of gross income, tend to be higher for lower income groups and, as shown by Collins and Turnbull (2013), the Irish tax system is not progressive across all ten income deciles once the impact of consumption taxes is added to the impact of direct taxes on income (see Table 4.11). Overall the case for a cut in direct taxes on income must be seen as extremely weak.

Table 4.11 Comparison of Total Household Tax Contributions across the Income Deciles, (Percentage Gross Income)

	Bottom	2	3	4	5	6	7	8	9	Top	State
Direct *(Income tax, SSCs)*											
	0.30	0.77	1.20	2.70	4.67	8.54	11.19	13.50	16.56	22.91	**13.74**
Indirect *(VAT, Excise, Other)*											
	27.37	18.02	16.45	14.49	13.46	12.75	11.06	9.96	8.53	6.33	**10.34**
Total											
	27.67	**18.79**	**17.65**	**17.19**	**18.13**	**21.29**	**22.25**	**23.46**	**25.09**	**29.24**	**24.08**

Source: Collins and Turnbull (2013)
Notes: Data used is from the Household Budget Survey published in 2012 and for the period 2009-2010. See Collins and Turnbull (2013) for details of the methodology used.

4.5 NERI Proposals for Budget 2015

A number of general points can be made in relation to Ireland's public finances. First, the public finances remain in deficit and further fiscal effort is required. Second, government revenue as a proportion of output is low by EU standards while primary public spending is not high by EU standards. However, care is required when proposing specific revenue increases. Taxes influence behaviour in a variety of different ways and in so doing influence economic efficiency, employment and growth. The marginal effect of a change in the tax rate depends upon the starting point. This is because taxes have non-linear impacts on behaviour. There are diminishing returns to adjusting taxes upwards, while taxes tend to have smaller effects on employment and growth when they start from a low base. One implication is that low tax economies like Ireland obtain larger net benefits from raising taxes than do high tax economies such as Denmark. A second implication is that broadening the tax base (e.g. be eliminating tax expenditures) can be preferable to increasing marginal rates.

Third, further reductions in public expenditure are likely to result in long-term damage to education, health, social programmes and other areas of public services. European levels of public services are simply not attainable without European levels of public spending and it is only possible to achieve those standards with European levels of revenue.

Fourth, public investment is low by EU standards. The Irish Fiscal Advisory Council (IFAC, 2014) and the IMF (2014b) have both identified the problem of the low level of public investment. Public investment is currently expected to average 1.5% of GDP over the period to 2018. This is well below the current Euro area average. Depreciation exceeded investment in 2013, meaning the Government's stock of capital declined in 2013. A shortfall in public investment has consequences for the economy's growth potential. Ireland's productive infrastructure already lags that of Western Europe in a number of key respects and infrastructure deficits are apparent in a number of areas including social housing, public transport, and broadband infrastructure and water services. A range of public investment options are described in Box 4.1.

Finally, there are conflicting estimates of the structural budget balance. On the balance of evidence it appear the public finances are still operating, albeit marginally, in a structural deficit. This suggests that only a small discretionary fiscal adjustment is necessary for 2015. The composition of the adjustment is crucial because the fiscal instruments have differing impacts on growth and equity outcomes. Ireland's low revenue base suggests there is no room for net tax cuts and that the bulk of the consolidation effort should be on the revenue side. However, fiscal consolidation is not simply a matter of raising taxes and cutting public spending. Public spending on R&D and innovation infrastructure, on physical infrastructure, on education, and on active labour market programs all plays an important role in managing the public finances in the medium-to-long term because such investments increase the potential output of the economy. Cuts in these areas often represent false economies in the long-run.

