

Quarterly Economic Observer

Autumn 2017



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About NERI and this publication

The Nevin Economic Research Institute (NERI) was 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 23rd *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. Unless otherwise stated, the data cited in this Observer are the latest available as of the 8th September 2017. The final draft of this document was completed on the 14th September 2017.

This report has been prepared by staff of the Institute. The lead author of this QEO is Dr Tom McDonnell with contributions from Paul Goldrick-Kelly, Paul MacFlynn, Ciarán Nugent and Dr Lisa Wilson. We are grateful to our 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.

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The Nevin Economic Research Institute
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Executive Summary

This edition of the NERI's *Quarterly Economic Observer* (QEO) outlines our latest expectations for the economic outlook in the Republic of Ireland and Northern Ireland (Section 1) and examines public finances and revenue sufficiency in the Republic of Ireland (Section 2).

Economic Outlook for the Republic of Ireland

- The Irish economy is growing strongly and is likely to continue to do so for the remainder of this year and well into 2018. We project growth of 4.5% in 2017.
- Labour market conditions should continue to improve in the short-term with strong employment growth but with modest increases in real wages. The unemployment rate is projected to fall below 6% sometime in early 2018.

Macroeconomic performance & projection, Republic of Ireland

	2016	2016	2017	2018	2019
Real Output		<i>Percentage real change over previous year</i>			
Gross Domestic Product	€265.4bn	5.1	4.5	3.4	3.1
Personal Consumption	€96.6bn	3.3	3.3	2.8	2.6
Government Consumption	€28.4bn	5.3	2.6	2.1	2.0
Investment	€87.7bn	61.2	0.9	5.8	3.7
Exports	€335.0bn	4.6	5.1	4.4	3.7
Imports	€274.4bn	16.4	3.5	5.0	3.7
Earnings		<i>Percentage nominal change over previous year</i>			
Average Hourly Earnings	€22.04	0.6	2.1	2.6	2.7
Government Finances		<i>Percentage of GDP</i>			
General Government Balance	-€1.8bn	-0.7	-0.4	-0.1	0.1
Gross Debt	€200.6bn	72.8	70.0	68.6	66.8
Labour Force		<i>Percentage change over previous year</i>			
Employment	2,020,000	2.9	3.4	1.7	1.6
		<i>Percentage of labour force</i>			
Unemployment	173,100	7.9	6.3	5.8	5.5

- There is very little evidence of overheating in the economy:
 - Total employment and the employment rate are below pre-crisis peaks while the employment rate is below the EU average.
 - Price inflation is close to zero while average hourly earnings are growing at just 1.6% year-on-year

- The recent growth in consumption follows close to a decade of stagnation so a period of fast growth partially reflects pent-up demand.
 - Consumer credit is less than half of its 2009 peak.
 - Underlying investment, while growing quickly, is doing so from a low base.
- Risks to the forecast are mainly skewed to the downside. The outlook for 2019 is particularly uncertain. Brexit and the potential for a UK exit from the single market and the customs union remains the most significant downside risk although it is impossible to quantify the scale of the potential damage.

Revenue Sufficiency and Potential Reforms in the Republic of Ireland

- Measured on a per capita basis combined taxes and social contributions in the Republic are significantly lower than in comparator high-income EU countries.
- There is no evidence the Republic's taxation system is onerous in comparison to other high-income European states. In fact, the evidence is clear that the Republic is a low tax state.
- In light of this, and in the context of substantial areas of under-spend in certain public services and in infrastructure, the case for further cuts in the aggregate level of taxation is very weak.
- We find that there is a strong case for increasing taxes on wealth (inheritances, gifts, net wealth, property, land) as the Republic is a particularly low tax country when it comes to levies on stocks of wealth and the international evidence suggests that these taxes have minimal negative consequences for growth and, if designed properly, are highly progressive.
- The most substantial revenue deficit is in the area of labour taxation - specifically social contributions. The bulk of this deficit relates to employer PRSI. Substantial reform is needed in this area.
- Finally, we point out that tax expenditures damage growth by distorting resource allocation, by creating inefficiencies in production and consumption and by diverting economic activity toward rent-seeking behaviour. Tax expenditures also tend to favour high-income households so their elimination would have positive equity implications.

Outlook for Northern Ireland

- The Northern Ireland labour market weakened in the three months ending in July 2017. The unemployment rate dropped by 0.1% but the employment rate also dropped by 0.5%.
- More than a year on from the Brexit referendum the fall in the value of Sterling continues to weigh heavily on the economy. Whilst this provides a boost to exporters and the tourism sector, there are concerns that it will soon be outweighed by a decline in consumer sentiment within the domestic economy.
- Whether the positive effects of Sterling's depreciation can outweigh the negative impacts will determine the short-term future of the Northern Ireland economy. Any longer term outlook is still very much rooted in the outcome of Brexit negotiations.

1 Economic Trends and Outlook

1.1 World

The Republic of Ireland has a small trade-dependent economy and its performance is highly sensitive to the performance of the global economy and in particular to that of the United Kingdom (UK), the euro area and the United States (US). The Northern Ireland economy is also small and trade dependent with very close links to that of Great Britain. Most institutional forecasters are projecting moderate growth in the **world economy** in 2017. However, the OECD's [Composite Leading Indicators \(CLIs\)](#) which are designed to anticipate turning points in economic activity, point to tentative signs of easing growth in the UK over the next six to nine months.

Table 1.1 Dashboard of Macroeconomic Indicators, Selected Regions*

	2012	2013	2014	2015	2016	2017
Real GDP	<i>Percentage volume change over previous year</i>					
Euro area	-0.9	-0.3	1.2	2.0	1.7	1.8
United Kingdom	1.3	1.9	3.1	2.2	1.8	1.6
United States	2.2	1.7	2.4	2.6	1.6	2.1
Unemployment**	<i>Percentage of labour force</i>					
Euro area	11.3	12.0	11.6	10.9	10.0	9.3
United Kingdom	8.0	7.6	6.2	5.4	4.9	4.8
United States	8.1	7.4	6.2	5.3	4.9	4.6
Inflation***	<i>Percentage annual average rate of change</i>					
Euro area	2.5	1.3	0.4	0.0	0.2	1.7
United Kingdom	2.8	2.6	1.5	0.1	0.6	2.5
United States	2.1	1.5	1.6	0.1	1.3	2.7
Compensation per Employee	<i>Percentage change from previous period</i>					
Euro area	1.1	1.4	1.4	1.4	1.4	1.8
United Kingdom	1.7	2.1	0.7	1.2	2.8	2.5
United States	2.4	1.1	2.6	2.6	2.1	2.5
Current Account Balance	<i>Percentage of Gross Domestic Product</i>					
Euro area	1.3	2.2	2.4	3.0	3.4	3.0
United Kingdom	-3.7	-4.4	-4.7	-4.3	-4.4	-3.3
United States	-2.8	-2.2	-2.3	-2.6	-2.6	-2.7
Fiscal Balance	<i>Percentage of Gross Domestic Product</i>					
Euro area	-3.6	-3.0	-2.6	-2.1	-1.7	-1.5
United Kingdom	-7.7	-5.6	-5.7	-4.4	-3.1	-2.8
United States	-7.9	-4.4	-4.0	-3.5	-4.4	-4.0

Notes: *2017 figures for *Inflation*, *Current Account* and *Fiscal Balance* are latest IMF projections. 2016 figure for US *Fiscal Balance* is latest IMF projection. 2016 and 2017 figures for *GDP*, *Unemployment* and *Compensation per Employee* are latest OECD projections.

**National definitions

***Average consumer prices

Sources: IMF [World Economic Outlook Database](#), OECD [Economic Outlook: Annex Tables](#)

The CLIs indicate stable growth momentum in the US and Canada; in the euro area as a whole, and in each of China, Japan and Brazil. The most recent [IFO World Economic Climate survey](#) of economic experts suggests the world economic climate is generally good and that the global economic recovery will continue, albeit at a slower pace in the second half of 2017. The only major advanced economy to report a deteriorating economic climate was the UK where overall sentiment is now negative. The prolonged uncertainty about Brexit appears to be weighing on sentiment towards the UK economy with the outlook for investment and consumption seen as particularly negative.

