Quarterly Economic Observer

Summer 2016

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Nevin Economic Research Institute

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 18th *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 end-June 2016. The final draft of this document was completed on 30th June 2016.

This report has been prepared by staff of the Institute. The lead author is Dr. Tom McDonnell. We are grateful to two 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 3) and provides an examination of the public finances, the fiscal rules and fiscal policy in the Republic of Ireland (Section 4).

The UK electorate's decision to leave the EU has increased the uncertainty surrounding our economic forecasts. Overall, the impact is highly likely to be negative for both economies on the island of Ireland while the UK itself could fall into recession in late 2016 or early 2017 on the back of declining consumption and investment. The size of the long-term negative economic impact will depend on the outcome of the negotiations between the UK and the EU.

Economic Outlook for the Republic of Ireland

- Internal and external factors will not be as favourable to growth in 2016 as they were in 2015. The impressive 2015 growth figures are unlikely to be replicated.
- We anticipate the economy will grow at a reasonably robust rate for the duration of the forecast period (2016 to 2018), albeit with growth moderating year-on-year. We project that real GDP will grow at close to 4.6% in 2016 and 3.7% in 2017.
- GDP growth in 2017 and 2018 will be based on increased domestic demand and will come on the back of further improvements in the labour market, higher levels of private consumption, mildly stimulatory fiscal policy, as well as strong growth in private investment.
- Labour market dynamics should continue to improve throughout 2016 and we are projecting employment growth of 2.6% and an average unemployment rate of 7.8%. The unemployment rate should fall below 7% in early 2018.
- The strengthening economy will boost the public finances with the deficit falling to around 1% in 2016 and 0.6% in 2017.

- However, our baseline forecast is subject to a wide range of downside risks. In particular, the precise impact of the Brexit decision on the Irish and EU economies is hard to quantify but likely to be significant.
- A recession or slump in the UK would negatively impact on Irish exports with consequences for employment and living standards. There is a risk that investment decisions will be postponed or cancelled in the UK. This would affect the UK's potential output with knock-on consequence for the potential growth rate of Irish exports.
- A further appreciation in the value of the euro against Sterling or an appreciation against the US dollar would damage Irish exports. The Republic would be particularly adversely affected by such a development given its openness to international trade.
- The introduction of trade barriers would reduce economy-wide efficiency and damage the potential for medium-term productivity growth.

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

	2015	2015	2016	2017	2018
Real Output		*Percentage real change over previous year*			
Gross Domestic Product	€214.6bn	7.8	4.6	3.7	3.6
Personal Consumption	€92.4bn	3.5	3.4	3.1	2.9
Government Consumption	€27.9bn	-0.8	1.5	1.7	1.4
Investment	€47.2bn	28.2	13.8	9.9	7.1
Exports	€260.6bn	13.8	6.7	5.1	4.7
Imports	€215.8bn	16.4	8.2	6.4	5.2
Earnings		*Percentage nominal change over previous year*			
Average Hourly Earnings	€21.90	0.9	2.1	2.3	2.4
Government Finances		*Percentage of GDP*			
General Government Balance	-€4.9bn	-2.3	-1.0	-0.6	0.1
Gross Debt	€201.3bn	93.8	88.7	86.1	82.3
Labour Force		*Percentage change over previous year*			
Employment	1,963,550	2.6	2.6	1.8	1.6
		Percentage of Labour Force			
Unemployment	203,625	9.5	7.8	7.3	6.9

Outlook for Northern Ireland and the United Kingdom

- The outlook for Northern Ireland economy has weakened given the result of the UK Brexit referendum and negative implications for trade and investment.
- Private sector spending is likely to slow if not decline in the second half of 2016.
- The main long-term impact on output in the UK may well come from the changed trade relationship with the EU. This is likely to generate a negative 'level effect' that permanently reduces income levels but does not affect long-term growth levels.
- The long-run potential growth rate will fall if there is a negative impact on investment levels or an exodus of human capital. The Brexit decision is likely to do some damage to the UK's financial services sector and there is potential for capital flight.
- The prospects for the Northern Ireland economy in the short to medium term will be dominated by the negotiations for the UK's exit from the European Union. In the very near term the uncertainty that surrounds these negotiations is likely to have a substantial impact on investment decisions by both domestic firms and potential international investors.

Public Finances, Fiscal Rules and Fiscal Policy in the Republic of Ireland

- On a no policy change basis, the Republic will have one of the lowest public spending-to-GDP ratios in the entire EU by 2021, and a historically low spending ratio by modern Irish standards.
- Such a low level of spending has significant negative implications for the future provision and quality of public services and infrastructure, and has implications for the future sufficiency of welfare payments.
- Adherence to the fiscal rules limits the fiscal space for new commitments to a little over €900 million in 2017. The net fiscal space available in each of 2019-2021 will be close to €3 billion per annum with cumulative unused fiscal space of at least €11.3 billion and possibly as much as €12.7 billion out to 2021.
- Accommodating demographic and inflationary pressures on public spending will absorb much of the unused fiscal space available between 2017 and 2021.

- Bottlenecks and infrastructure deficits are already apparent in a number of areas including housing, transport and communications infrastructure. Failure to invest sufficiently in education, national innovative capacity, and infrastructure will constrain the long-term growth of the Irish economy.
- In addition, an increase in transfer payments will be required in Budget 2017 to cover cost of living increases.
- Give the above analysis it is our view that there is no room for tax cuts in Budget 2017.

1 Introduction

The United Kingdom electorate's decision to exit the European Union has increased the uncertainty surrounding economic forecasts for the Republic of Ireland and Northern Ireland. The impact is highly likely to be negative and significant. In addition, the confluence of favourable tailwinds associated with low interest rates, low oil prices, accommodative ECB monetary policy and favourable exchange rates that boosted economic growth in the Republic in 2015 is unlikely to be as favourable over the medium-term. Even so, the short-term outlook is for a continuation of strong growth.

The prospects for the Northern Ireland economy in the short to medium term will be dominated by the negotiations for the United Kingdom's exit from the European Union. In the very near term the uncertainty that surrounds these negotiations is likely to have a substantial impact on investment decisions by both domestic firms and potential international investors.

In this *Quarterly Economic Observer* (QEO) as well as reviewing recent economic trends on both parts of the island, and outlining our expectations for the future economic outlook, we also provide an examination of the public finances and fiscal policy in the Republic of Ireland and explain the fiscal rules and associated significance for the amount of fiscal space available between 2017 and 2021.

The QEO is structured as follows. Recent economic trends in both parts of Ireland are reviewed in Section 2. Section 3 updates the NERI's macroeconomic projections while Section 4 describes and analyses the public finances, fiscal rules and fiscal policy in the Republic of Ireland.[1]

The Nevin Economic Research Institute 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 subject to review as fresh information and data become available.

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[1] The analysis in this document 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

2.1 Recent trends in the World Economy

The world economy grew by 3.1% in real terms in 2015 (IMF, 2016a). This was the weakest level of growth since 2009 and reflects the generally poor growth performance of emerging market and developing economies including recessions in Brazil and Russia and declining growth in China. Growth was even slower in the OECD group of rich countries, at 2.1%, albeit a marginal improvement over the previous year (OECD, 2016a). World trade volumes grew by just 2.8% overall in 2015 and just 2.5% for goods, both well below their twenty year average rates. Euro area growth was stronger in 2015 (1.6%) than in recent years (Table 2.1). Even so, the euro area's performance was sluggish given the impact of low energy prices supporting household real disposable income and corporate profits.

Table 2.1 Dashboard of Macroeconomic Indicators (World)

	2011	2012	2013	2014	2015	2016*
Real GDP	*Percentage volume change over previous year*					
Euro area	1.6	-0.9	-0.3	0.9	1.6	1.6
United Kingdom	2.0	1.2	2.2	2.9	2.2	1.9
United States	1.6	2.2	1.5	2.4	2.4	2.4
Unemployment**	*Percentage of labour force*					
Euro area	10.1	11.3	11.9	11.5	10.8	10.2
United Kingdom	8.1	8.0	7.6	6.2	5.4	5.1
United States	8.9	8.1	7.4	6.2	5.3	5.0
Inflation	*Percentage annual average rate of change*					
Euro area (HICP)	2.7	2.5	1.3	0.4	0.0	0.4
United Kingdom (HICP)	4.5	2.8	2.6	1.5	0.1	0.8
United States (CPI)	3.1	2.1	1.5	1.6	0.1	0.8
Compensation per Employee	*Percentage change from previous period*					
Euro area	1.8	1.1	1.4	1.3	1.4	1.7
United Kingdom	1.1	1.7	1.5	0.3	1.8	2.0
United States	2.6	2.4	1.1	2.6	2.2	2.9
Current Account Balance	*Percentage of Gross Domestic Product*					
Euro area	0.2	1.3	2.0	2.4	3.0	3.5
United Kingdom	-1.7	-3.3	-4.5	-5.1	-4.3	-4.3
United States	-3.0	-2.8	-2.3	-2.2	-2.7	-2.9

Notes: *2016 figures for GDP, Inflation and Current Account Balance are latest IMF projections while 2016 figures for Unemployment Rate and Compensation per Employee are latest OECD projections. All projections predate the outcome of the UK Brexit referendum.
**National definitions.

Sources: IMF World Economic Outlook (April, 2016a), OECD Economic Outlook (June, 2016a).

The euro area's unemployment rate has persistently been in double digits since 2010 and averaged 10.8% in 2015. However, this aggregate figure masks large variations between countries. Germany had an average unemployment rate of 4.6% in 2015, whereas Spain's was at 22.1%. The United States and the United Kingdom appear to be approaching full-employment as their unemployment rates are hovering near 5%. However, low unemployment rates have yet to translate into substantial year-on-year increases in compensation per employee, particularly in the United Kingdom.