Box 4.1	Capital Spending Priorities for the Republic
Housing	Up to 100,000 households are on housing waiting lists. 20,000 additional social housing units should be built over the next four years. These are in addition to the 4,500 units that NAMA has committed to provide. Such a building programme can be structured on a commercial basis, enabling the State to draw on funds available from the Strategic Investment Fund and other sources such as pension funds. In addition to the social benefits, housing workers is a simple requirement to allow labour mobility to regions that show greater job creation.
Telecoms/ Broadband	Ireland ranks poorly in terms of broadband infrastructure relative to other Western European countries. Broadband is a General Purpose Technology (GPT) and facilitates innovation and growth in multiple economic sectors. Investment in this area is vital for regionally balanced job creation. Providing Wi-Fi hotspots should be viewed as the provision of a public good.
Repair existing buildings and retrofit public buildings	Given the benefits in terms of energy usage of retrofitting buildings, the public sector should take the lead, demonstrating the benefits to the private sector. The expertise gained can then be put to use in the private sector. It is estimated the cost of deep retrofitting per dwelling ranges from €5,000 to €15,000. Rain harvesting should be installed on public buildings, schools, hospitals and local authority housing.
Transport	Public transport projects which develop improved alternatives to private vehicle use and minimise reliance on fossil fuels. Examples for consideration include extending fourth-tracking from Hazelhatch to Newbridge; and the efforts of Foynes Port company to reinstate the rail link to that port. A study with the Northern Ireland executive should be conducted regarding electrification of the Dublin-Belfast rail line.
Energy:	Government should prioritise developing an all-Island energy market. Northern Ireland is heavily dependent on imported fossil fuels for its total energy needs, and is a potential export market for renewable energy generated south of the border.
Water/Waste	The harsh winter of 2010 highlighted the poor state of water infrastructure in Ireland. A programme of investment in new pipe-laying beneath potential frost level could be initiated. At present 46% of sewage treatment plants in urban areas fail to meet the EU urban wastewater directive, and this needs to be addressed. Over 40% of municipal waste (including hazardous waste) is exported. There should be a role for public investment in the solid waste sector due to the need to upgrade domestic infrastructure.

Taxing Wealth

Low taxes on capital increases the real value of wealth assets and shifts the tax burden onto those with less means. Theory and evidence (Johansson et al, 2008; Heady et al, 2009) both suggest that taxes on property, wealth and passive income have minimal impact on long-run economic growth and have smaller employment effects than taxes on labour income and consumption. Taxes on property and wealth are also redistributive if properly designed and helpful to tax authorities in fighting tax evasion and criminal activity by revealing inconsistencies between income flows and wealth. At least €200 million can and should be raised in Budget 2015 through the increased taxation of wealth. This should be done through the reform of Capital Acquisition Tax and the introduction of a Net Wealth Tax.[20]

Tax Reliefs

Tax expenditures, which are analogous to government spending programs and can carry large fiscal costs, tend to deliver larger benefits to higher income households. Reliefs allowing a tax deduction at the individual's marginal rate of income tax are more valuable to, and will disproportionately benefit, those with the highest income tax rates. Given the highly regressive nature of the pension tax reliefs it is essential that the Budget 2013 commitment to reduce the cost of pension tax expenditures by €250 million is fulfilled. Favourable tax treatment for certain asset categories and types of investment, for example, pensions and housing distorts investment decisions. The distortion erodes allocative efficiency in the economy, is damaging to growth, and provides mechanisms for tax avoidance. Preferential treatment for certain classes of asset can also encourage asset price bubbles. The property related tax reliefs played a crucial role in Ireland's economic crash and given this experience any attempt to stimulate house prices whether through the introduction of schemes such as government guarantees or subsidies, or through tax breaks for house buyers, should be seen as deeply unwise and misguided. Favourable tax treatment for housing assets relative to that available for other forms of investment is likely to be particularly damaging to long-term growth because it distorts capital flows away from productive investments and toward non-productive investments in housing. A minimum of €100 million should be raised in Budget 2015 through the reform of tax expenditures.

Consumption Taxes

There is often a trade-off between policy goals. While taxes on labour can be damaging to employment, consumption taxes tend to be more regressive than other taxes. Ireland already has a relatively high Implicit Tax Rate (ITR) on consumption, and to the extent that there is any scope for increasing taxes on consumption, that increase should be limited in Budget 2015 to the introduction of water charges. Water charges for households are expected to generate €350 million per annum and in 2015 revenue will be counted for one year and three months; thus generating around €440 million. It

[20] See McDonnell (2013 and 2014c) for further discussion on taxing property and wealth and the options for the potential implementation of a wealth tax in the Republic of Ireland.

is crucial that water charges are equality proofed. A system of income related water credits should be established to prevent water charges from pushing households into poverty.[21] A net annual yield of €500 million can be achieved by introducing water charges for households and by increasing water rates on businesses.