The IMF expects the pickup in **global** growth to remain on track with global output projected to grow by 3.5% in 2017 and 3.6% in 2018. Baseline forecasts should be treated with caution given the number of downside risks to the global economy, the uncertain future path of innovation and productivity growth, the unprecedented level of uncertainty about US fiscal and trade policy, and the uncertain outcome of the Brexit negotiations. In addition, low commodity prices could damage commodity exporters while a normalisation of monetary policy in the US could lead to capital flowing out of emerging economies. Individually or in combination this would slow growth and increase macroeconomic strains in a number of countries. The IMF and other agencies have also pointed to financial sector risks and excessive credit growth in China which could cause a sudden sharp slowdown in the global economy.

While Brexit continues to cloud the outlook for the **UK** economy there is increasing evidence of slow down with GDP growth of just 0.2% in the first quarter of 2017 and then 0.3% in the second quarter. The volume of retail trade fell month-on-month in May and also in July. The value of Sterling continues to fall and this decline is now feeding through into higher inflation and downward pressure on real wages. Annual HICP inflation was 2.6% in July. Real wages grew by 2.1% year-on-year in the second quarter of 2017 but fell by 0.5% in real terms. Despite the fall in Sterling the UK is on course to have a current account deficit in excess of 3% in 2017. On a more positive note, the unemployment rate is down to 4.4% which is the lowest rate seen since 1975.

The **euro area's** performance is improving and the bloc grew by 0.5% in the first quarter and 0.6% in the second quarter. The latest Purchasing Managers' Index for the euro area suggests that reasonably strong growth will continue until the end of 2017. Inflation was stable at a below target 1.3% in July and the ECB's monetary policy

stance should remain highly supportive over the short-to-medium term, although its asset purchases will start to decline. Unemployment remains high in the euro area as a whole but is firmly on a downward trend. The unemployment rate was 9.1% in June marking the lowest rate since February 2009. However, there is extremely wide variation within the bloc – the unemployment rate was 3.8% in Germany and 21.7% in Greece.

The **US** economy grew by 0.3% in the first quarter and by 0.6% in the second quarter. The labour market is continuing to strengthen. Annual inflation was 1.7% in July while average hourly earnings were up 2.5% year-on-year in the same month. The unemployment rate was 4.3% in July equalling a 16-year low. Monetary policy is expected to tighten with one more rate increase in 2017 and further rate increases in 2018. There is a concern that tightening monetary policy will impact on borrowers domestically and will increase economic instability in emerging economies with dollar liabilities. Momentum towards a more expansionary fiscal stance in the form of higher infrastructure spending and tax cuts have stalled somewhat. Even so, fiscal expansion may still happen in 2018.

1.2 Republic of Ireland

Trends and analysis

The economy appears to have grown strongly in 2016. National Income and Expenditure data from the CSO shows that real GDP grew 5.1% in 2016 (5.2% in current prices) while real GNP grew by 9.6%. The quarterly national accounts show an annual increase of 6.1% in real GDP in the first quarter of 2017. Notably *information & communication* was up 28% over the period while *building & construction* was up 20.7%. However, the Irish economy is distorted by a large multinational sector and the scale of distortion to the national accounts from certain multinational activities make headline GDP and GNP unreliable as barometers of the Republic's economic performance and the economy's cyclical position.

The CSO have developed a modified estimate of Gross National Income in an attempt to provide a less distorted picture of the underlying performance of the economy. This modified estimate excludes certain globalisation effects that disproportionately affect the measurement of the size of the economy. This modified estimate, known as GNI*,

excludes some of the impact of re-domiciled companies (€5.8 billion in 2016) as well as the depreciation of R&D related intellectual property assets (€27.8 billion in 2016) and the depreciation of leased aircrafts (€5 billion in 2016). The CSO estimate that modified GNI (GNI*) was €189.2 billion in 2016 or 68.7% of GDP (€275.6 billion).

While GDP in current prices grew by a total of 49% in the decade between 2006 (€185 billion) and 2016 (€275.6 billion), GNI* at current prices has grown by a much more modest 17.9% over the same decade increasing from €160.4 billion to €189.2 billion. Modified GNI is estimated to have grown by 9.4% in 2016. Unsurprisingly the public finances appear much more fragile when modified GNI is used as the denominator. While the debt to GDP ratio was 72.8% at the end of 2016 the debt to GNI* was 106%.

Table 1.2 Dashboard of Macroeconomic Indicators, Republic of Ireland

	2012	2013	2014	2015	2016	Latest
<i>Percentage volume change over previous year</i>						
Gross Domestic Product	0.0	1.6	8.3	25.6	5.1	6.1 (Q1'17)
Domestic Demand	2.4	-1.6	8.3	9.3	21.3	6.5 (Q1'17)
Personal Consumption	-0.9	-0.7	2.0	4.2	3.3	1.8 (Q1'17)
Retail Sales (SA)	-0.9	1.3	8.2	9.5	6.7	3.3 (Q2'17)
Industrial Production	-1.5	-2.2	22.9	34.8	0.7	-0.9 (Q2'17)
<i>Percentage annual average rate of change</i>						
Employment	-0.6	2.4	1.7	2.6	2.9	3.5 (Q1'17)
Average Hourly Earnings	0.2	-0.3	-0.1	0.2	0.6	1.6 (Q2'17)
Average Weekly Earnings	0.6	-0.5	0.3	1.2	1.1	2.2 (Q2'17)
Inflation (HICP)	1.9	0.5	0.3	0.0	-0.2	0.4 (M8'17)
<i>Percentage of annual GDP or quarterly GDP</i>						
Investment	19.6	18.7	20.8	20.3	31.8	22.2 (Q1'17)
Current Account Balance	-2.6	2.1	1.6	10.9	3.3	12.4 (Q1'17)
Government Balance	-8.0	-6.1	-3.6	-1.9	-0.7	-2.0 (Q1'17)
Government Gross Debt	119.5	119.4	104.5	76.9	72.8	74.3 (Q1'17)
<i>Percentage of labour force</i>						
Unemployment	14.7	13.0	11.3	9.4	7.9	6.3 (M8'17)
Long-term Unemployment	9.0	7.8	6.6	5.3	4.2	3.6 (Q1'17)
<i>Percentage of population</i>						
Deprivation	26.9	30.5	29.0	25.5	-	25.5 (2015)
At Risk of Poverty	17.3	16.5	17.2	16.9	-	16.9 (2015)
<i>Percentage</i>						
Gini Coefficient	31.8	32.0	32.0	30.8	-	30.8 (2015)

Notes: Quarterly ('Q') and monthly ('M') data is compared to same period of the previous year. Rates of change represent the average value over the four quarters, or twelve months. *Gross Debt* is end-year figure as a % of annualised GDP or latest quarterly figure as % of annualised GDP. *Unemployment* is average for four quarters or latest quarter seasonally adjusted.

Sources: CSO: [National Income and Expenditure](#), CSO [Quarterly National Accounts](#), CSO [Retail Sales Index](#), CSO [Industrial Production and Turnover](#), CSO [Consumer Price Index](#), CSO [Earnings and Labour Costs Survey](#), CSO [Balance of International Payments](#), CSO [Government Finance Statistics](#), CSO [Quarterly National Household Survey](#), CSO [Survey on Income and Living Conditions](#).

Despite the issues surrounding measurement of national output the dashboard of indicators in Table 1.2 makes clear that the real economy has been growing strongly. Employment grew 2.9% in 2016 and 3.5% on an annual basis in the first quarter of this year. The seasonally adjusted unemployment rate was 6.3% in August compared to 7.9% in August 2016. Unemployment fell by 33,900 over the year. Construction grew 15.1% in real terms in 2016 and 20.7% on an annual basis in the first quarter of this year. Personal consumption grew by 3.3% in real terms in 2016 though growth slowed to 1.8% on an annual basis in the first quarter of 2017. Finally, activity indicators such as volume retail sales have been strong with growth of 6.7% in 2016 and an average of +3.1% in the first half of 2017.

In addition, the CSO have developed a new indicator called modified domestic demand which is intended to give a more accurate measure of activity in the domestic economy by stripping out intellectual property investment and purchases of aircraft by leasing companies. Modified domestic demand grew by 4.8% in 2016 and by 3.5% on an annual basis in the first quarter of 2017.