There was no HICP price inflation in the euro area in 2015 despite the European Central Bank's programme of quantitative easing and its policy of keeping interest rates extremely low. The impact of the ECB's policies has been offset by declining energy prices. Deflation risks are not just a euro area phenomenon with inflation running close to zero in the United States and in the United Kingdom. The lower prices for energy and other commodities are weighing on exporters of these goods and adding to financial imbalances in many commodity-exporting economies. Indeed there have been sharp downturns in a number of emerging economies, particularly commodity exporters.

Recent GDP data for the Republic of Ireland's and Northern Ireland's main trading partners has been modestly positive. In the first quarter of 2016 real output compared with the previous year was up 0.6% in the euro area, by 0.4% in the United Kingdom, and by 0.2% in the United States (Eurostat, 2016a). Industrial production in the euro area was up 2% in April over the previous year, and up 4.5% in the United Kingdom (Eurostat, 2016b). The euro area seasonally adjusted unemployment rate continues to decline and fell to 10.2% in April 2016 (Eurostat, 2016c) while total employment was up 0.3% in the first quarter of 2016 (Eurostat, 2016d) compared with the previous quarter (by 0.1% in the United Kingdom). Finally, retail trade volumes were up 1.4% in the euro area in April compared to the previous year and were up 4.5% in the United Kingdom (Eurostat, 2016e). On the other hand, deflation risks persist. Compared to the previous year, the euro area's annual HICP inflation was estimated to be 0.1% in June 2016 (Eurostat, 2016f) although prices were up 0.9% if energy is excluded.

Overall, if we consider the artificial tailwinds from accommodative monetary policy, along with the gains from lower energy prices, the recovery in the advanced economies has been fairly disappointing with only modest gains in wages and subdued investment growth.

2.2 Recent trends in the Republic of Ireland Economy

While the headline figures are flattered by distortions caused by the multinational sector the Republic's economy appears to have grown rapidly in 2015. GDP grew in volume terms by 7.8% (see Table 2.2) while real GNP grew by 5.7%. Industrial production grew 15.7% in 2015.

Table 2.2 Dashboard of Macroeconomic Indicators (ROI)

	2011	2012	2013	2014	2015	Latest
	Percentage volume change over previous year					
Gross Domestic Product	2.6	0.2	1.4	5.2	7.8	9.2 *(Q4'15)*
Domestic Demand	0.8	0.6	-1.2	5.7	9.3	7.8 *(Q4'15)*
Retail Sales	-3.0	-1.1	0.7	6.4	8.2	8.1 *(M5'16)*
Industrial Production	-0.4	-1.5	-2.2	22.9	15.7	4.4 *(M4'16)*
	Percentage annual average rate of change					
Employment	-1.8	-0.6	2.4	1.7	2.6	2.4 *(Q1'16)*
Average Hourly Earnings	-0.3	0.2	-0.4	-0.2	0.2	0.7 *(Q1'16)*
Inflation (HICP)	1.2	1.9	0.5	0.3	0.0	-0.2 *(M5'16)*
	Percentage of gross domestic product					
Investment	17.2	19.1	17.7	19.3	22.0	23.7 *(Q4'15)*
Current Account Balance	0.8	-1.5	3.1	3.6	4.5	4.9 *(Q4'15)*
Government Balance	-12.6	-8.0	-5.7	-3.8	-2.3	-3.1 *(Q4'15)*
Government Gross Debt	109.1	120.1	120.0	107.5	93.8	93.8 *(Q4'15)*
	Percentage of labour force					
Unemployment	14.7	14.7	13.1	11.3	9.5	7.8 *(M5'16)*
Long-term Unemployment	8.6	9.0	7.9	6.6	5.3	4.7 *(Q1'16)*
	Percentage of households					
Deprivation	24.5	26.9	30.5	29.0	n/a	29.0 *(2014)*
At Risk of Poverty	16.0	16.5	15.2	16.3	n/a	16.3 *(2014)*
	Percentage					
Gini Coefficient	31.1	31.2	31.3	31.8	n/a	31.8 *(2014)*

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

Sources: CSO Quarterly National Accounts (2016a), CSO Retail Sales Index (2016b), CSO Industrial Production and Turnover (2016c), CSO Quarterly National Household Survey (2016d), CSO Earnings and Labour Costs Annual (2016e), CSO Earnings and Labour Cost Quarterly (2016f), CSO Consumer Price Index (2016g), CSO Balance of Payments (2016h), CSO Government Finance Statistics (2016i), CSO Monthly Unemployment (2016j), CSO Survey on Income and Living Conditions (2015).

Real growth in domestic demand of 9.3% appears to suggest the domestic economy was growing strongly. In particular, capital formation (investment) grew by 28.2%. However, the growth in investment and in headline domestic demand is distorted by the impact of substantial increases in investments in intangibles (intellectual property) in 2015. Stripping out the growth of intangible investments and aircraft purchases reveals a growth in underlying domestic demand of about 3.8% in 2015.

The pick-up in household spending that began in 2014 continued apace in 2015 with personal consumption growing by 3.5% on an annual basis. The fall in oil prices in 2014 and 2015 increased the real income and purchasing power of Irish households. Analysis from the Central Bank of Ireland (2016a) suggests the boost to real gross disposable income accumulates to 1.5 percentage points by the end of 2015 and that the associated increase in purchasing power boosted the volume of personal consumption. In addition, the drop in energy costs has reduced input costs for producers' thereby improving margins; increasing corporate profitability, and incentivising and facilitating higher investment levels.

The previous drag on disposable income and domestic demand from fiscal austerity was replaced by a mild fiscal stimulus in 2015 (i.e. tax cuts and public spending increases) that modestly boosted disposable income and domestic demand. Budget 2015 was the first Irish budget to increase disposable income in seven years. In addition, the European Central Bank's policy mix of low interest rates and quantitative easing is supporting investment by pushing down financing costs. The associated fall in the cost of sovereign borrowing has helped ease the pressure on the public finances and may have increased confidence that fiscal policy will be somewhat more relaxed in the future thus encouraging greater consumer spending in 2015.

It is likely that improved consumer confidence was exerting a positive effect on demand given the end of austerity budgets; the ongoing decline in household debt as a proportion of disposable income; the gradual increase in household net worth (CBI, 2016b), and the ongoing improvements in the labour market. In our view the Irish economy remains below but approaching its potential level. If this is correct, it suggests that there was an up-swing positive multiplier effect operating on domestic demand in 2015.

Exports grew 13.8% in 2015. Net exports benefited in 2014-2015 from the weakness of the euro against a trade weighted basket of currencies. Total exports were 113.8% of GDP in 2014 and the Republic was perhaps best placed within the euro area to benefit from the weakness of the euro in 2014-15 owing to its high level of trade external to the euro area. The reasonably strong growth performances of the United

States (23% of exports) and the United Kingdom (16% of exports) contributed to growth in Irish net exports given that these are such important export markets for Irish companies. The United Kingdom in particular is an important destination for indigenous small and medium-sized Irish exporters.

The labour market continues to improve with annual employment growth of 2.6% in 2015, and 2.4% in the year to the first quarter of 2016. Total employment is now 1,976,500. However, total employment is around 170,000 below its peak. Total employment in the final quarter of 2015 was down 8% compared to the final quarter of 2007, while the average employment rate in 2015 was six percentage points below the rate recorded for 2007 (CSO, 2015d).

The number of people in long-term unemployment was three times higher in the first quarter of 2016 (100,600) than in the first quarter of 2008 (33,000). The associated loss of skills, confidence and experience is likely to have some permanent scarring effect on labour supply, on equilibrium unemployment and on potential output. More positively, long-term unemployment has halved from its peak of 204,300 in the first quarter of 2012 and is now down to 4.7%. The unemployment rate was 8.4% in the first quarter of 2016 with substantial regional variation. Unemployment rates are lowest in the Mid-East (5.9%) and Dublin (6.9%) and highest in the South-East (12.5%) and Midlands (11.6%). The seasonally adjusted unemployment rate is estimated to have fallen to 7.8% in May.

Almost one third (29%) of households were experiencing deprivation in 2014, representing a doubling of the proportion of households (14%) experiencing deprivation since 2006, while 8% of households were in consistent poverty (CSO, 2015). In this context any discussion of the Republic as a success story for austerity and internal devaluation, or indeed as a model for the rest of Europe, appears somewhat misplaced.

Average weekly earnings were €707.99 in the first quarter of 2016. This was up 1.1% compared to the previous year but down 0.3% over the previous quarter (CSO, 2016f). Average weekly paid hours were 31.6 in the first quarter, which was also down on the previous quarter (32.4). Average hourly earnings increased by 0.7% over the year going from €22.25 to €22.40. In sectoral terms the change in average weekly earnings over the year ranged from +6.9% in *financial, insurance and real estate* to -1.7% in *transportation and storage*. *Information and communication* (+4.4%) had the largest average increase over the year in hourly wages while *public administration and defence* had the largest decline (-1.3%). Average hourly total labour costs increased 0.6% in the year to first quarter 2016.

Prices in May were unchanged over the previous year in CPI terms and marginally in decline (-0.2%) in HICP terms (CSO, 2016g). However, excluding energy products the CPI was up 1.0% in May compared to the previous year and 0.5% compared to the previous month. *Transport* (-0.53%) made the largest downwards contribution to the overall annual change in the CPI mainly reflecting lower petrol and diesel prices but also a fall in the price of motor cars and air fares. The annual rate of inflation for services was 2.6% in the year to May, while prices for goods declined 3.3%.

Residential property prices rose 7.4% in the year to May with prices increasing 8.5% outside of Dublin (CSO, 2016k). Household net worth increased 1.4% during the fourth quarter of 2015 and is now €626.1 billion or €135,078 per capita (CBI, 2016b). Overall net worth has risen by 41.7% since its low in the second quarter of 2012. Household debt as a proportion of disposable income fell 4.7 percentage points over the quarter and now stands at 155.1%.