Employer PRSI

Ireland's extremely low take from social contributions is unsustainable in the long-term. Targeting employer PRSI contributions on just the portion of salaries above €100,000 will affect relatively few employments (circa 45,000) and would not affect the marginal tax rate on employee salaries. €100 million can be raised in this way. Much more substantial reform of social insurance is required in the longer-term.

Other tax reforms

Ireland should take sufficient steps to reform its corporate tax system in order to ensure the Irish tax regime does not facilitate aggressive tax avoidance by multinationals and that its regime does not generate negative tax 'spill-overs' for other countries, particularly countries in the global south. In addition, the Revenue Commissioners have stated that an allocation of €6.5 million to increase audit, investigation and compliance resources by 125 staff would yield €100 million. These resources should be allocated as part of Budget 2015.

Spending proposals

Alongside the revenue package we propose €400 million of additional public spending to serve as a social emergency fund. This additional funding would be reserved for a number of targeted social programmes including additional resources for community supports in deprived areas and additional resources for mental health services. €200 million of this additional funding should be allocated to address Ireland's social housing crisis. Carryover from previous policy measures will generate additional fiscal savings in 2015. Savings under the Haddington Road Agreement represent the most substantial of these savings.

Finally, we propose an off-the-books public investment of €1.0 billion in 2015 with further investment in subsequent years. The 2015 allocation would bring Ireland up to

[21] See McDonnell (2014a).

the EU average for public investment. Financing investment can be centralised and leveraged through an independent Strategic Investment Bank or Strategic Investment Fund. The LSE Growth Commission (2013) has proposed an Infrastructure Bank or Strategic Investment Bank for the United Kingdom and such a proposal is at least as relevant for Ireland as it is for the UK. The European Investment Bank, the European Bank for Reconstruction and Development, Germany's KfW, and the UK's Green Investment Bank all provide templates for such a vehicle. The establishment of public investment banks are currently under discussion in a number of countries, for example the USA and France. The creation of the Ireland Strategic Investment Fund (ISIF) is a welcome innovation in the Irish context though it remains to be seen how the ISIF will actually operate in practice.[22]

Table 4.12 NERI's Proposed Fiscal Stance for Budget 2015, (€ millions)

Contraction	(€millions)	Expansion	(€millions)
Revenue	**900**		
Taxes on wealth *(CAT and Net Wealth Tax)*	200		
Reform of tax expenditures	100		
Employer PRSI	100		
Water charges	500		
Expenditure	**300**	**Expenditure**	**400**
Carryover *(including HRA)*	300	Capital spending *(Social Housing)*	200
		Current spending	200
Total Fiscal Contraction	**1,200**	**Total Fiscal Expansion**	**400**
Net Fiscal Contraction	**800**		

Notes: HRA refers to the Haddington Road Agreement; CAT refers to Capital Acquisitions Tax
In addition to this structural package NERI is proposing that there should be an 'off-the-books' €1 billion increase in public capital expenditure in 2015 which would be sourced from the ISIF. In practice this represents a reallocation of the ISIF's capital resources for use in Ireland from abroad. The reallocation of ISIF resources would be for commercial projects, would not increase exchequer borrowing and would therefore not increase the deficit.
Net revenue carryover is expected to be negligible in 2015.
Table 4.12 does not include additional revenue from allocation of €6.5 million to the Revenue Commissioners to increase audit, investigation and compliance resources.