Despite strong growth we do not see evidence that the economy is overheating. Total employment and the employment rate are below pre-crisis peaks while the employment rate is below the EU average. Price inflation is close to zero while average hourly earnings are growing at just 1.6% year-on-year. The recent growth in consumption follows close to a decade of stagnation so a period of fast growth partially reflects pent-up demand. Consumer credit is just 43.4% of its 2009 peak and 77.7% of its 14 year average. Underlying investment, while growing quickly, is doing so from a low base. It is true that property prices are growing quickly. However, this reflects the mismatch between supply and demand in the housing market where supply is running at close to half of projected long-run demand.

The headline current account surplus was 3.3% of GDP in 2016 and 12.4% in the first quarter of 2017. However, the current account is distorted in much the same way as GDP and the CSO have developed a modified current account balance (called CA*) that records the retained earnings of redomiciled firms as functionally equivalent to factor income outflows and that adjusts for the depreciation of certain capital assets (intellectual property and aircraft leasing). Modifying the current account balance in this way turns a 2016 surplus of €9.2 billion into a deficit of €29.4 billion (15.5% of GNI*). Ostensibly this suggests the economy is dramatically overheating. However,

[Coffey \(2017\)](#) argues that the sum of net aircraft and intellectual property imports (balance sheet relocations of multinationals worth €42.8 billion in 2016) should be added back into the modified current account balance. He estimates that doing so generates a CA* surplus of 7% of GNI*. Overall, our contention is that the evidence strongly suggests that the Irish economy is not yet overheating.

Box 1.1 A Non-Employment Index

The [Non-Employment Index](#) is compiled to complement traditional labour market indicators for more comprehensive analysis of labour markets. The measure fills a widely recognised gap in the study of labour markets and is designed to estimate an economy's available labour supply and to address in greater depth the extent to which an economy's potential labour force is utilised. The index counts an array of individuals hitherto categorised as outside of the labour force in the calculation of labour market indicators such as the unemployment rate (e.g. students, discouraged workers and those who currently don't want a job). In addition, the measure includes workers who are generally considered employed but are not working to their full potential i.e. the involuntarily underemployed. These categories of potential additional labour are weighted according to their respective historical transition rates from inactivity to employment to take account of differences in their attachment to the labour market.

Building on work in the U.S by [Hornstein, Kudlyak and Lange \(2015\)](#), [Byrne & Conefrey \(2017\)](#) have proposed a similar measure for Ireland. Their findings on underemployment ([similar to findings produced recently by NERI](#)) have implications for the current debate on the risk of the Irish economy 'over-heating' and the associated inflationary pressure on wages. The degree of the identified underutilization suggests that there is still the potential for significant employment growth in Ireland before such inflationary pressures come about.

The largest category of non-employed workers considered in the index are potential workers who reported that they do not want a job. The absolute figure (2015) is over 800,000 individuals who are not counted in the unemployment rate. This is a significant number. However, it is also important to consider this figure in context and to note some of the characteristics of this group. According to the most recent QNHS data (2017 Q1), the principal economic status of 27% of these respondents are current students, 19% are retired, 9% are disabled and 41% are on home duties. When considering the age profile 20% are under-19 and 23% are over 64. As a proportion of the working age population, this figure has actually decreased slightly since 2002 (23.45%-22.26%).

Maximizing the employment rate through the reduction of barriers to employment is key to growing the productive capacity of the economy and should be a key policy priority. However, there are few practical policy options to activate most individuals within this group. A significant proportion of the 320,000 or so individuals who report that they do not want a job and are on home duties likely decide to do so after a cost/benefit analysis which includes the prohibitive cost of childcare in Ireland. Providing childcare supports at a similar level to our European counterparts would make it more attractive for many of these individuals to enter the labour force.

Outlook

We project that real GDP will grow by 4.5% in 2017 (see Table 1.3). Such strong growth will come on the back of an improving labour market and in particular very

strong employment growth of close to 3.4% in 2017. Employment growth and GDP growth will be slower in 2018 and 2019 as the economy approaches capacity. Even so, we are projecting above trend GDP growth of 3.4% in 2018 and 3.1% in 2019. There is a high degree of uncertainty around the 2019 projection given the lack of precedent for an event like Brexit and the uncertainty surrounding the outcome of negotiations. In addition, we make the technical assumption of no further volatility to the national accounts arising from multinational activity. Risks to the baseline forecast are discussed in Box 1.2.

Table 1.3 Macroeconomic performance & projection, Republic of Ireland

	2016	2016	2017	2018	2019
Real Output		<i>Percentage real change over previous year</i>			
Gross Domestic Product	€265.4bn	5.1	4.5	3.4	3.1
Personal Consumption	€96.6bn	3.3	3.3	2.8	2.6
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Labour Force		<i>Percentage change over previous year</i>			
Employment	2,020,000	2.9	3.4	1.7	1.6
		<i>Percentage of labour force</i>			
Unemployment	173,100	7.9	6.3	5.8	5.5

Notes: Projections for *Gross Domestic Product* and components refer to real economic activity; *Investment* refers to Gross Fixed Capital Formation; *Employment*, *Unemployment* and *Earnings* all represent the average value over the four quarters.

Sources: NERI estimates for 2017-2019; 2016 data is from CSO [National Income and Expenditure](#), CSO [Earnings and Labour Costs Survey](#), CSO [Government Finance Statistics](#) and CSO [Quarterly National Household Survey](#).

Personal consumption is projected to grow strongly in the short-term (3.3% in 2017 and 2.8% in 2018). The higher consumption levels will be driven by a sharp increase in employment, a falling unemployment rate, rising wage and income levels, and improving household net wealth. The dramatic increase in investment in 2016 of 161.2% will mean that headline gross fixed capital formation (investment) will not increase much if at all in 2017. However, this will mask strong growth in underlying investment i.e. investments other than those in intellectual property and aircraft

leasing. Underlying domestic demand will be the main driver of growth in 2018 and 2019 driven by strong growth in housing output as supply responds to demand.

Brexit and a weakening Sterling will put downward pressure on net exports. At the same time, exports will benefit from the improving performance of the euro area. Headline imports will grow less quickly in 2017 as we anticipate much of the sharp rise in imports in 2016 was related to once-off activity multinational activity that will not be repeated in 2017. Underlying imports (imports excluding R&D assets) should grow strongly on the back of robust growth in domestic incomes and demand.

Box 1.2 Macroeconomic Risks and Uncertainties: Republic of Ireland

The major macroeconomic risks and uncertainties are essentially unchanged since the Summer QEO. These can be broadly identified as:

- A) Brexit.** The outcome of negotiations will have a significant impact on the Republic's economic performance. It is impossible at this stage to quantify the scale of the damage though a **UK exit from the single market and customs union** along with the imposition of tariffs would be particularly damaging. The agri-sector is particularly vulnerable to such an outcome. The UK's lower growth potential will translate into structurally lower demand for exports from the Republic, while a weaker Sterling would reduce exports in the short-term. Finally, a prolonged period of uncertainty around the final deal will lead to delays and postponements in investment decisions.
- B) US Policy.** A US led **move towards protectionism** would have a very damaging impact on the Republic given the openness of the Irish economy. At the same time, proposed policy changes in the US in relation to **corporate taxation** would negatively impact on the Republic's attractiveness as a location for FDI.
- C) European policy.** The Republic's tax and regulatory advantages may also come under threat from momentum towards a **Common Consolidated Corporate Tax Base** at EU level and from an understandable **desire to prevent facilitation of aggressive tax avoidance** by corporations. These developments are however welcome from an economic justice perspective. Finally, while monetary policy should remain supportive in the short-term the ECB will start to tighten policy eventually and this process could be accelerated if the economic recovery in the euro area becomes more established. Tightening monetary policy and increasing **interest rates** would prove challenging for the Irish economy given the still high public and private debt ratios. Rising interest rates would exert downward pressure on domestic demand and employment.
- D) Other.** Geopolitical instability could lead to an increase in **oil prices**. As an energy importer, a sharp rise in oil prices could reduce real household disposable incomes and personal consumption. It would also reduce investment to the extent that it impacts on corporate balance sheets. A number of analysts have pointed to concerns about a **credit bubble and potential crash in China**. If these concerns are realised it could lead to a slowdown in the world economy.