Irish government 10-year bond yields have been below 2% since August 2014 and reached a record low of 0.59% in late-June of 2016. The euro was trading at around 1.11 US dollars at end-June 2016 and at around 0.83 UK Sterling. Sterling fell in value in late June following the decision of the UK electorate to vote for an exit from the European Union while the euro fell 2% against the US dollar.

The headline general government deficit was €4.9 billion or 2.3% of GDP in 2015 (CSO, 2016j). Gross debt was €201.3 billion or 93.8% of annualised GDP at the end of December 2015. Net debt was €171.4 billion or 79.8% of annualised GDP.

The Exchequer recorded a deficit of €125 million to end-May 2016. Excluding one-off transactions shows an underlying year-on-year improvement of €1.4 billion. Tax revenue was €18.8 billion to end-May 2016 representing a year-on-year increase of €1.55 billion (9.0%). Tax revenue was 4.3% above profile although the Department of Finance believes that much of this over performance may relate to timing issues. Gross voted current expenditure was €20.5 billion to end-May down 0.7% year-on-year.

2.3 Recent trends in the Northern Ireland Economy

The most significant recent economic event for Northern Ireland was clearly the decision by UK voters to exit the European Union. How exactly the exit negotiations will play out is not known, but the possible impacts for Northern Ireland will be discussed in Section 3. The referendum result does occur at a time when Northern Ireland's economy is struggling to regain momentum in its recovery. Over the last year there has been some growth in both jobs and output it may yet prove that structural weaknesses in the Northern Ireland economy are holding it back from the pace of recovery achieved by both the Republic of Ireland and the United Kingdom. The first half of 2016 has brought mixed results for the economy and as Section 3 will discuss, the result of the referendum may pose significant challenges in the immediate future.

Table 2.3 Dashboard of Macroeconomic Indicators (N Ireland)

	2011	2012	2013	2014	2015	Latest
	Percentage volume change over previous year					
Gross Value Added	-0.2	1.1	0.6	0.7	-	0.7 *(2014)*
NICEI	-1.7	-1.3	0.1	0.7	1.4	0.4 *(Q4'15)*
Index of Services	-2.7	-1.2	0.7	1.4	1.4	0.6 *(Q1'16)*
Index of Production	7	-1.4	1	2.2	1.9	-0.2 *(Q1'16)*
	Percentage annual average rate of change					
Employment Rate	2.0	-0.3	-0.6	1.8	0.3	0.7 *(M2-M4'16)*
Average Hourly Earnings	1.7	1.5	2.5	-1.3	4.2	4.2 *(2015)*
Inflation (UK)	4.5	2.8	2.6	1.5	0	0.3 *(M5 2016)*
	Percentage of GVA					
Exports	28.7	28.4	29.7	28.4	-	28.4 *(2014)*
Government Spending	59.4	58.5	57.7	57.6	-	57.6 *(2014)*
	Percentage of labour force					
Unemployment	7.2	7.5	7.5	6.4	6.1	5.8 *(M2-M4'16)*
Youth Unemployment	18.2	20.1	22.5	19	19.3	13.4 *(M2-M4'16)*
Long-term Unemployment	3.2	3.8	4	3.4	3.6	2.8 *(M2-M4'16)*
	Percentage of households					
Relative Poverty	20	22	19	21	-	21 *(2014)*

Notes: Total employment refers to all persons in employment (ILO definition) aged 16-64 as a proportion of all persons aged 16-64.

Sources: ONS (2015) Regional Gross Value Added (Income Approach); NISRA (2016) Northern Ireland Composite Economic Index Q4 2105; NISRA (2016) Index of Production Q1 2016; NISRA (2016) Index of Services Q1 2016; NISRA (2016) Labour Force Survey (Feb-Apr); NISRA (2015) Annual Survey of Hours and Earning 2015; ONS (2016) Consumer Price Inflation: May 2016; HMT (2015) Public Expenditure Statistical Analyses 2015; NISRA (2015) Households Below Average Income Report 2013-14

Measured by Gross Value Added (GVA), Northern Ireland's economy has struggled to establish a growth trajectory over the past number of years. The most up to date figures from the Northern Ireland Composite Economic Index (NICEI) indicate limited growth of 0.4% in the final quarter of 2015, leading to an annual growth rate of 1.4%

over the year. In 2015 growth was driven by the private sector which increased by 2%, whilst public sector activity fell 1.3%.

In previous quarterlies we have identified how growth in the private sector has struggled to keep pace with contractions in the public sector. As public spending seems set to decline at least until 2020/2021, Northern Ireland cannot afford any deterioration in the private sector if it is to avoid slipping back toward recession. The need for robust private sector growth comes at a challenging time for the international economy that has already produced significant job losses within the manufacturing sector in Northern Ireland. Whilst these job losses have been announced, the impact in terms of lost output and employment is not likely to show up in any figures until later this year when closures and redundancies take effect.

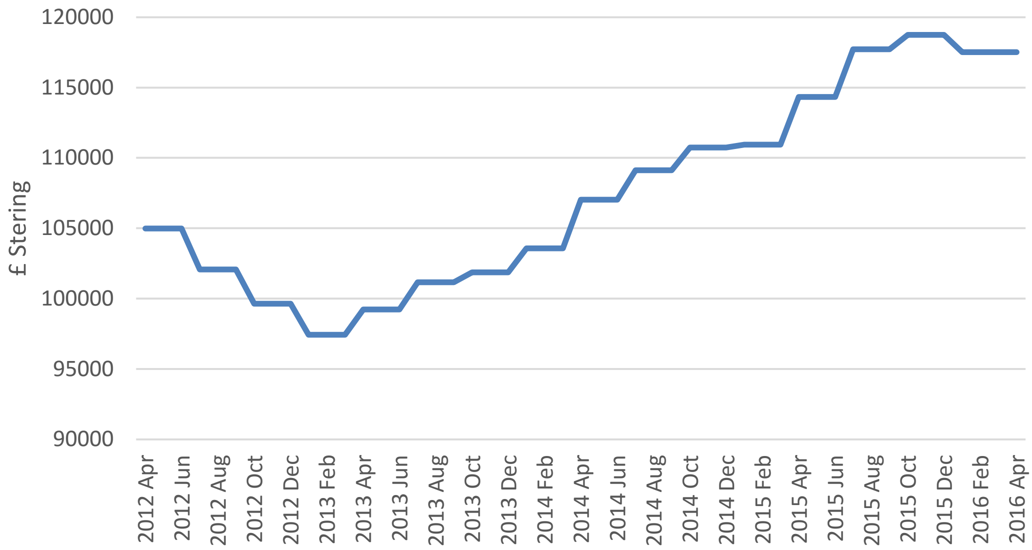
Unemployment in Northern Ireland fell to 5.8% in the three months ending in April this year with employment growth of 8,000. A fall of more the 4,000 in the number of people classified as economically inactive saw the overall rate of economic activity in Northern Ireland (74%) reach its highest level on Labour Force Survey (LFS) records. Major revisions to LFS population data saw the rate of youth unemployment fall by 5% in the three months ending in April. The reduction in youth unemployment of 5,000 was enough to counter an increase of 3,000 in unemployment for older age groups. For such a large drop to occur over one quarter is quite surprising and whether this is an aberration or an adjustment should be confirmed in next month’s data.

Table 2.3 shows that Northern Ireland exports, which totalled £9.7bn in 2014, have remained at roughly 28% of GVA since 2011. Exports accounted for 32% of UK output (ONS, 2016) but this is dwarfed by its Republic of Ireland equivalent where exports were greater than GVA in 2014 (CSO, 2016). The prospects for Northern Ireland trade are discussed in Section 3.

Chart 2.1 shows a new house price index developed by the Office for National Statistics. The index shows the strong performance of Northern Ireland’s housing market up to the crash but more importantly it also shows how average house price have decreased and then flat-lined since the beginning of the year. This trend has not been confined to Northern Ireland as a similar fall-off occurred in Wales while prices in England have either stood still or seen a much reduced pace of growth in the first part of 2016.

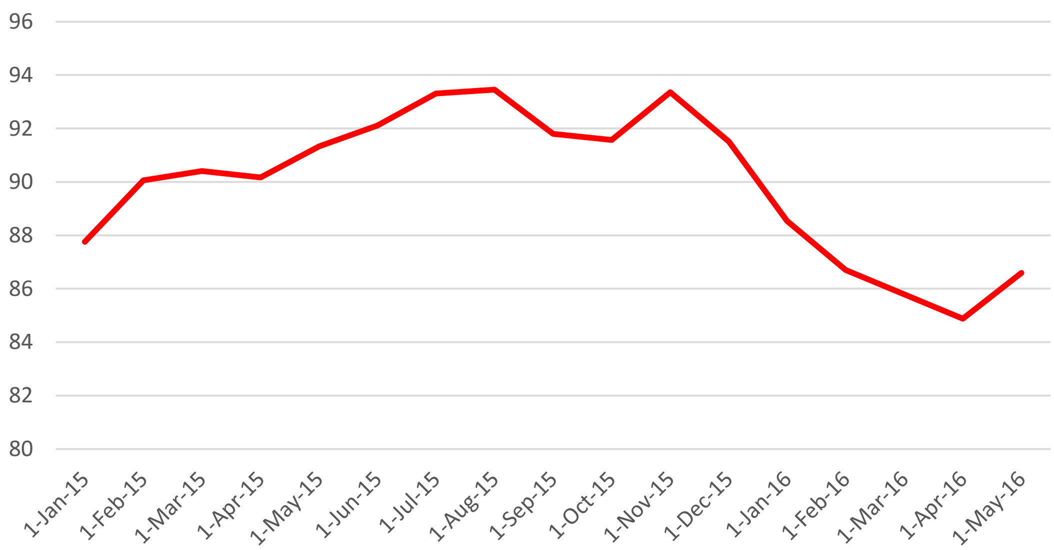
Uncertainty surrounding the possibility of a BREXIT stands out as one of the main reasons for a drop in market confidence since the beginning of the year. In particular, the warning from HM Treasury that BREXIT could force house prices to drop by between 10% and 18% is likely to have impacted the market. The result of the referendum could cause a surge toward the end of the year, but confidence in the market could remain muted for some time.