4.6 Outcomes under Alternative Approaches

The economy is a complex, evolving, and dynamic system characterised by multiple equilibria. The 2008 crash highlighted the failures and limitations of prediction in macroeconomic science. Goodhart (1975) and Lucas (1976) emphasise the difficulties inherent to economic policymaking. For example they argue it is much too simplistic to

[22] See Duggan (2013) for a wider discussion of investment options including options for infrastructure funding.

try to predict the effects of a change in economic policy entirely on the basis of historically observed relationships. Relationships that appear to hold in the economy can change in response to changes in economic policy. If a new policy alters the incentives and opportunities presented to rational or bounded rational agents, then the new policy will also alter the behaviour of those agents. Such behavioural changes are difficult to predict in advance and make policy outcomes uncertain.

Although policymakers cannot fully control or predict outcomes it would be overstating to suggest they are powerless to influence outcomes. While we must always preface our predictions with appropriate caveats, we do have some understanding of the key causal mechanisms underlying economic outcomes. The fiscal consolidation effort will have consequences for output, employment, government revenues and the public finances. Here we use estimates from O'Farrell (2013) to compare the effects of NERI's proposed budget plan with the Government's stated plan to pass €2 billion of contractionary fiscal measures in 2015. We also compare both plans with a 'Do Nothing' scenario.

We estimate the more growth friendly choice of fiscal consolidation instruments under the NERI plan, coupled with the 'off book' programme of public investment, delivers a more benign outcome in terms of GDP growth, employment, and the unemployment rate (Table 4.13). The NERI plan is estimated to yield over 34,000 more jobs than the Government's plan and over 18,000 more jobs than the 'Do nothing' approach. GDP in 2015 is estimated to be 1.9% higher under the NERI plan than under the Government's plan while unemployment is estimated to be 1.7 percentage points lower under the NERI plan. The government deficit in 2015 is estimated to be essentially the same under both the Government and the NERI plan although it should be emphasised that this is predicated on the temporary €1 billion investment stimulus remaining off-books. We estimate under both the Government's plan and the NERI plan that the deficit would improve by 0.8% of GDP compared to the 'Do nothing' scenario. The actual deficit in 2015 will depend on levels of growth in output and employment.[23]

[23] In Section 3 we estimated that the general government deficit will be 2.5% in 2015 given our assumptions for growth in output, unemployment and employment growth.

Table 4.13 Estimated Differences in 2015: Output, Employment and the Public Finances, (Percentage Point Difference)

	Government Plan vs. 'Do Nothing'	NERI Plan vs. 'Do Nothing'	NERI Plan vs. Government Plan
GDP Growth	-1.2	+0.7	+1.9
General Government Balance	+0.8	+0.8	+0.0
Employment (Persons)	-16,500	+18,100	+34,600
Unemployment Rate	+0.8	-0.9	-1.7

Sources: O' Farrell (2013); NERI calculations

Notes: See O'Farrell (2013) for a discussion of the methodology and the caveats surrounding the estimates
Government Plan refers to the €2.0 billion adjustment signalled in budgetary documentation (€0.7 revenue and €1.3billion expenditure); It is assumed over 80% of the revenue adjustment is composed of indirect taxes and that the remaining revenue component is made up of direct taxes; The expenditure adjustment is assumed to be composed of a mix of cuts to social transfers, public sector wages, and non-wage public consumption.
'Do Nothing' means no net discretionary fiscal adjustments in Budget 2015;
The NERI Plan is described in Table 4.12
Figures may not sum due to rounding; Employment estimates rounded to nearest 100

4.7 Conclusion

On the balance of evidence it appears likely that Ireland's structural deficit is now close to zero, albeit still marginally in deficit. If so, there is minimal need for additional discretionary consolidation. However, the debt to GDP ratio is still too high and it is too early to claim the public finances are repaired. Additional adjustments are needed to place the Irish economy on a sustainable path. Stabilising the public finances is an important public policy goal. Yet just as important is the need to avoid embedding a high level of structural long-term unemployment in the economy. As people's human capital degrades they find it increasingly difficult to return to work and this reduces the productive capacity of the economy. Too much austerity will reinforce the hysteresis effect in the labour force and reduce the Irish economy's output equilibrium over the long-term.