Strong job growth and a tightening labour market (falling unemployment rates and increasing job vacancy rates) should increasingly feed through into faster wage growth. After a long period of stagnation real wages are set to increase each year out to the end of the decade. Workers in fast growing sectors such as construction should experience particularly strong gains. While inflation should remain subdued in the short-term wage pressure and strengthening domestic demand should start to push up prices gradually over the forecast horizon. At the same time, further falls in Sterling would put downward pressure on prices. The public finances should continue to improve over the medium-term.

1.3 Northern Ireland

According to the Northern Ireland Composite Economic Index (NICEI) the Northern Ireland economy grew by 0.3% in the first quarter of 2017. This is down from the 2.1% growth recorded in the last quarter of 2016 and just ahead of the 0.2% growth in UK GDP in the first quarter of 2017. More than a year on from the Brexit referendum the fall in the value of Sterling continues to weigh heavily on the economy and the Effective Exchange Rate of Sterling has fallen 4% in recent months. Whilst this provides a boost to exporters and the tourism sector, there are concerns that it will soon be outweighed by a decline in consumer sentiment within the domestic economy. Inflation which reached a high of 2.7% in May of this year is likely to face further pressure in the final months of 2017 owing to the weakness of Sterling. Whether the positive effects of Sterling's depreciation can outweigh the negative impacts will determine the short-term future of the Northern Ireland economy. Any longer term outlook is still very much rooted in the outcome of Brexit negotiations.

The *Production* sector was responsible for much of the significant upturn in total output growth in the final quarter of 2016. However, Production sector growth in the first quarter of 2017 fell to -0.8% and was followed by a significant decline of 3.6% in the second quarter. Much of the recovery in the latter half of 2016 was driven by one-off factors. There was a significant, above average increase in both the *Water* and *Mining* sectors in Q4 2016. Both of these sectors make up less than 12% of the total sector, but the increases were large enough to impact the overall index. The boost for the Mining sector was maintained in Q1 2017, but growth in Water, the larger of the two sectors, was not.

The *Manufacturing* sector showed strong growth in Q4, which was maintained in Q1 of 2017. Most of this growth was driven by a recovery in engineering, pharmaceuticals and basic metals. This was eclipsed entirely in Q2 as output in *Food, Beverage and Tobacco* manufacturing decreased by almost 20%. This is likely due to the closure of the JTI (Japan Tobacco International) manufacturing plant in Ballymena. The closure began in 2016 but the final wind-down is likely to have distorted overall growth in the sector in the second quarter. The food manufacturing sector has been in subtle decline since mid-2012. This is concerning because the food manufacturing sector, and primary production in general, would be expected to gain most from a depreciation in Sterling. Secondary manufacturing tends to require more inputs many of which need to be imported and so the positive impacts of depreciation are usually skewed toward primary manufacturing. Even accounting for the impact of JTI, at present the food manufacturing sector does not look to be in good health. This is troubling because the primary manufacturing sector is the most labour intensive and is likely to have the largest impact in the local labour market. In addition, the primary manufacturing sector and Food and Beverages in particular have been identified as the sector most at risk from a hard Brexit. The future customs arrangements on the Island of Ireland will be key to assessing the prospects for this sector in the medium term.

There was a contraction of 1% in the *Services* sector in the second quarter of the year, and within this the *Wholesale, Retail, Accommodation and Food* sector saw a small decline of 0.7%. This sector which accounts for 36% of Services output has been flat since the third quarter of 2016. The *tourism* sector would be expected to see a large boost from a more favourable exchange rate and there has been a notable upsurge in hotel and guesthouse occupancy rates which were up 14% by June of this year. This would seem to indicate that while increased tourism may be providing some boost to the sector, it is likely being outweighed by pressures in the domestic economy. There are no official indicators for domestic demand in Northern Ireland, but unofficial measures can provide some insight. The Danske Bank Northern Ireland Consumer Confidence Survey indicated a sharp increase in sentiment between Q4 2016 and Q1 2017. In light of the increased inflationary pressures, this was somewhat surprising. The same survey now indicates that sentiment fell in the second quarter of 2017, albeit marginally. At UK level, the second estimate of UK GDP indicated a significant fall in household spending in the second quarter. The degree to which this dynamic is

present in the Northern Ireland economy may explain the weakness in the Service sector industries, but it is difficult to evaluate this from the data available at present.

Table 1.4 Dashboard of Macroeconomic Indicators (Northern Ireland)

	2012	2013	2014	2015	2016	Latest
<i>Percentage volume change over previous year</i>						
Gross Value Added	1.1	1.1	0.2	1.6	-	
NICEI	-1.4	0.0	0.7	1.5	1.6	
Index of Services	-1.4	0.5	1.2	1.3	3.2	
Index of Production	-1.4	1	2.3	2.0	0	
<i>Percentage annual average rate of change</i>						
Employment Rate	-0.3	-0.6	1.8	0.3	1.5	-0.5 (M5-M7 '17)
Average Hourly Earnings	1.5	2.5	-1.3	4.2	-	4.2 (2016)
Price Inflation (UK)	2.8	2.6	1.5	0	1	2.3 (M8'17)
<i>Percentage of GVA</i>						
Exports	28.9	30.0	28.4	26.5	-	
Government Spending	61.6	60.2	60.6	-		
<i>Percentage of labour force</i>						
Unemployment	7.5	7.5	6.4	6.1	5.8	5.3 (M5-M7 '17)
Youth Unemployment	20.1	22.5	19	19.3	14.9	11.6 (M5-M7 '17)
Long-term Unemployment	3.8	4	3.4	3.6	2.6	2.6 (M5-M7 '17)
<i>Percentage of population</i>						
Relative Poverty	19	21	22	18	-	18 (2015)

Notes: Employment Rate refers to all persons in employment (ILO definition) aged 16-64 as proportion of all persons 16-64. GVA is deflated using UK GDP deflator. NI Exports refer to sales outside the UK. Exports refers to both goods and services sold from NI beyond the UK. Government Spending refers to Total identifiable expenditure on services apportioned to NI.

Source: [ONS Regional Gross Value Added](#) (Income Approach); [HMT GDP Deflators](#); NISRA [Northern Ireland Composite Economic Index](#); NISRA [Index of Production](#); NISRA [Index of Services](#); NISRA [Labour Force Survey](#); NISRA [Annual Survey of Hours and Earning](#); ONS [Consumer Price Inflation](#); HMT [Public Expenditure Statistical Analyses](#); NISRA [Households Below Average Income](#)

The *Construction* sector saw the largest downturn of any sector in the first quarter of 2017, but indicators of business sentiment in the sector suggest that this may be short-lived. Infrastructure spending provided a significant increase to activity in Q4 of 2016, but this was more than wiped out in Q1 by a decrease in private sector infrastructure output. However, over the last two years, public sector infrastructure output has actually fallen behind that of the private sector for the first time on record. This situation may be altered if the £400m of infrastructure funding agreed between the DUP and the Conservative party is realised in Northern Ireland in the near future, but at present infrastructure output is dependent on the private sector. Housing output increased substantially in Q1 and a recent survey from the Construction Employers Federation would seem to indicate that this housing expansion may lift overall growth within the sector in the coming quarters. Once again, this growth is being driven predominantly by the private sector.

The Northern Ireland labour market weakened in the three months ending in July 2017. The unemployment rate dropped by 0.1% but the employment rate also dropped by 0.5%. Long-term unemployment, defined as those in unemployment for over 12 months has remained static for the past year and now comprises over half of the total of unemployed persons.

Box 1.3 Job Quality, Flexibility and The Taylor review of modern working practices

In the Autumn of 2016 Prime Minister Theresa May commissioned Matthew Taylor, Chief Executive of the Royal Society for the Encouragement of Arts, Manufactures and Commerce to undertake a review to consider how employment practices need to change in order to keep pace with modern business models. One of the central aims of the review was to consider the extent that emerging business practices put pressure on the trade-off between flexible labour and benefits such as higher pay or greater work availability, so that workers lose out on all aspects.