Chart 2.1 Average House Prices 2012-2016, (N Ireland)



Source: Office for National Statistics (2016) House Price Index April

Chart 2.2 Sterling Average Effective Exchange Rate Index



Source: Bank of England (2016) Monthly Average Effective Exchange Rate Index

Another indicator of uncertainty in the run up to the BREXIT referendum was the performance of Sterling. Having strengthened significantly following a low reached in early 2013 the effective exchange rate in May fell below the rate it was at the beginning of 2015. Given the result of the referendum it is likely that Sterling will suffer a significant loss of value in the markets compared to its pre-referendum level. Whether this value can be recovered will depend very much on the outcome of exit negotiations outlined in Section 3.

Box 2.1 New Northern Ireland Executive and Draft Programme for Government

Following elections to the Northern Ireland Assembly in May a new Northern Ireland Executive was formed between the Democratic Unionist Party and Sinn Féin. The Executive will comprise of seven government departments, reduced from nine previously. The Department for the Economy will combine the functions of the old Departments of Enterprise, Trade and Investment along with the former Department of Employment and Learning.

The new Executive published a draft Programme for Government on the 26th of May (NI Executive, 2016). The document adopts a new structure similar to that of the Scottish Government where objectives are based around outcomes for citizens and there is a well-defined measure for how that can be achieved and also a means of evaluating success in that endeavour.

In total there are 14 outcomes and 42 indicators and measures listed in the document. While the outcomes are quite vague and cross-cutting, it is possible to identify a number that will have implications for economic policy

- We prosper through a strong, competitive, regionally balanced economy
- We have a more equal society
- We are an innovative, creative society, where people can fulfil their potential
- We have more people working in better jobs
- We have created a place where people want to live and work, to visit and invest

The document then outlines a number of aspirational indicators of success for these outcomes along with measures for the indicators that will be monitored at various intervals. The document fails to identify how any of these goals would be achieved, but it quite clear as to how they will be assessed. The lack of detail on delivery seems to be a purposeful attempt to draw attention away from how services are delivered and move it to an evaluation of what government policies actually achieve. This is a novel way to set out government priorities and while it may frustrate policy analysts looking to assess government plans for the next five years, it deserves the opportunity to show its worth.

3 Economic Outlook

3.1 Introduction

Growth prospects for small economies like the Republic of Ireland and Northern Ireland economies are heavily dependent on the economic performance of the wider global economy as well as on future trade and competitiveness patterns. The openness of the Republic's economy makes it particularly exposed to international trends. In this section of the QEO we outline our assumptions for the economies of the main trading partners of the Republic and of Northern Ireland. We then set out our baseline expectation for the short-term performance of both of the Irish economies. The main risks to the forecasts are also considered.

3.2 Macroeconomic Assumptions for the Global Economy

Prior to the decision of the United Kingdom electorate to vote to leave the European Union the European Commission (2016a), IMF (2016a) and OECD (2016a) were forecasting that world real economic growth would be around 3% to 3.2% in 2016 while world trade growth would be a more subdued 2%. Modest investment and productivity growth suggested weak prospects for world economic growth in the short-term. The general fall in commodity prices has damaged growth prospects for many emerging economies and created substantial financial instability risks for commodity exporters. While policy stimulus in China has reduced the probability of an sharp growth decline in the Chinese economy in 2016, a medium-term slowdown in the annual growth rate seems inevitable given the extended period of very rapid growth in investment. Chinese investment slowdown will put further downward pressure on commodity prices and on trade growth in emerging economies.

Most major forecasters are projecting the euro area economy will grow at a somewhat subdued 1.4% to 1.8% and that growth will be somewhat higher in the United States (1.8% to 2.4%). Prior to the Brexit decision the United Kingdom economy was generally forecast to grow a little under 2% in 2016. That forecast will need to be revised down and the IMF (2016b) forecasts post-Brexit growth of 1.1% to 1.7% in 2016. The uncertainty surrounding the outcome of the United Kingdom's Brexit referendum will have dampened investment and trade somewhat in the first half of the year and that uncertainty is now likely to persist until at least end-2018. Private sector spending is likely to slow if not decline in the second half of 2016.

The main long-term impact on output in the United Kingdom may well come from the changed trade relationship with the EU. This is likely to generate a negative 'level effect' that permanently reduces income levels but does not affect long-term growth levels. The long-run potential growth rate will fall if there is a negative impact on investment levels or an exodus of human capital. The Brexit decision is likely to do some damage to the United Kingdom's financial services sector and there is potential for capital flight.

Analysis from the IMF (2016b), the OECD (2016b) and NIESR (2016) indicates that Brexit will negatively impact on the United Kingdom's output and employment levels. The IMF's analysis suggests the level of uncertainty arising from the Brexit decision will be similar to that experienced during the global financial crisis and that this uncertainty will damage investment and consumer spending. Overall, the Fund forecasts that real GDP will be 1.4% lower in 2021 under a limited impact scenario and 4.5% lower under an adverse impact scenario. NIESR estimate that Brexit will lower GDP by around 1% in 2017 compared to the baseline, and that Brexit will lower output by between 2.7% and 7.8% by 2030. The OECD's central scenario is for real GDP to be 5.1% lower in 2020 relative to the UK staying in the EU.

The Brexit decision will impact negatively on the euro area economy. On the other hand, low energy prices, supportive monetary policy and financing conditions and less drag from contractionary fiscal policy will all support higher consumption and investment. Even so, the growth benefits from cheap oil and the euro's depreciation will soon have run their course and potential growth remains weak as a legacy of the euro crisis and associated policy outcomes (low investment levels, high public and private debt, and eroded skill base), as well as due to aging effects and slow productivity growth.

A continuation of even a modest recovery in the euro area should see its unemployment rate fall below 10% by the end of 2016 and some upward pressure on wages after years of sluggish growth in compensation per employee. Upward wage pressure and price inflation should be more intense in the United Kingdom and the United States given the tightness of the labour market. Price inflation will remain well below the 2% target in almost all OECD countries and close to 0% in the euro area. The United Kingdom may be an exception to the low inflation trend given the Brexit related decline in Sterling and increase in the cost of imports. Inflation should start to take hold in most of the OECD in late 2016 or 2017 as oil prices rise from their current levels.

Global economic growth is generally forecast to accelerate somewhat in 2017 with most major forecasters prior to the Brexit decision projecting global growth of 3% to 3.5% and growth in the OECD group of advanced economies of around 2%. However, there are a number of downside risks most notably the risk of ongoing fall-out from the Brexit decision as well as the possibility of widening conflict in the Middle East and associated contagion effects. The prospect of tightening monetary policy in the United States is another risk to the global economy as it could further damage the balance sheets of already vulnerable commodity exporters.

Finally, most advanced economies remain characterised by low investment levels and this suggests modest growth rates in the short-to-medium-term in the absence of a concerted effort by governments to use fiscal policy to boost public capital investment levels.

3.3 Macroeconomic Projections for the Republic of Ireland

Internal and external factors will not be as favourable to growth in 2016 as they were in 2015 and the impressive 2015 growth figures are unlikely to be replicated. High frequency indicators such as the Services and Manufacturing PMIs and the Consumer Sentiment Index are all suggestive of moderating growth. Currency movements will not been as favourable to net exports in 2016 due to the decline in the value of Sterling while much of the gains from lower energy prices are already factored into the 2015 output figures. The Brexit decision is likely to exert downward pressure on investment and exports. Research from the ESRI HERMES model suggests that a 1% reduction in UK GDP would reduce Irish GDP by around 0.2% relative to baseline over two years. The IMF (2016b) estimates that Irish GDP will be lower by 0.7% to 1.8% of GDP relative to the baseline by 2019.

Based on existing data, our medium-term forecasts, assuming full use of available fiscal space for public spending increases or tax cuts, and tentatively accounting for the

Brexit result, we are now projecting that real GDP will still grow at a robust and above trend level of close to 4.6% in 2016 and will then grow by close to 3.7% in 2017 and 3.6% in 2018 as the output gap closes (see Table 3.1).

GDP growth in 2017 and 2018 will be based on increased domestic demand and will come on the back of further improvements in the labour market, higher levels of private consumption, mildly stimulatory fiscal policy, as well as strong growth in private investment. We forecast that nominal GDP will exceed €229 billion in 2016 and €241 billion in 2017 (Table 3.2 compares our real GDP projections to those of other agencies).

Table 3.1 Projections for Output, Earnings, the Public Finances and the Labour Market (ROI)

	2015	2015	2016	2017	2018
Real Output		*Percentage real change over previous year*			
Gross Domestic Product	€214.6bn	7.8	4.6	3.7	3.6
Personal Consumption	€92.4bn	3.5	3.4	3.1	2.9
Government Consumption	€27.9bn	-0.8	1.5	1.7	1.4
Investment	€47.2bn	28.2	13.8	9.9	7.1
Exports	€260.6bn	13.8	6.7	5.1	4.7
Imports	€215.8bn	16.4	8.2	6.4	5.2
Earnings		*Percentage nominal change over previous year*			
Average Hourly Earnings	€21.90	0.9	2.1	2.3	2.4
Government Finances		*Percentage of GDP*			
General Government Balance	-€4.9bn	-2.3	-1.0	-0.6	0.1
Gross Debt	€201.3bn	93.8	88.7	86.1	82.3
Labour Force		*Percentage change over previous year*			
Employment	1,963,550	2.6	2.6	1.8	1.6
		Percentage of Labour Force			
Unemployment	203,625	9.5	7.8	7.3	6.9

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 2016-2018; 2015 data is from CSO National Accounts (2016a, CSO Earnings and Labour Costs Survey (2016e), Government Finance Statistics (CSO, 2016i) and CSO Quarterly National Household Survey (2016d).