The budget is about choices. In this section we have proposed an alternative approach to achieving the 2015 EDP deficit target of less than 3 per cent of GDP. We find that a better outcome can be achieved in terms of equity, growth and employment by pursuing a three pronged strategy based on A) a discretionary fiscal adjustment composed mainly of increases in government revenue, B) an accompanying investment package that restores annual public investment in the Republic to the EU average in 2015 and C) a modest increase in social spending as part of a social emergency fund targeted at the most vulnerable individuals and communities.

5 Conclusion

Our outlook is for gradual improvement in both of the economies on the island of Ireland. Although our base-line outlook for employment and growth in the Republic is positive there are concerns about the still high level of private indebtedness, weak credit conditions and very high levels of long-term unemployment and youth unemployment. Our growth projections are conditional on a recovery in the European economy. Economic recovery appears to be taking hold in the Northern Ireland economy. However the medium term picture is cloudy. Economic prospects are uncertain due to the potential impacts of the Scotland independence referendum in September and next May's general election in the UK. The result of the general election has implications for the UK's membership of the EU.

The Republic's public finances remain fragile and our proposals for Budget 2015 reflect the need to restore the public finances to a sustainable path. Government revenue as a percentage of GDP is very low by Western European standards and it is very much evident that there is no room for tax cuts in Budget 2015. On the other hand further cuts to public spending will put immense pressure on public services, public investment and social transfers. Primary public spending is already low by EU standards and by historical standards in modern Ireland. Therefore any new fiscal contraction measures should be on the revenue side. All new revenue measures should be supportive of growth and equity objectives. Finally, fiscal policy is more than just deficit reduction. The Republic's low level of public investment is a drag on employment and potential output. An 'off-the-books' investment stimulus funded from the Ireland Strategic Investment Fund (ISIF) would go some way to addressing this problem.

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7 Appendix

Appendix 7.1. Overview of recent economic trends – Republic of Ireland

	2009	2010	2011	2012	2013
Total Expenditure					
Consumption €m	83,294	82,200	82,380	82,634	83,061
Investment: private and public €m	26,096	19,293	17,266	17,434	18,385
Government consumption €m	29,304	26,196	25,701	25,096	25,052
Exports €m	146,369	157,810	166,964	176,736	177,142
Imports €m	-120,352	-128,326	-131,840	-136,990	-138,734
Domestic Demand €m	137,205	127,122	126,332	125,540	126,990
Total Income					
GDP €m	162,284	158,097	162,600	163,938	164,050
GNP €m	133,919	131,812	130,662	132,649	137,917
Income from Agriculture €m	2,066	2,580	3,179	2,876	n/a
Income non-Agriculture: Wages €m	74,454	69,221	68,315	68,390	n/a
Income non-Agriculture: Other €m	43,042	48,840	54,073	52,885	n/a
Employment					
Labour Force	2,242,400	2,196,700	2,173,700	2,165,800	2,182,100
Labour Force Participation Rate %	62.3%	61.0%	60.4%	60.2%	60.7%
Employment	1,953,600	1,886,100	1,845,600	1,841,300	1,899,300
Employment full-time	1,530,800	1,459,700	1,411,300	1,395,000	1,448,600
Employment part-time	422,700	426,400	434,300	446,300	450,700
Underemployment	112,900	112,500	140,800	147,600	139,300
Unemployment	288,900	310,600	328,100	324,500	282,900
Unemployment %	12.9%	14.1%	15.1%	15.0%	13.0%
Long-term Unemployment	80,600	152,600	191,700	193,000	165,100
Long-term Unemployment %	3.6%	6.9%	8.8%	8.9%	7.6%
Migration					
Immigration	41,800	53,300	52,700	55,890	n/a
Emigration	69,200	80,600	87,100	88,989	n/a
Net Migration	-27,500	-27,400	-34,400	-33,099	n/a