The report '[Good work: The Taylor review of modern working practices](#)' was published in July describing itself as having '*a single overriding ambition: All work in the UK economy should be fair and decent with realistic scope for development and fulfilment*'. It goes on to explain why decent work matters and outlines seven actions that need to be taken to achieve the goal of fair and decent work. It describes decent work as that which benefits employees through good rewards, security of employment, predictability in terms of working hours, training and development, trade union presence, good communication and ways of working that support task discretion and involve employees in securing business improvements.

The identification of all of these aspects of job quality is to be welcomed, particularly in the context of an increasing body of evidence demonstrating the importance of good quality work for individual workers, business productivity and performance, the economy and society. Disappointingly however in addressing the question of whether demand for flexible labour puts pressure on job quality the Taylor Review succumbs to the myth that job quality must be compromised in order to achieve flexible employment. The Taylor Review presents as inevitable that in return for flexibility workers should expect to trade-off on different aspects of job quality. Specifically, Taylor states that '*in return for greater job security individuals may decide to reduce their flexibility. Likewise, those opting for maximum flexibility may find that pay suffers as a result with fewer opportunities for further development through training.*'

However, it is not at all clear why these trade-offs to job quality are inevitable. Why should flexibility come at the cost of job security? Or pay? Or training and development? The Taylor Review does not provide answers to these questions; questions which will become increasingly pertinent if as the evidence suggests workers and businesses increasingly seek flexible labour, the number of poor quality jobs rise and productivity growth remains flat. All in all, the Taylor Review remains overly timid and avoids the difficult questions. In doing so it does not speak to the central aims of the review, and in the end, provides no guidance to Government on how it might go about making flexible labour decent work.

2 Revenue Sufficiency and Potential reforms in the Republic of Ireland

2.1 Introduction

The general fiscal position of the Irish state has steadily improved over the last several years. The most recent data for the last full fiscal year 2016 show a general government deficit of just over €1.8 billion or 0.7% of GDP. Gross public debt has declined from a year-end peak of €215.3 billion to €200.6 billion between 2013 and 2016. This same decline measured relative to GDP represents a fall from 119.4% to 72.8% of GDP by the final quarter of 2016, though the improvement is greatly exaggerated by the large and distorted nominal increase in GDP observed in 2015.

While these developments reflect a welcome improvement in the sustainability of the public finances, other longstanding issues exist in relation to the sufficiency of expenditure by government (McDonnell and Goldrick-Kelly, 2017)¹ and, by extension, aggregate state revenue in the form of taxes and social contributions.² We discuss taxation in aggregate terms, as well as under a number of broad subheadings in comparison to other, similarly economically developed, European states.

We find that aggregate revenues in Ireland are significantly lower than in comparator countries. Linking this to our findings in the Summer 2017 Quarterly Economic Observer (QEO),³ we see this revenue shortfall as directly leading to a number of spending deficits that are troubling from a long-run economic growth perspective. In light of these deficits, as well as cumulative pressures arising from the maintenance of expenditures in real terms given an expanding and ageing population, we conclude that the case for tax cuts in subsequent Budgets is very weak. Forthcoming budgets should, at the very least, maintain aggregate taxation levels and consider those revenue-raising measures most consistent with inclusive and sustainable growth.

¹ McDonnell, T. and P. Goldrick-Kelly (2017) [Public Spending in the Republic of Ireland: A Descriptive Overview and Growth Implications](#), NERI Working Paper No. 46, June 2017.

² The OECD publication [Taxing Wages 2015-2016](#) treats compulsory social security contributions (SSCs) paid to general government as tax revenues. The OECD points out that being compulsory payments they clearly resemble taxes. They also note that better comparability between countries is obtained by treating social security contributions as taxes. Consequently all references to 'aggregate revenues' in this section of the QEO refer to the aggregate of taxes and SSCs.

³ NERI (2017) [Quarterly Economic Observer](#), Summer 2017.

2.2 The Public Finances

The Republic's general government deficit has shown annualised improvement from its peak in 2010 and has declined to €1.8 billion or 0.7% of GDP in 2016. This represents steady improvement over 2015's deficit of approximately €5 billion or 1.9% of GDP and 2014's deficit of €7.1 billion or 3.7% of GDP. This period has also been associated with a decrease in the gross government debt from a year-end nominal maximum of €215.3 billion, or 119.4% of GDP in 2013, to €200.6 billion or 72.8% of GDP in 2016. Importantly this ratio has been skewed downwards by the 2015 distortion to GDP. The most recent quarterly data for Q1 2017 show an increase in the nominal face value of gross government debt to €208.2 billion, though this is primarily related to greater issuance of government bonds.

Recently observed, substantial declines in gross debt to GDP ratios are misleading however, due to a major positive shift in statistically measured output, which largely reflect certain multinational activity. A significant portion of this activity is not substantively tied to domestic economic activity and potential tax yields are likely to be significantly less than for other economic activity. The Fiscal Advisory Council,⁴ as a result, prefer a measure of 'debt to government revenue' as a measure of debt sustainability. Using their methodology, the ratio of Irish gross debt to total government revenue amounted to 284.2% in the first quarter of 2017, only exceeded within the EU by Greece, Portugal and Italy. This suggests continued relative fragility in the public finances and potential revenue insufficiency. On the other hand, debt to government revenue is itself problematic as a measure of fiscal sustainability as aggregate government revenue is fundamentally a policy choice. Finally, as noted in the previous section, the Republic's debt to GNI* ratio was 106% in 2016.

Adherence to the preventative arm of the Stability and Growth Pact taking into account the full-year cost of previously introduced measures implies a residual net fiscal space of around €350 million (assuming the proposed public sector pay agreement is approved) is available to government for Budget 2018.⁵ Net fiscal space expands after 2018 given current policy commitments and forecasts of Ireland's structural position. The headline fiscal space may be misleading, however, as demographic shifts and changes in the price level may erode this space in real terms. Taking the Fiscal

⁴ IFAC (2017) [Fiscal Assessment Report](#), June 2017.

⁵ Department of Finance (2017) [Summer Economic Statement 2017](#), July.

Council's estimates of 'standstill costs', implies a deterioration in public service quality given currently outlined resource allocation to tax cuts.

2.3 Per capita Revenue Comparisons

The most commonly used way to compare the scale of the tax take in different countries is to use GDP as the denominator. This is intended to reflect government receipts scaled to fiscal capacity. Measured in these terms, the Republic is one of the lowest tax jurisdictions among the advanced economies at 27.2% of GDP in 2016.⁶ Total revenue is 19 percentage points less than the Euro Area average and 3.7 percentage points less than the United States. The IMF forecast that this will decline to 26.3% of GDP in 2022, further widening the gaps to peer countries.