Real disposable household income is increasing on the back of strong growth in employment, rising average hourly earnings and negligible price inflation. Higher levels of disposable income and improving household net worth will support higher levels of spending, while falling household debt should mean lower levels of deleveraging and increased consumption. We are projecting that personal consumption will grow by 3.4% in 2016 before moderating to 3.1% in 2017 and 2.9% in 2018. Strong employment growth and pent-up demand after years of stagnant or declining demand will provide tailwinds in 2016 while low energy prices will continue to boost real incomes and monetary policy will remain highly accommodating.

Table 3.2 Range of Projections for Real GDP Growth (ROI)

	2016	2017	2018	2019	2020	2021
NERI *(July)*	4.6	3.7	3.6	-	-	-
Department of Finance *(April)*	4.9	3.9	3.9	3.3	3.1	2.9
Central Bank of Ireland *(April)*	5.1	4.2	-	-	-	-
European Commission *(May)*	4.9	3.7	-	-	-	
IMF *(April)*	5.0	3.6	3.2	2.8	2.7	2.7
OECD *(June)*	5.0	3.4	-	-	-	
ESRI *(June)*	4.6	4.2	-	-	-	

Sources: Dept. Finance Stability Programme Update (DoF, 2016a); CBI Quarterly Bulletin (CBI 2016c); European Commission European Economic Forecast (EC, 2016a); IMF World Economic Outlook (IMF 2016a); OECD Global Economic Outlook, (OECD 2016a); ESRI Quarterly Economic Commentary (ESRI, 2016)

We project that investment will grow very strongly over the next few years with growth of 13.8% in 2016 and 9.9% in 2017 driven by improved private sector balance sheets and access to capital, strengthening labour market dynamics, supportive monetary policy, and the strong potential for catch-up growth given the persistently low underlying investment to GDP ratio over the previous half decade. Brexit related uncertainty may dampen short0term investment growth but there may also be a Brexit dividend if there is a diversion of investment away from the United Kingdom. While investment growth in 2015 was distorted by the large increase in investment in intangibles we expect that underlying investment (i.e. excluding intangibles and aircraft purchases) will expand rapidly in the next few years. We anticipate that firms will increasingly move to rebuild their capital stock as underlying conditions in the economy improve and that pressure to increase the housing stock will eventually translate into substantial increases in house building over the next few years.

The volume growth of exports and imports reached double digits in 2015. However, we are forecasting that net exports will make a negligible contribution to growth in each of 2016, 2017 and 2018 with imports growing faster than exports in each year. Stronger short-term growth in imports will be driven by the expected increases in real disposable household income, domestic consumption and investment. We expect future growth in the volume of exports to be broadly in line with external demand indicators adjusted for movements in exchange rates and other elements of competitiveness. Exports should gradually decline down to trend growth in the Republic's trading partners. Trade data suggests a slowdown in goods exports and imports in early 2016 and the Brexit outcome will put further pressure on exports as the euro increases in value against Sterling.

Labour Market

Labour market dynamics should continue to improve throughout 2016 and we are projecting employment growth of 2.6% and an average unemployment rate of 7.8%. The unemployment rate should fall below 7% in early 2018 although the speed of decline in the unemployment rate should slow in the next few years as the output gap closes. Employment growth will moderate in 2017 (1.8%) and again in 2018 (1.6%) as the economy approaches potential output. Pressure for wage growth will accelerate as the unemployment rate continues its fall and the economy approaches its potential. On the other hand, the absence of significant inflationary pressures will dampen growth in average hourly earnings across the economy. Even so, growth in average early hourly earnings should be around 2.1% in 2016 and then somewhat faster in 2017 (2.3%) and 2018 (2.4%). Aggregate growth in hourly earnings will vary from sector to sector reflecting sectoral differences in labour demand and the tightness of labour supply.

Public Finances

In light of our projections for economic output and the labour market, as well as our assumptions for Budget 2017 and Budget 2018, we are now projecting that the government's general budget balance will improve to minus 1% of GDP in 2016 (around €2.3 to €2.4 billion in nominal terms) and then again to minus 0.6% of GDP in 2017. We project that the government will have a modest surplus of 0.1% of GDP in 2018. The ongoing fall in the numbers unemployed will lead to reduced expenditure on income supports while more people employed and rising disposable incomes will generate additional revenue flows. We now project that the gross debt to GDP ratio will fall to about 82.3% of GDP by the end of 2018.

Risks to the Outlook

Our baseline forecast is subject to a wide range of downside risks. In particular, the precise impact of the Brexit decision on the Irish and EU economies is hard to quantify but likely to be significant. Brexit has also set a precedent for exit from the EU thereby damaging confidence in the European Union project and opening the possibility of further disruption to trade flows and investment patterns. The main risks to the outlook include:

- A recession or slump in domestic demand in the United Kingdom would negatively impact on Irish exports with consequences for employment and living standards. There is a risk that investment decisions will be postponed or cancelled in the United Kingdom. This would affect the United Kingdom's potential output with knock-on consequence for the potential growth rate of Irish exports.
- A further appreciation in the value of the euro against Sterling or an appreciation against the US dollar would damage Irish exports. The Republic would be particularly adversely affected by such a development given its openness to international trade. If negotiations between the EU and the UK become contentious it could spark a further weakening of Sterling while the introduction of trade barriers will reduce economy-wide efficiency and damage the potential for medium-term productivity growth.
- A faster than expected rise in energy prices would reduce real disposable incomes and adversely affect investment and consumption decisions. A further deterioration of the geopolitical situation in the Middle East could impact negatively on global trade and exert upward pressure on energy prices.
- A tightening of monetary policy appears unlikely in the short-term given the weakness of the recovery in the Euro area, the absence of inflationary pressures, and the still high unemployment rate. While the risk may well be low, higher interest rates would have a particularly damaging impact on domestic demand and would expose fragilities in an economy characterised by still high private and public sector debt overhangs.
- Developments related to the Base Erosion and Profit Shifting (BEPS) project and the Common Consolidated Corporate Tax Base (CCCTB) project may reduce the Republic's relative attractiveness as a location for Foreign Direct

Investment (FDI). The United Kingdom's leaving of the EU may increase momentum towards the CCCTB.

- A sharp slowdown in the Chinese economy would impact negatively on world trade and could increase financial instability in commodity exporters. A slowdown in the rate of growth of world trade and the global economy would have a damaging impact on Irish exports.

3.3 Macroeconomic Outlook for Northern Ireland

The United Kingdom may be headed for recession in the wake of the Brexit decision with private sector spending likely to slow and perhaps decline. The prospects for the Northern Ireland economy in the short to medium term will be dominated by the negotiations for the UK's exit from the European Union. In the very near term the uncertainty that surrounds these negotiations is likely to have a substantial impact on investment decisions by both domestic firms and potential international investors. The process of leaving the EU will take a minimum of two years and is likely to last significantly longer if issues of contention emerge. For the UK the broad outline of the proposed trading relationship with the EU needs to be decided as a matter of urgency. This can give at least some certainty to firms and will allow planning for the medium term. For Northern Ireland clarity will urgently be needed on border controls, freedom of movement of workers between the Republic of Ireland and Northern Ireland and the future of already pledged EU funding.

What relationship between the UK and the EU?

With no precedent for a country leaving the EU there is no indication of what trading relationship might exist between the EU and the UK. A number of options are possible and they can be loosely grouped into four areas.

1. *Membership of the European Economic Area*. This is the relationship enjoyed currently by Norway, Iceland and Lichtenstein. Countries in the EEA enjoy access to the EU's internal market, but not its Customs Unions. All members of the EEA are currently members of the Schengen area and accept free movement of goods, people, services and capital. Members of the EEA

contribute to the EU budget and must transpose some EU laws into national law (European Parliament, 2016). This option would likely be the least disruptive to trade in the medium term and any disruption caused by Brexit in the short-term could be reversed. However, the EEA does not cover the Common Agricultural Policy or the Common Fisheries Policy. All Interreg and PEACE funding for Northern Ireland would also be in the gift of Westminster. Whilst the Westminster government would no longer have to contribute as much as £12bn to the EU budget, it would have to contribute in the region of £5bn for the same arrangements as a country such as Norway. This would leave the UK as a net contributor to the EU of £5bn rather than £8bn at present.

2. *Membership of the EFTA*. This is the arrangement enjoyed by Switzerland and it is the only member of the EFTA not to be a member of the EEA or the EU. Switzerland has a series of bilateral agreements with the EU which allow structured access to the Single Market (European Parliament, 2016). Switzerland is also a member of the Schengen area and all citizens of EFTA countries have the right to live and work in all other EFTA countries. Whilst this option would be open to the UK, bilateral agreements that currently exist between the EU and Switzerland could take many years to negotiate for the UK and this could create greater disruption to EU trade.
3. *Membership of the EU Customs Union*. This is the arrangement currently enjoyed by Turkey. The key difference between the Free Trade Area and the Customs Union is that members of the Customs Union all impose common external tariffs and no customs or duties within the union (European Union, 2014). There is no free movement of people and Turkey is not a member of the Schengen area.
4. *Bilateral Agreement between the UK and the EU*. This is the option currently being pursued by Canada. Canada already has a free trade agreement with the non-EU members of the EFTA on goods trade and the yet to be ratified CETA agreement between the EU and Canada would seek to eliminate nearly all tariffs between the two countries. This would eventually eliminate up to 92% of the tariffs and duties on agricultural products (European Commission, 2015), but importantly this would not eliminate non-tariff barriers such as common food standards. Such an arrangement, if it is made available by the EU could take a number of years to agree considering that the EU-Canada negotiations began in 2008.