Appendix 7.1 (cont.). Overview of recent economic trends – Republic of Ireland

	2009	2010	2011	2012	2013
Public Finances					
Total General Gov. spending €m	78,144	103,544	76,550	69,844	70,371
Total General Gov. revenue €m	55,963	55,149	55,331	56,623	58,866
General Gov. Balance €bn	-22.18	-48.40	-21.22	-13.22	-11.50
General Gov. Gross Debt €bn	104.5	144.2	169.2	192.5	202.9
General Gov. Gross Debt % GDP	64.4%	91.2%	104.1%	117.4%	123.7%
Earnings and Prices					
Average earnings € per week	699.10	693.70	687.67	691.93	677.13
Average earnings % change	0.3%	-0.8%	-0.9%	0.6%	-2.1%
Private sector av. earn. % change	3.6%	-2.4%	-2.5%	1.0%	-1.3%
Public sector av. earn. % change	-2.4%	-0.8%	0.7%	1.2%	-1.2%
Inflation CPI %	-4.5%	-1.0%	2.6%	1.7%	0.5%
Inflation HCPI %	-1.7%	-1.6%	1.1%	2.0%	0.5%
Inequality and Poverty					
Gini coefficient	29.3	31.4	31.1	31.2	n/a
Quintile ratio	4.3	4.8	4.9	5.0	n/a
Relative poverty %	14.1%	14.7%	16.0%	16.5%	n/a
Consistent poverty %	5.5%	6.3%	6.9%	7.7%	n/a
Deprivation rate %	17.1%	22.6%	24.5%	26.9%	n/a

Sources: CSO (2014f) Quarterly National Accounts; CSO (2014e) National Income and Expenditure; CSO (2014g) Quarterly National Household Survey; CSO (2013) Population and Migration Estimates; CSO (2014c) Earnings and Labour Costs; CSO (2014b) Consumer Price Index; CSO (2014h) SILC Reports; and Eurostat online database.

Notes: Earnings and labour market data are for Q3 in all years.
Domestic Demand is Total Domestic Demand.
National accounts data reported at current market prices.

Appendix 7.2 Overview of recent economic trends– Northern Ireland

	2009	2010	2011	2012	2013
Total Expenditure					
Personal consumption £m	-	-	-	-	-
Investment: private and public £m*	7,918	7,268	-	-	-
Government consumption £m	-	-	-	-	-
Exports £m	5,270	5,438	5,910	5,627	5,987
Imports £m	5,152	5,417	5,774	5,690	5,807
Domestic Demand £m	-	-	-	-	-
Total Income					
GVA £m	28,447	28,945	29,063	29,410	-
GNP £m	-	-	-	-	-
Income from Agriculture £m	116	356	381	-	-
Income non-Agriculture: Wages £m	17,157	17,111	17,624	-	-
Income non-Agriculture: Other £m	11,175	11,477	11,058	-	-
Employment					
Labour Force	808,000	834,000	859,000	864,000	866,500
Labour Force Participation Rate	58.5%	59.9%	61.1%	61.0%	60.7%
Employment	750,500	773,500	794,000	797,500	795,000
Employment full-time	581,000	593,500	609,000	597,500	596,000
Employment part-time	171,250	175,000	184,000	193,000	198,000
Underemployment	25,500	27,000	32,000	41,500	43,000
Unemployment	52,500	59,500	62,000	65,000	65,000
Unemployment rate %	6.5%	7.1%	7.2%	7.5%	7.6%
Long-term Unemployment	17,500	26,000	27,500	33,000	35,000
Long-term as % of Unemployed	33.3%	43.7%	44.4%	50.8%	53.5%
Migration					
Immigration	25,261	24,544	23,724	23,255	-
Emigration	21,604	23,394	25,218	24,570	-
Net Migration	3,657	1,150	-1,494	-1,315	-