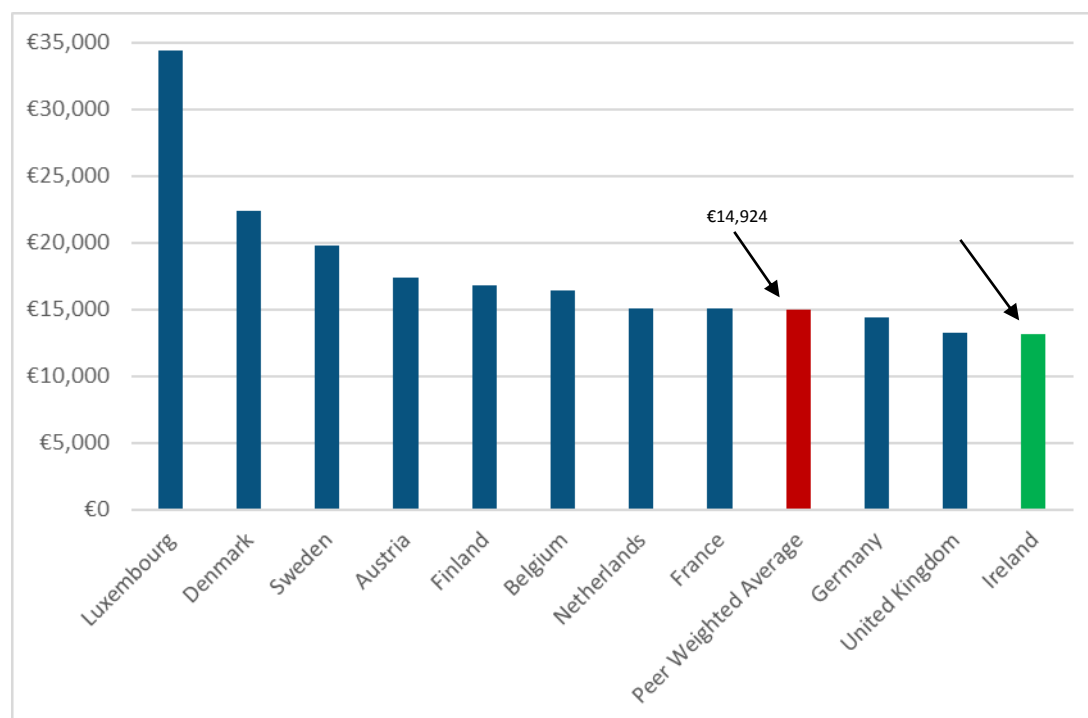
However, comparisons based on GDP are highly problematic given the substantial distortionary effects of multinational activity on the Irish national accounts. Comparisons based on GNI or GNI* are also problematic as neither of these indicators represent the full fiscal capacity of the state most notably revenue from corporation tax. There are also no international comparators for GNI*. Therefore, following the methodology of the Summer QEO, we scale revenue from Tax and Social Contributions (T&SC) to population – that is, we calculate tax contributions per person. Comparisons can then be made relative to other high income EU economies, specifically those with a GDP per capita of €30,000 or more in 2014. The qualifying 'peer countries' used for comparative purposes are Luxembourg, Denmark, Sweden, Netherlands, Austria, Finland, Germany, Belgium, United Kingdom (UK) and France.

Chart 2.1 displays per capita T&SC in 2015. While social contributions are occasionally argued to be outside of 'overall tax paid' they are included here given their involuntary nature as per OECD methodology (see footnote 2). The Republic is distinctive for its relatively low levels of aggregate T&SC receipts, the lowest in per capita terms. The relatively small contribution of social security contributions to revenue explains the Republic's low level of aggregate T&SC receipts. If we exclude social contributions the Republic rises to 7th of the 11 comparators with per capita tax receipts exceeding the population weighted peer country average by over €600 per person, or €2.9 billion when scaled to the overall population. Peer country average social contributions,

⁶ IMF (2017) [Fiscal Monitor](#), April 2017.

however, exceed Irish levels by €10.9 billion scaled over the population. The net difference is over €1,700 per person or €8 billion in aggregate.

Chart 2.1 Per Capita Receipts from Taxes and Social Contributions 2015



Sources: [Eurostat \(2017\) Main National Accounts Tax Aggregates](#). [Eurostat \(2017\) Population on 1 January Age and Sex](#). Author's calculations.

Aggregate T&SC levels greatly determine the capacity to deliver public services and infrastructure and provide redistributive transfers. However, the composition of the tax take is also of relevance. The relative division of taxes under different compositional headings can and does effect resource allocation and economic growth. Different types of tax are also incident on different portions of the population and have differential impacts in terms of progressivity, effecting inequality. It is useful to decompose aggregate T&SCs under three broad economic activities: *Labour*, *Consumption* and *Capital*. *Taxes on labour* refer to those linked to wages and are withheld at source for the most part. These deductions are paid by employers and employees and include social contributions. Taxes and compulsory contributions levied against the income of the non-employed are also included.⁷ *Consumption taxes* are levied on transactions between consumers and buyers as well as on finished goods.

⁷ This category relates to taxes levied on social transfers and old-age pension schemes. Self-employed contributions are allocated to Capital.

Taxes on capital are those incident on capital and business income as well as those on stocks of capital.

Broad ‘implicit’ tax rates or ITRs are presented – the ITR is the ratio of tax collected to the respective tax base, representing all activity under a given heading. Table 2.1 displays the Republic’s ITRs relative to the peer weighted average as well as the implied collection gaps calculated on that basis. The aggregate tax on labour in the Republic of Ireland is lower than in the comparator average by approximately €2.2 relative to its own base. This is netted out by consumption taxation, where it is implied that Ireland collects an above average amount of tax (€2.6 billion).

The largest discrepancy, however, is exhibited by capital taxation, where the application of peer average implicit rates (assuming no other changes) would net €19.1 billion in extra revenue. These bases can, however, be biased according to effects similar to those that render GDP problematic, particularly in the case of capital. Direct comparisons should be treated with extreme caution. With this in mind, the following sections decompose respective tax takes according to average payments per person in a given jurisdiction.

Table 2.1 Comparison of Implicit Tax Rates 2015

Country	ITR Labour %	ITR Consumption %	ITR Capital %
Ireland	32.9	24.2	14.5
Peer Weighted Average (PWA)	35.7	21.1	33.7
Ireland gap to PWA	2.8pp	-3.1pp	19.2pp
Implied Ireland gap to PWA (total) Billions €	2.2	-2.6	19.1

Sources: [Eurostat \(2017\) Taxation trends in the European Union](#). Author’s calculations.

Notes: Implicit tax rates (ITR) measure the ratio between tax revenue under each category and their respective base. The ITR on labour is the sum of all direct and indirect taxes as well as social contributions from employees and employers levied on employed labour income divided by total employee remuneration in that jurisdiction. The ITR on consumption relates to consumption taxes divided by the final consumption expenditure of households in that territory. The ITR on Capital is the ratio between capital tax revenue and potentially taxable capital and business income. It should be noted that due to data unavailability, Luxembourg is excluded in comparator calculations of the ITR on capital – though the effect is modest given population weighting.

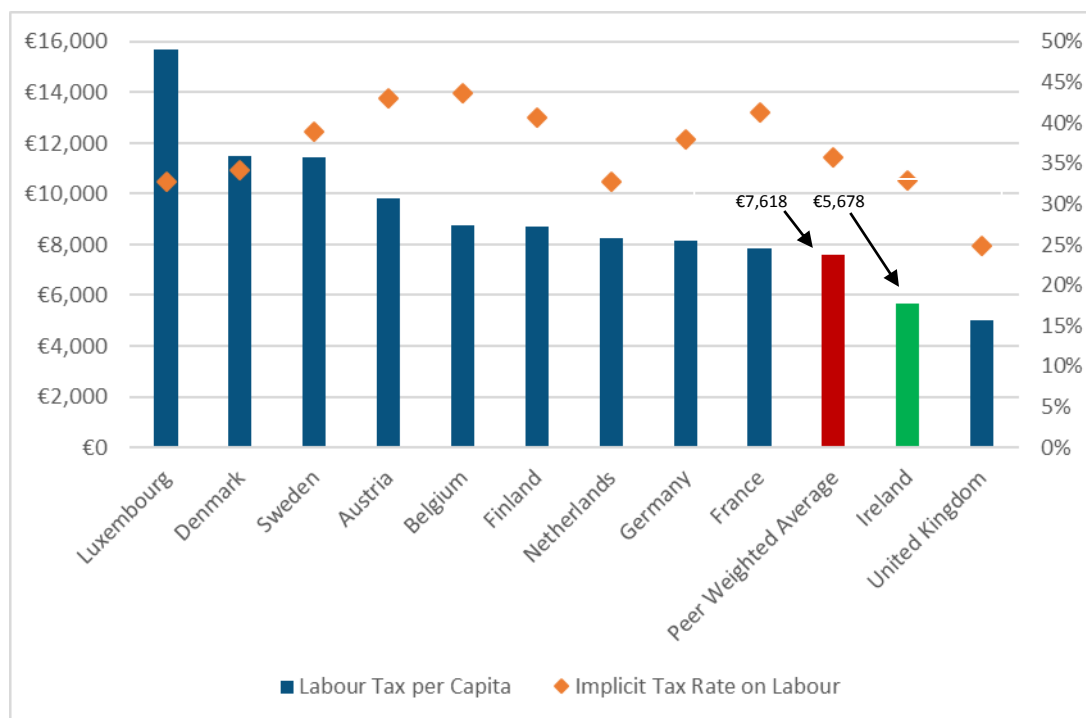
2.4 Aggregate Taxes on Labour

Taxation on Labour is generally the largest component of overall taxation revenue, making up typically half of receipts in the European Union compared to 43% in the Irish case.⁸ This category includes government income from tax and social