What relationship between the UK and the world?

The UK government may opt for one of these options but it may also opt for none. The UK could continue to trade with the EU through the World Trade Organisation and levy its own tariffs on EU imports. The UK may also form regional trade agreements with non-EU members such as the Central European Free Trade Agreement which is now made up mostly of former Yugoslav republics as most central European states gave up membership on joining the EU.

The UK may also seek new trade agreements, or seek to re-establish trade agreements with other countries that will lapse on the UK's exit from the EU. This could help make up for the market share that will be lost if the UK leaves the single market. However, it is worth re-emphasising that trade agreements take time and that while significantly expanding global free trade agreements may be in the interest of the UK, there may not be the same level of enthusiasm elsewhere.

Finally, it is also worth remembering that the UK government has not negotiated a trade deal since 1974 and that the deals made between other countries and the EU reflect the relative power of a body that negotiates for a market of 500 million people. This will not be matched by a nation state negotiating for a market of 65 million people.

How will this effect Northern Ireland?

An NERI working paper released in April (Mac Flynn, 2016) detailed how the Northern Ireland economy as presently structured could be disrupted by Brexit. Based on that research it is hard to avoid the conclusion that uncertainty in the short term will lead to a negative economic shock for Northern Ireland. The manufacturing sector and food processing in particular along with the retail sector were identified as particularly vulnerable to a disruption in EU trade. This would likely have had a disproportionate impact on female and rural based workers. The impacts of a Brexit on the all-island economy would have also been more likely to impact activity and jobs in border counties. Northern Ireland is also likely to be disrupted through the depreciation of sterling. The expected fall in overall UK economic output will put further pressure on UK public finances with knock-on effects for Northern Ireland.

Whilst exiting trading relationships will remain in place until negotiations for exit are completed, Northern Ireland firms may only have two years to adapt to whatever trading relationship is agreed. How easily firms can adapt to that new relationship will likely determine the length of any economic disruption.

Most of the available forecasts for the Northern Ireland economy were made prior to the referendum result and are now largely redundant. Some forecasters had begun to revise down growth expectations for 2016 due to the uncertainty of the referendum campaign itself, with a much larger deterioration expected in the event of a Leave vote. Oxford Economics (2016) was the only forecasting body to model Brexit outcomes with regard to economic growth in Northern Ireland. Their projections for output ranged from -0.1% to -5.6% by 2030 relative to the baseline for nine post-Brexit scenarios. It remains to be seen which of these scenarios best describes the UK's negotiated settlement, only then can any meaningful modelling take place.

4 The Public Finances, Fiscal Rules and Fiscal Policy in the Republic of Ireland

4.1 Introduction

The Republic's long-run economic growth; employment and equity goals can best be achieved by prioritising use of the available fiscal space to increase public capital investment levels; along with provisions for additional spending on education; on research and development (R&D) subsidies and innovation capacity building, as well as on measures to reduce barriers to employment such as through childcare subsidies. In addition, an increase in transfer payments will be required in Budget 2017 to cover cost of living increases. Finally, we argue for a set of sustainable pro-growth reforms to increase total government revenue as a percentage of output.

On a no policy change basis, the Republic will have one of the lowest public spending-to-GDP ratios in the entire European Union (EU) by 2021, and a historically low spending ratio by modern Irish standards. Such a low level of spending has significant negative implications for the future provision and quality of public services and infrastructure, and has implications for the future sufficiency of welfare payments.

The medium-term structural deficit[1] target is likely to be achieved by 2018 and perhaps as early as end-2017. Adherence to the fiscal rules limits the net fiscal space for new commitments to a little over €900 million in 2017. The net fiscal space available in each of 2019-2021 will be close to €3 billion per annum with cumulative unused fiscal space of at least €11.3 billion out to 2021. However, accommodating demographic and inflationary pressures on public spending will absorb much of the unused fiscal space available between 2017 and 2021.

4.2 The Public Finances

The general government deficit in the public finances was 2.3% of GDP in 2015. The underlying deficit which excludes one-off items was 1.3% and the year-end gross debt-

[1] The structural balance is an estimate of the budget balance that would obtain under current policies if actual output were equal to the economy's potential output. It excludes one-off and temporary measures, and attempts to correct for a number of factors including, real output, equity, house prices, and unemployment.

to-GDP ratio was 93.8% or €201.3 billion (Table 4.1). Interest expenditure on the public debt was 3.1% of GDP meaning the primary underlying surplus was 1.8% of GDP.

Table 4.1 Public Finance Estimates and Projections (ROI)

	2015	2016	2017	2018	2019	2020	2021
General Government Balance (% of GDP)							
IMF	-1.6	-0.4	0.3	0.4	0.3	0.2	0.2
Department of Finance	-2.3	-1.1	-0.4	0.4	1.2	2.0	2.8
Structural Balance (% of potential GDP)							
IMF	-1.2	-0.5	0.0	0.0	0.0	0.0	0.0
Department of Finance**	-2.4	-2.0	-0.8	0.1	1.0	2.0	2.8
OECD*	-2.6	-1.7	-1.6	-	-	-	-
European Commission	-2.2	-2.0	-1.0	-	-	-	-
Gross Debt (% of GDP)							
IMF	95.2	88.6	84.6	80.4	77.2	74.3	71.2
Department of Finance**	93.8	88.2	85.5	81.3	77.7	73.3	68.9

Sources: IMF (2016c): Fiscal Monitor April 2016; Department of Finance (2016a): Stability Programme Update (SPU) April 2016; OECD (2016a): Economic Outlook May 2016, European Commission (2016): Spring Forecasts May 2016

Notes: *Cyclically adjusted budget balance. After correcting for the one-off and temporary measures it is called the structural budget balance.
**In practice the post-2018 fiscal stance will most likely be to maintain a structural deficit of minus 0.5% of potential GDP in order to minimally comply with the Medium Term Objective (MTO). The Department of Finance assumptions for the general government balance and for gross debt should be understood in this context.

The NERI's most recent projections for economic growth and the exchequer finances (Table 3.1) are for a government deficit of close to 1% of GDP in 2016 as well as a year-end gross debt-to-GDP ratio of 88.7%. Budget 2017 will therefore take place with a small deficit in the public finances and a medium-to-high, albeit declining, debt to GDP ratio. The public finances, while improving, remain fragile and vulnerable to external policy decisions and external and internal growth shocks.

We expect that close to €0.9 billion of unused (i.e. net) fiscal space will be allocated in Budget 2017 leading to a modestly higher growth rate in 2017 and a budget deficit near to 0.6% of GDP once the knock-on impact of the fiscal multipliers is considered.

The medium-term budgetary trends, as outlined in the government's Stability Programme Update, or SPU (DoF, 2016a), show, absent a change in policy direction, a further entrenchment of the Republic's position as one of the lowest tax and spend economies in the EU (Table 4.2). Discretionary expenditure on public services relative to the size of the economy will be substantially lower in 2021 than it was in 2015 with public spending falling from 35.1% of GDP to 26.6% of GDP (29.8% of fiscal capacity if we use the Fiscal Council's GDP-GNP hybrid as the appropriate Irish measure). Allocating all of the unused fiscal space over the next five years to public spending would increase the spending to-GDP ratio to 30% and the spending-to-hybrid ratio to 33.6%. These amounts are around two-thirds of the average for the euro area and are also lower than the United Kingdom (IMF, 2016c). Public spending is already at the lower end of the EU spectrum and a no-change scenario implies significant pressures on government services, public investment and social payments.

Table 4.2 Revenue and Expenditure Comparisons (% GDP)

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

Sources: IMF (2016c); Department of Finance (2016a), NERI calculations

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

The government's projections in the SPU show revenue falling from 32.8% of GDP in 2015 to 29.4% of GDP in 2021. Revenue from consumption, labour and capital were all already below the EU average in 2014 when considered as percentages of GDP (Table 4.3), although revenue from consumption is in line with the EU average when considered in GDP-GNP hybrid terms. The low level of labour taxation is mainly explained by the low level of contributions from employers and the non-employed compared to the contributions made by these groups in other EU countries.

A more meaningful barometer of how the Republic compares with other EU countries is the Implicit Tax Rate (ITR). The ITR provides a good measure of the effective average tax yield from different types of economic income or activities as it expresses aggregate tax revenues as a percentage of the potential tax base. As it happens, the

Republic has a relatively high ITR on consumption, but has lower than average ITRs on labour and, in particular, capital (Table 4.4).

Table 4.3 Comparison of Revenue by Type (% GDP)

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

Sources: European Commission (2016b): DG Taxation and Customs Union; NERI calculations
Notes: Data for EU represents weighted averages. Taxes on labour includes social contributions.

The Republic's below average ITR on labour is a by-product of the low level of social security contributions in the Republic compared to the EU. Net social security contributions averaged 13.4% of GDP in the EU and 15.5% in the euro area in 2014. This compares to just 5.8% in the Republic. Using the GDP-GNP hybrid as the fiscal base we find that the difference in social contributions explains almost all of the difference in revenue between the Republic and the euro area.

Table 4.4 Implicit Tax Rates, (% of potential tax base)

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

Sources: European Commission (2016b): DG Taxation and Customs Union; Eurostat (2015): Taxation Trends in Europe Annual Report 2014; NERI calculations
Notes: *Unweighted country average. Excludes Ireland. Data for Croatia not available.
** Not all EU countries reported the ITR on capital. More recent data is expected in 2016.