Appendix 7.2 (cont.) Overview of recent economic trends– Northern Ireland

	2009	2010	2011	2012	2013
Public Finances					
Total General Gov. spending £m	17,807	18,860	19,001	19,273	
Total General Gov. revenue £m	-	-	-	-	
General Gov. Balance £m	-	-	-	-	
General Gov. Debt nominal £m	-	-	-	-	
General Gov. Debt % GDP	-	-	-	-	
Nominal earnings and Prices					
Average earnings £ per week	354.60	354.70	354.50	360.80	366.80
Average earnings % change	2.8%	0.0%	-0.1%	1.8%	1.7%
Private sector av. earn. % change	-	0.6%	0.1%	-2.3%	2.4%
Public sector av. earn. % change	-	6.5%	1.9%	5.4%	0.8%
Inflation CPI %	-	-	-	-	
Inflation HCPI %	-	-	-	-	
Inequality and Poverty					
Gini coefficient	-	-	-	-	-
Quintile ratio	-	-	-	-	-
Relative poverty %	20%	22%	20%	21%	-
Consistent poverty %	19%	20%	20%	24%	-
Deprivation rate %	-	-	-	-	-

Sources: HMT Public Expenditure Analysis 2013; HMRC RTS; ONS Gross Value Added (Income Approach); LFS Quarterly Supplement; NISRA Northern Ireland Migration Flows; NISRA Annual Survey of Hours and Earnings; Department of Social Development Poverty Bulletin

Notes: Where cells are blank the data are unavailable.
Imports and exports refer to trade external to the UK.
*Investment as Gross Fixed Capital Formation (estimated).

Appendix 7.3 Additional Tables for Section 4

Table 7.3.1 General Government Debt: IMF Estimates and Projections, (Per cent of GDP)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Gross Debt												
Ireland	24.9	44.2	64.4	91.2	104.1	117.4	122.8	123.7	122.7	119.6	116.8	113.1
Euro area	66.4	70.3	80.1	85.7	88.1	92.8	95.2	95.6	94.5	92.6	90.4	88.1
Net Debt												
Ireland	10.5	21.2	38.6	70.4	85.1	92.8	100.3	103.5	103.4	101.5	99.4	96.4
Euro area	51.9	54.1	60.2	64.3	66.5	70.2	72.4	73.2	72.6	71.3	69.6	67.7

Source: IMF: Fiscal Monitor April 2014 (April 2014a).

Note: IMF estimates for Ireland are based on assessment of current policies as expressed in budget documentation and stability programme updates.

Table 7.3.2 Maturity Profile of Irish Sovereign Debt - excluding short-term debt, (€ millions)

Year of Maturity	Fixed Rate/Amortising Bonds	Floating Bonds	EU/IMF & Bilateral Facilities (excluding EFSM)	EFSM
2014	10		35	
2015	2,264		633	5,000
2016	10,197		2,502	
2017	6,419		3,291	
2018	9,287		3,700	3,900
2019	14,500		5,447	
2020	20,896		6,140	
2021	38		3,840	3,000
2022	40		1,228	
2023	5,042		398	
2024	6,682			800
2025	11,836			
Post 2025	972	25,034	18,411	9,800
Total	**88,182**	**25,034**	**45,624**	**22,500**

Source: NTMA (May, 2014).

Note: EFSM loans are subject to a seven year extension that will bring their weighted average maturity from 12.5 years to 19.5 years. The NTMA does not expect Ireland will have to refinance any of its EFSM loans before 2027 although the revised maturity dates of individual EFSM loans has yet to be determined.

The floating bonds are the bonds issued to the Central Bank of Ireland in February 2013 in exchange for the IBRC promissory notes.

Table 7.3.3 Cumulative Fiscal Adjustments 2008-2015, (€ billions)

	Total adjustment (including 2015)	2008-2010	2011-2013	2014	2015 (Signalled)
Revenue	**-11.5**	-5.6	-4.3	-0.9	-0.7
Expenditure	**-20.5**	-9.2	-8.4	-1.6	-1.3
of which					
Capital Expenditure	*-5.0*	*-1.6*	*-3.3*	*-0.1*	*0.0*
Current Expenditure	*-15.5*	*-7.6*	*-5.1*	*-1.5*	*-1.3*
Total adjustment	**-31.8**	-14.7	-12.6	-2.5	-2.0

Sources: Department of Finance budgetary documentation; Budget 2009 to Budget 2014 inclusive.
Notes: Figures may not sum due to rounding. Total adjustment includes the €2.0 of additional measures projected for 2015.

Notes

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