⁸ Eurostat (2017) [Taxation Trends in the European Union](#), 2017 Edition

contributions levied on employed as well as non-employed income (e.g. receipts from social payments and pensions).⁹

Chart 2.2 Per Capita Receipts from Taxes on Labour and ITR on Labour 2015



Sources: [Eurostat \(2017\) Population on 1 January Age and Sex](#), [Eurostat \(2017\) Taxation trends in the European Union](#). Author's calculations

Chart 2.2 displays data from the comparator countries for both measures of labour taxes. In terms of per capita contributions, the Republic is the lowest revenue jurisdiction, with the exception of the UK. The revenue gap relative to the weighted peer average is €1,940 per capita, or an aggregate total of €9 billion. Decomposing labour taxation according to payments from the employed, employers and non-employed individuals shows that the gap is explained by the relative dearth of social contributions paid on labour income to the Irish state relative to the comparator countries. Taxation on income paid by employees is actually above average, but this surplus is more than offset by a €9.5 billion cumulative shortfall in employer and non-employed payments largely comprised of social contributions.

⁹ A certain proportion of *Taxes on individual or household income including holding gains* is attributed to tax collected on self-employed and capital income. These are included under the capital taxation heading.

The Republic is somewhat less of an outlier with respect to the ITR on labour income. Effective rates of taxation exceed some higher receipt countries, though the effective rate is below the peer weighted average. Application of the peer country average ITR on labour of 35.7% would have implied slightly over €2.2 billion in additional revenue.

The Republic is also an outlier when it comes to the tax wedge. The tax wedge is the difference between labour costs to the employer and the corresponding net take-home pay of the employee. It is calculated by expressing the sum of personal income tax, employee plus employer SSCs together with any payroll tax, minus benefits as a percentage of labour costs. According to cross-country data from the OECD,¹⁰ the Republic had the lowest tax wedge in the EU15 in 2016 both for a single person (27.1%) and for a family (8.3%) at average earnings, and also had lower tax wedges than in the United States (31.7% and 20.8% respectively). The peer weighted average for the comparator high-income countries was 43.1% and 33.3% respectively while the OECD median was 38.1% and 28.1% respectively. The disproportionately generous treatment of families in the Republic is particularly notable.

For a single person the tax wedge arising specifically from the income tax is higher than in five of the 10 comparator countries and higher than in the OECD median. It is the relatively small social contributions from both employees and employers that make the Republic of Ireland an outlier in terms of the tax wedge. A single person on the average wage also had the lowest combined income tax and SSC as a percentage of gross wage earnings in the EU15 in 2016.

The relative imbalance in labour taxation between the Republic and the peer weighted average is principally due to the low effective rate of employer's PRSI. This is discussed further in Goldrick-Kelly and McDonnell, (2017 forthcoming). On the other hand employee labour taxation (income tax and SSC) based on wages and salaries is close to the peer weighted average.

2.5 Aggregate Taxation on Consumption

Taxes on consumption refer to those levied on transactions between final consumers and producers as well as those on finished consumption goods. This refers to taxes such as *VAT*, *import duties*, *excises* as well as other expenditure taxes.

¹⁰ OECD (2017) [Taxing Wages 2017](#). Paris: OECD.

In aggregate terms, Ireland collects a relatively large amount of consumption related taxes, exceeding peer-weighted averages by €207 per capita implying close to €1 billion extra tax for the population as a whole. Total tax collected under this category also appears to be comparatively large in comparisons of the ITR on consumption. The Republic's ITR on consumption of 24.2% compares to a peer country weighted average of 21.1%. The percentage point gap of 3.1 for the ITR implies additional revenue of €2.6 billion relative to the peer country average.

Table 2.2 decomposes aggregate per capita consumption receipts under a couple of broad tax headings. The largest component of consumption tax, VAT, is relatively small in comparison to per capita averages for the comparator countries, representing receipts that are about €107 smaller per person, or close to €0.5 billion in aggregate. The aggregate discrepancy between the Republic's levied consumption taxes and peer averages are explained by non-VAT consumption taxes (e.g. excise tax), amounting to an excess of €1.4 billion in total tax terms. While *Pollution* taxes comprise a relatively small portion of overall receipts from consumption activity, taxes collected under this category are only a third of the peer average, entailing a revenue gap of approximately €0.1 billion.

Table 2.2 Per Capita Receipts from Taxes on Consumption 2015

Comparator	Value Added Taxes €	Other Taxes on Consumption €	Total €
Ireland	2583	1806	4389
Peer Weighted Average (PWA)	2688	1493	4183
Ireland gap to PWA (per Capita) €	107	-308	-207
	0.5	-1.4	-1.0
Implied Ireland gap to PWA (total) € Billions			

Sources: Eurostat (2017) Main National Accounts Tax Aggregates. Eurostat (2017) Population on 1 January Age and Sex. Eurostat (2017) Taxation trends in the European Union. . Author's calculations.

2.6 Aggregate Taxation on Capital

Taxes on capital can be broken down into two main categories: *Taxation on Capital and Business Income* and *Taxation on Stocks*. The former refer to taxes levied on flows of income deriving from asset ownership while the latter encompasses taxation tied to the assets themselves. *Capital and business income* includes the profit and income of corporations, self-employed income and dividends. Taxes on the capital stock include

wealth taxes, inheritance, real estate taxes, fixed asset taxes, professional licencing and levies on production.

In aggregate terms, Irish taxation related to capital is comparatively average. Ireland's €3129 in receipts is only €21 less than the peer country weighted average, implying a shortfall in collection of around €0.1 billion. This is despite the Irish state's high capital and business tax receipts – which are €1.2 billion more than the peer country average when scaled to the population. This can be attributed to the Republic's unusually large corporate tax receipts, which are €2.5 billion higher than comparators. In the absence of corporate tax receipts, the Republic's capital taxation would be approximately €557 lower than the peer weighted average, amounting to a deficit of €2.6 billion.

Table 2.3 shows that the Republic is a low tax country when it comes to levies on stocks of wealth. Taxes on stocks collect €278 less per person than the comparator average, or €1.3 billion scaled to the population.

Table 2.3 Per Capita Receipts from Taxes on Capital 2015

	Capital and Business Income Taxes €	Taxes on Stocks €	Total €	Total Less Corporate Tax Receipts €
Luxembourg	6665	3107	9772	5695
Denmark	2420	1638	4057	2800
Belgium	2317	1569	3886	2656
United Kingdom	2061	1734	3795	2810
France	2146	1397	3544	2676
Ireland	2311	818	3129	1630
Austria	2440	476	2916	1991
Sweden	2262	621	2883	1522
Finland	2102	585	2688	1857
Germany	1893	467	2360	1477
Netherlands	1649	678	2327	1236
Peer Weighted Average	2054	1096	3150	2187
Ireland gap to PWA (per Capita) €	-258	278	21	557
Implied Ireland gap to PWA (total) € Billions	-1.2	1.3	0.1	2.6

Sources: [Eurostat \(2017\) Population on 1 January Age and Sex](#), [Eurostat \(2017\) Taxation trends in the European Union](#). . Author's calculations.

2.7 Taxation for Inclusive Economic Growth

In the summer edition of our Quarterly Economic Observer, we pointed to large shortfalls in public expenditure in areas that are particularly significant to long-run economic growth: including education, infrastructure and R&D. Deficits in these areas are likely to be detrimental to the economy's long-run growth potential and in this context the €2.5 to €3 billion shortfall in spending represents a false economy. Other deficits in public service provision and the generalised future costs associated with an expanding and ageing population led us to conclude that net tax cuts should not be pursued in upcoming Budgets.

Of course any additional resources for infrastructure, education, R&D or childcare will have to be funded from somewhere. While in the short-run such policies could be funded through debt financing, in the long-run they must be funded by taxes and other revenue sources.