We have seen that public spending as a share of economic output is set to reach a very low rate historically by 2021. However, the Republic's relatively young population means there is relatively less demand pressure on government spending than there is in other EU countries. For example, old age spending accounts for 10.3% of GDP in the EU in 2014 compared to just 3.7% in the Republic (Eurostat, 2016g). However, this difference is not purely demand driven. The per capita spend on the elderly is much higher in the EU than it is in the Republic meaning the difference in spending is partially reflective of policy choices. In addition, the Republic's young population means there is extra demand pressure on the education and childcare budgets. The Republic's relatively favourable demographics are set to deteriorate in the coming years. IFAC (2016) estimate that just maintaining the current level of real public services will absorb close to €6 billion of extra spending over the next five years due to pressures arising from changing demographics and inflation.

There is a broad consensus within the economic growth literature that public spending on education, on R&D, and on the public capital stock (infrastructure) are critical inputs into the process of generating long-run increases in productivity based economic growth (LSE, 2015; McDonnell, 2015). However, the Republic is currently a relatively low spender in each of these three areas (Table 4.5). Government forecasts from the Summer Economic Statement (DOF, 2016b) show that capital spending, even ex post use of the fiscal space, will remain at historically low levels for the foreseeable future and will be just 2.4% of GDP in 2021 and at least €1.5 billion below the optimal level for an economy the size of the Republic's. Bottlenecks and infrastructure deficits are already apparent in a number of areas including housing, transport and communications infrastructure (rural broadband). Failure to invest sufficiently in education, national innovative capacity, and infrastructure will constrain the medium and long-term growth of the Irish economy. Such an outcome would damage the sustainability of the public finances.

Table 4.5 Public Spending on R&D (GERD - Higher Education and Government), Capital Formation and Education, % GDP

R&D		Fixed Capital Formation		Education	
Ireland	0.4	Ireland	1.8	Ireland	4.3
EU	0.7	EU	2.9	EU	4.9

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

Notes: R&D and Education are 2014. Data for Fixed Capital Formation (Investment) is 2015. Education spending is on a Classification of the Functions Of Government (COFOG) basis.

4.3 The Fiscal Rules

The parameters for Budget 2017 are set by the requirements of the *preventive* arm of the Stability and Growth Pact (SGP). Previous budgets were constrained by the need to hit particular fiscal targets as part of the Excessive Deficit Procedure agreed with the

European Commission under the *corrective* arm of the SGP. In 2015 the minimum requirement was a government deficit no worse than 3% of GDP. The preventive arm works somewhat differently and is assessed under two main pillars. The two pillars are the *Structural Balance Rule* and the *Expenditure Benchmark Rule*.

A balanced budget in structural terms is a balanced budget after adjusting for the cyclical position of the economy and is calculated net of once-off factors such as asset sales. The structural balance rule says that any country not at its *Medium-Term Budgetary Objective* (MTO) must achieve a specified minimum improvement in its structural balance. The Republic's MTO requires a structural deficit of no worse than 0.5% of potential GDP and a minimum annual improvement of 0.6 percentage points until the lower limit of the MTO is reached.

The structural balance remains constant if spending grows in line with potential GDP; improves if spending grows below potential GDP, and deteriorates if spending grows faster than potential GDP. The European Commission (2016a) estimates that the structural deficit is 2% in 2016 (Table 4.1). This means that public spending is required to grow at a slower rate than potential GDP in 2017.

The expenditure benchmark rule places a cap on the annual corrected growth of public spending that can only be exceeded if new '*Discretionary Revenues Measures*' are taken which structurally increase government revenue e.g. increases to tax rates. The cap is equal to the medium-term growth rate of potential GDP and is called the *reference rate*. The reference rate is updated yearly based on a forward and backward looking ten year average for nominal potential GDP growth. The European Commission (2016a) estimates the reference rate for real potential growth is 3.3% in 2017 and that there is an assumed GDP price deflator of 1.2% (IFAC, 2016). Thus if the Republic had achieved its MTO there would be permitted nominal expenditure growth of 4.5% in 2017.

The expenditure benchmark also makes use of a concept called the *convergence margin*. The convergence margin is applied to every country in the preventive arm of the SGP not already at its MTO. This ensures that the allowable growth in net expenditure will be less than the reference rate and is scaled appropriately for each country so that the required improvement is made over the year. The convergence margin reduces the Republic's allowable expenditure growth by 2 percentage points in 2017. As such the permitted nominal growth in expenditure is 2.5% (Table 4.6).

To calculate the available fiscal space under the expenditure benchmark we must first correct the measured growth in the public expenditure aggregate to exclude interest expenditure and co-financing of EU funding. We must also adjust for cyclical unemployment expenditure, while the figure for gross fixed capital formation must be adjusted to reflect the four year average. Doing so compensates for the volatile and lumpy nature of capital spending. Finally, an adjustment is made for net discretionary measures. Measures to reduce government revenue will reduce on a one-for-one basis the allowable increase in public spending and vice versa.

Table 4.6 Unused Fiscal Space within the Fiscal Rules (ROI)*

		2017	2018	2019	2020	2021
A	Reference rate of Potential Growth (% y/y)	3.3	3.4	3.6	3.7	3.7
B	GDP Deflator Applicable (% y/y)	1.2	1.3	1.3	1.3	1.3
C	Application of Convergence Margin (percentage point)	-2.0	-2.1	0.0	0.0	0.0
D *(A+B-C)*	Corrected Nominal Expenditure Growth Limit (%y/y)	2.5	2.6	4.9	5.0	5.1
E	Corrected Expenditure Aggregate (€bn)**	68.6	69.6	70.4	71.3	72.2
F	Net DRMs (€bn)***	0.1	0.5	0.4	0.4	0.4
G *(E-F)*	Corrected Expenditure less DRMs(€bn)	68.5	69.1	70.0	70.9	71.8
H *(G/E_{t-1})*	Nominal growth (%y/y)*	1.0	0.9	0.6	0.6	0.7
D	Corrected Expenditure Growth Limit (%y/y)	2.5	2.6	4.9	5.0	5.1
I *((E_{t-1} x (1 + D/100))*	Permitted Expenditure (€bn)*	69.5	70.4	73.0	74.0	74.9
J *(I+F)*	Allowable Corrected Expenditure adjusted for DRMs (€bn)	69.6	70.9	73.4	74.4	75.3
K *(D-H)*	Unused Fiscal Space within Growth Limit (percentage point)	1.5	1.7	4.3	4.4	4.4
L (J-E_{t-1})	Gross Fiscal Space Adjusted for DRMs (€bn)*	1.8	2.3	3.8	4.0	4.0
M	Pre-committed Expenditures	0.8	1.1	0.9	0.9	1.0
N *(L-M)*	**Net Fiscal Space (€bn)***	**1.0**	******1.2**	**3.0**	**3.1**	**3.0**

Sources: Irish Fiscal Advisory Council: Fiscal Assessment Report (2016), Department of Finance: Summer Economic Statement (2016b) and NERI calculations.

Notes: *Rounding affects totals.
**Corrected expenditure is estimated at €67.8 billion in 2016 (DoF, 2016b).
***DRMs are Discretionary Revenue Measures. The adjustments here are based on the non indexation of tax bands and credits.
****Non-application of the convergence margin increases the fiscal space by €1.4 billion. In such an event the fiscal space would rise to €2.6 billion in 2018.

When all of these adjustments are made the *nominal corrected expenditure aggregate* on a no policy change basis increases from €67.8 billion in 2016 to €68.5 billion in 2017. This is an increase of marginally over 1%. However, as discussed above, the Republic is actually allowed to increase its corrected nominal expenditure by 2.5% in 2017 so there is unused fiscal space of almost 1.5 percentage points on top of the already allocated corrected nominal expenditure of €68.5 billion. In nominal terms this extra space amounts to between €900 million and €1 billion (Table 4.6).

This €900 million represents an upward revision from earlier Departmental estimates of €500 million. The upward revision in the 2017 fiscal space is explained by the upward revision of the reference rate from 4% to 4.5%. Cumulative net fiscal space for the five years is close to €11.3 billion if it is accepted that the convergence margin ought to be applied in 2018.

The estimate of net fiscal space is sensitive to the potential growth rate of the economy. A structural shock to the economy; a secular decline in productivity, sustained underinvestment, or an underperformance of employment growth due to lower population growth or some other reason, would damage the economy's output growth potential (shown to average 3.5% in Table 4.6). The OECD (2013) projects a real GDP growth rate of 3% out to 2030 an estimate that is supported by Crafts (2014). Potential GDP growth could well be higher than this in the short-to-medium term given expected above trend employment growth over the next five years. However, we cannot be sure that this level of employment growth will in fact materialise. An average reference rate of real potential growth of 3% over the next five years, as opposed to 3.5%, would reduce the cumulative net fiscal space by close to €1.8 billion over the next five years.

Not all fiscal measures have the same impact on potential output. In particular, long-run productivity growth can be facilitated through appropriate investments in education and skills (human capital), equipment and infrastructure (physical capital), and supports for innovation and Research and Development. Thus, over the long-run investments in these areas can actually increase the fiscal space available to government.

Structural deficits and the convergence margin

The convergence margin reduces the cumulative fiscal space by €2.8 billion over the period 2017-2018 (€1.4 billion in 2017 and €1.4 billion in 2018). To determine whether it is necessary to apply the convergence margin we must first estimate the structural balance. The structural balance cannot be directly observed and measuring it requires us to first estimate the output gap – i.e. the cyclical position of the economy.

A negative output gap means the economy is performing below its potential and implies the structural balance is better than the underlying budget balance. On the other hand a positive output gap means the economy is overheating and implies the structural balance is worse than the underlying budget balance. Estimates of the output gap are uncertain and often subject to substantial revision even years later. This is particularly the case for a small economy like the Republic with relatively large migration flows.