The problem of expenditure deficits therefore directly raises the issue of revenue sufficiency and the potential resources that can be exploited to pay for additional expenditure. An important consideration is whether tax increase might reduce the growth rate. The growth rate is not a monotonic function of the tax rate. In general, as Jones and Manuelli (2005) argue¹¹, there is no growth when taxes are too low (not enough public goods are provided) or too high (the private returns to capital accumulation are too low).

Gale and Samwick (2014) argue¹² that the net impact on growth of income tax levels is ambiguous theoretically and they point to estimates suggesting the actual effect is small. Indeed the report of the LSE Growth Commission (2013) in the UK points out that: 'there is no reliable evidence that the growth potential of an economy is limited by the size of the government over the wide range we see in OECD countries.'¹³ Huge shifts in taxes in the US since 1870 have been accompanied by no observable shift in

¹¹ Jones, L. and R. Manuelli (2005) [Neoclassical Models of Endogenous Growth: The Effects of Fiscal Policy, Innovation and Fluctuations](#). In: P. Aghion and S. Durlauf eds. *Handbook of Economic Growth: Volume I*. Amsterdam: Elsevier Press.

¹² Gale, W. and A. Samwick (2014) [Effects of Income Tax Changes on Economic Growth](#), The Brookings Institution, September 2014.

¹³ LSE Growth Commission (2013) [Investing for Prosperity: Skills, Infrastructure and Innovation](#), The report of the LSE Growth Commission. London: LSE.

growth rates. Hungerford (2012) finds¹⁴ that higher tax rates have not been associated with higher or lower real per capita GDP growth rates to any significant degree in the US. Gale and Samwick do point out, however, that a revenue neutral shift towards base broadening (i.e. eliminating tax expenditures and using the additional resources to reduce headline rates) would be beneficial to economic growth. Overall the current state of knowledge is that theoretical models have ambiguous implications about the effects of taxes on growth (see Jones and Manuelli, 2005).

Economic growth must be inclusive if it is to translate into quality of life improvements for all in society. The IMF highlights¹⁵ the link between rising inequality and the fragility of growth. They estimate that lower net inequality (i.e. after taxes and transfers) is robustly correlated with faster and more durable growth. The fund also estimates that redistribution is generally benign in terms of its impact on growth and that the combined direct and indirect effects of redistribution are on average pro-growth. Arguments that redistribution is bad for growth therefore appear to have little if any empirical grounding.

On the other hand OECD staff determined in a 2008 paper¹⁶ that there is evidence to suggest that taxes on property, wealth and passive income have minimal negative consequences for economic growth and are highly redistributive. Taxes on land and immovable property appear to be particularly pro-growth. We have seen that the Republic has a significant per capita revenue deficit for taxes on stocks of wealth and this suggests that tax reform could reasonably start by significantly increasing these types of taxes and eliminating tax expenditures related to wealth stocks and wealth transfers.

A 2013 paper by OECD staff¹⁷ considered the impact of fiscal policy on welfare outcomes (economic growth and equity) and with these objectives in mind constructed a hierarchy of 17 fiscal consolidation instruments (Table 2.4). The Table shows that spending on education and spending on childcare and family resources is

¹⁴ Hungerford, T. (2012) [Taxes and the Economy: An Economic Analysis of the Top Tax Rates since 1945](#). Congressional Research Service, September 2012.

¹⁵ International Monetary Fund (2015a) [Causes and Consequences of Income Inequality: A Global Perspective](#), IMF Discussion Note June 2015. Washington: IMF

¹⁶ Johansson, Å, Heady, C., Arnold, J., Brys, B. and L. Vartia (2008) [Taxation and Economic Growth](#), *OECD Economics Department Working Papers*, No. 620. Paris: OECD.

¹⁷ Cournède, B., Goujard, A. and A. Pina (2013) [Reconciling Fiscal Consolidation with Growth and Equity in](#) OECD Journal: Economic Studies – Volume 2013.

the most beneficial fiscal instrument in terms of balancing long-run equity and growth while business and other subsidies are the least beneficial.

Table 2.4 Balancing Equity and Growth: Hierarchy of Fiscal Instruments

Rank	Instrument	Rank	Instrument	Rank	Instrument
1	Education	6=	Non-environmental consumption taxes	10=	Personal income taxes
2	Childcare/Family	8=	Sale of goods and services	10=	Recurrent taxes on immovable property
3=	Health services (in kind)	8=	Other government consumption	15=	Pensions
3=	Social Security Contributions	10=	Unemployment benefits	15=	Other property taxes
5	Public capital investment	10=	Environmental taxes	17	Business and other subsidies
6=	Sickness/disability payments	10=	Corporate income taxes		

Source: Cournéde, Goujard and Pina (2013) Reconciling Fiscal Consolidation with Growth and Equity in OECD Journal: Economic Studies – Volume 2013

Notes: Hierarchy considers impact of fiscal instruments on growth and equity objectives. Rank 1 represents the fiscal instrument with the most beneficial welfare outcome arising from expansion – i.e. from increasing spending or from reducing the tax.

The OECD's hierarchy of fiscal instruments makes clear that there is a strong case for increasing taxes on wealth (inheritances, gifts, net wealth, property, land) for redistributive purposes as well as for more directly growth enhancing reasons. In general, it appears that taxes on property, wealth and passive income have minimal negative consequences for long-run economic growth and, if designed properly, are highly progressive. In particular, recurrent property taxes tend to be strongly pro-growth relative to other forms of taxation. The distribution of wealth is more concentrated than the distribution of income and wealth inequality grows over time in the absence of progressive taxation and the taxation of acquired wealth (see McDonnell, 2013)¹⁸. Given the discrepancy in revenue between the Republic and peer countries there is a very strong case for increasing taxes on capital stocks.

¹⁸ McDonnell, T. (2013) [Wealth Tax: Options for its Implementation in the Republic of Ireland](#), NERI Working Paper No. 6, September 2013.

In addition to taxes on assets there is a strong case for gradually phasing out much of the system of tax expenditures. In a previous QEO¹⁹ we pointed out that tax expenditures damage growth by distorting resource allocation, by creating inefficiencies in production and consumption and by diverting economic activity toward rent-seeking behaviour. Tax expenditures also tend to favour high-income households so their elimination has positive equity implications. For example, Collins and Hughes (2016) point out²⁰ that the bulk of the benefits of pension related tax breaks go to high income households and find that over half the value of the tax break in 2013 went to the top 10% of earners. Finally, by weakening the tax base these reliefs necessitate higher tax contributions from households not in a position to benefit from the reliefs.

On the other hand increasing consumption taxes, which are already generally high in the Republic compared to peer countries, is problematic because these taxes do not take into account ability to pay and therefore have a disproportionately negative impact on the well-being of lower income households (see for example Collins).²¹

The most substantial revenue deficit is in the area of labour taxation - specifically social contributions. In addition, maximum effective rates of taxation (income tax and employee social contributions) are significantly below OECD and EU15 averages for low and average wage single earners and couples. Eliminating the revenue deficit with peer countries means generating substantially more revenue from social contributions in particular – with the bulk of this coming from employer PRSI.

Finally, sustainable quality of life improvements are incompatible in the long-run with environmental degradation, and, as such, economic policy must always account for environmental costs and benefits. In this context there is a strong argument in favour of increasing environmental taxes to generate additional fiscal space.

¹⁹ NERI (2015) [Quarterly Economic Observer](#), Autumn 2015.

²⁰ Collins, M. and G. Hughes (2016) [Tax Expenditure on Occupational Pensions in Ireland: Relevance, Cost and Distribution](#), Pensions Policy Research Group, TCD, June 2016.

²¹ Collins, M. (2014) [Modelling the Distributive Impact of Indirect Taxation Changes in the Republic of Ireland](#), NERI Working Paper No. 20, September 2014.

2.8 Conclusion

There is no evidence that the Republic's taxation system is onerous in comparison to other high-income European states. In fact, the evidence is clear that the Republic is a low tax state.

In light of this, and in the context of substantial areas of under-spend in certain public services and in infrastructure, the case for further cuts in the aggregate level of taxation is very weak. Tax cuts will limit the capacity of the Irish state to invest in growth enhancing areas and to pursue social objectives. Finally, tax cuts will reduce the resilience of the State to economic shocks and will reduce the ability to manoeuvre for a countercyclical response in the event of a future recession.

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