Table 4.1 shows a range of estimates for the structural deficit. The Department of Finance and the European Commission estimate that the structural deficit will be 2% of potential GDP in 2016. This is worse than the estimate for the general government balance and implies the economy is overheating. The projections are based on the Commission mandated harmonised methodology. On the other hand the IMF estimates that the structural balance and the underlying balance are broadly equivalent in 2016 suggesting fairly minimal overheating.

The Commission' methodology for estimating structural parameters has been critiqued by Klär (2013) and by Bergin and Fitzgerald (2014). One reason the Commission's methodology appears flawed is that it is overly pro-cyclical with estimates for structural unemployment too closely following recent trends in actual unemployment. As a result the Commission's estimate for structural unemployment is very likely to be too high. This is generating an 'overheating bias' in their output gap calculations.

A strong case can be made that the economy is not overheating in 2016. The economy's still high unemployment rate, combined with the evident lack of domestic price and wage pressure in the economy; the current account surplus even after correcting for redomiciled PLCs; the improving net international investment position; the low underlying investment ratio and the lack of housing supply; and finally, the lack of private sector credit market easing, cumulatively suggests that actual output is still *below* its potential output in 2016.

Given the weight of evidence it appears that the Republic's output gap is still negative. If this is correct it means that the structural deficit is somewhat better than the current deficit in the government's finances and most likely below 1% of potential output. Our analysis is that application of the convergence margin to the Budget 2017 calculations appears to be appropriate on balance. On the other hand, applying the convergence margin in 2017 would improve the public finances sufficiently for the Republic to achieve its MTO of a structural deficit no worse than 0.5% of potential GDP. At that point it would be unnecessary to apply the convergence margin to future budgets. This would increase the net fiscal space available in Budget 2018 by €1.4 billion to €2.6 billion.

4.4 Fiscal Policy for Budget 2017[2]

The Irish Fiscal Advisory Council (2016) estimates that maintaining the current level of real public services and benefits will cost an additional €6 billion public spending between 2016 and 2021 due to demographic and price pressures. Some of this amount is already factored into the estimate of fiscal space with, for example, €2 billion factored into pre-committed expenditures to account for demographic costs. Even so, the scale of these pressures illustrates just how limited the scope is for new spending in the absence of new discretionary tax raising measures. How best to use this limited space should be guided by the twin goals of economic growth and equity and should also be consistent with environmental goals.

Economic growth depends on the investment rate, demographic changes, participation and unemployment rates, and changes in total factor productivity. Over the long run the growth of labour productivity is a function of growth in the stocks of human and fixed capital, as well as changes in the technological base and its diffusion. Different fiscal instruments have different effects on long-run potential growth. Growth friendly fiscal policies are those that boost the amount of labour inputs employed and/or those that boost average labour productivity (McDonnell, 2015). Of particular interest are fiscal measures that are either conducive to labour force participation, or that assist in the formation and development of human capital, fixed capital, or the development of national innovative capacity.

Spending on education, R&D, and infrastructure are the fiscal instruments most strongly associated with long-run economic growth (OECD, 2015). Education spending

[2] See McDonnell (2015) for a more extensive discussion of the growth impacts of different fiscal instruments.

is crucial for human capital formation and generates positive externalities (side-effects) for the wider economy. Investment has a positive effect on fixed capital accumulation and the economy's productive capacity. Knowledge based growth can be induced by the public sector directly investing in R&D inputs. A growth friendly fiscal strategy will prioritise each of these areas over other fiscal instruments such as tax cuts. Unfortunately the Republic spends less than the EU average on each of these areas as a percentage of GDP. A coherent five year growth strategy will require substantial spending increases in each of these three areas.

The Republic's productive infrastructure already lags that of Western Europe in a number of respects and the low capital investment level has been criticised by a wide range of institutions and commentators. Ideally, public capital investment would be increased from its current level to at least 3% or even 3.5% of GDP by 2021. Doing so would use up €3.2 billion to €4.7 billion of the total net fiscal space out to 2021 (i.e. an average annual increase of €800 to €900 million).

In terms of total government R&D spending, Denmark spends €473 per capita; Finland and Sweden spend close to €375 per capita, and Germany and the United States spend €315 per capita (Eurostat, 2016h). The Republic spends just €158 per capita. Increasing R&D expenditure to United States levels (i.e. almost 0.8% of GDP) would absorb a further €1 billion of fiscal space. Such an investment would boost the Republic's long-run growth potential.

In addition, family supports and in-kind public health services can boost long-run economic growth to the extent that they facilitate the formation of human capital, while childcare subsidies and tapering welfare benefits can encourage labour force participation particularly for women. Poorer households tend to be more dependent on certain public services, notably healthcare, and to benefit disproportionately from unemployment-related and disability benefits. Increased spending in these areas will tend to reduce inequality. In general, social transfers are progressive and increasing them tends to enhances equality while reducing deprivation rates.

With limited fiscal space there is a strong case for discretionary measures to increase revenue and cut wasteful spending. On a spending neutral basis a reweighting of public spending away from defence and business subsidies and towards education, R&D and public investment would be beneficial for long-run economic growth.

On the revenue side the most growth friendly fiscal instruments are recurrent taxes on immovable assets and other property taxes. This includes taxes on inheritances and gifts as well as net wealth taxes. Additional revenue can and should be raised from these sources. As pointed out in McDonnell (2015) there is evidence to suggest taxes on property, wealth and passive income have minimal negative consequences for long-run economic growth and, if designed properly, are highly progressive.

Fiscal policy can also boost potential growth through the gradual elimination of most tax expenditures (tax breaks). 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. Legislation should ensure that all tax expenditures come with three year sunset clauses built-in that automatically close the relief unless the tax expenditure can pass a cost benefit analysis with consideration of opportunity costs and alternatives and with growth and equity impacts fully considered.

Adherence to the fiscal rules limits the space for increasing public spending in Budget 2017 to a little over €900 million. The NERI's view is that a proposed two-to-one split between new spending and tax cuts is inappropriate given the suboptimal growth and equity implications of this split. It is our view that given the immense pressures on the expenditure side there is no scope available for reducing the relative tax level in Budget 2017 and that it would be unwise to do so.

The NERI's view is that the allocation for new public spending measures should be increased to €1.8 billion and that the additional fiscal space needed for this increase should be obtained through a series of discretionary revenue measures sufficient to increase structural revenue by €900 million. Given the extremely low levels of public capital investment and government spending on R&D, combined with the scale of the potential benefits to economic growth, it is appropriate these areas should receive large allocations from the new available resources. The NERI proposals are described in Table 4.7:

Table 4.7 Illustrative Budgetary Package, (€ millions)

	Yield		Cost
Taxes on wealth and property*	**500**	**Current Expenditure**	**800**
Reform CAT related and other tax expenditures	*200*	*Demographic pressures, anti-poverty measures and childcare subsidies*****	*800*
Non-indexation of property tax bands	*50*	**R&D and Capital Expenditure**	**1,000**
Introduce a net wealth tax	*250*	*Capital spending******	*800*
Reforms to PRSI**	**150**	*R&D*	*200*
Increase employer PRSI on the portion of income in excess of €100,000**	150		
Excises	**150**		
Introduce excise tax on sugar and increase excise on cigarettes	100		
Anti-fraud measures***	**100**		
Tax compliance measures	*100*		
Total yield	**900**	**Total cost**	**1,800**
		Net Fiscal Cost	**900**

Notes: Figures are indicative and rounded to the nearest €50 million. CAT refers to Capital Acquisitions Tax.
*Tax expenditures are generally damaging to growth while taxes on immovable property, wealth and passive income are growth and employment friendly compared to other taxes.
**€150 million to be raised through reforms to employer's PRSI with the yield hypothecated for subsidised childcare. Increasing the employer PRSI rate to 13.75% on incomes in excess of €100,000 would yield over €150 million.
***Refers to submission from Revenue Commisioners arguing that allocating €6.5 million to increase audit, investigation and compliance resources would yield €100 million per annum.
****Includes sufficient resources to increase social transfer rates to offset inflation's erosion of living standards, along with additional resources for the aid budget, mental health services, and community supports in deprived areas.
*****Increases to capital spending have a smaller impact on the 2017 fiscal space than tax cuts and increases to current spending. Consequently the illustrative budgetary package would use up less than the allowable €900 million or so of fiscal space.

4.5 Conclusion

The Republic's long-run economic growth; employment and equity goals can best be achieved by prioritising use of the available fiscal space to increase public capital investment levels to potential growth levels; along with provisions for additional spending on education; on R&D subsidies and supports, on national innovation capacity building, as well as on measures to reduce barriers to employment such as through childcare subsidies. Social payments should be increased by at least the cost of living as failure to do so will see the living standards of the most vulnerable fall in 2017 while deprivation will rise. Given the immense pressures on the spending side we propose a set of discretionary revenue measures sufficient to generate an additional €900 million of fiscal space in 2017.

5 Conclusion

As outlined throughout this edition of the *Quarterly Economic Observer* (QEO), the outlook for economic growth has become more uncertain in the wake of the United Kingdom's decision to exit the European Union. The precise impact of the Brexit decision on the Irish and EU economies is hard to quantify but likely to be negative and significant.

Our analysis in Section 4 of this document shows that on a no policy change basis, the Republic of Ireland will have one of the lowest public spending-to-GDP ratios in the entire EU by 2021, and a historically low spending ratio by modern Irish standards. Such a low level of spending has significant negative implications for the future provision and quality of public services and infrastructure, and has implications for the future sufficiency of welfare payments.

Adherence to the fiscal rules limits the space for increasing public spending in Budget 2017 to a little over €900 million. The NERI's view is that a proposed two-to-one split between new spending and tax cuts is inappropriate given the suboptimal growth and equity implications of this split. It is our view that given the immense pressures on the expenditure side there is no scope available for reducing the relative tax level in Budget 2017. The Republic's long-run economic growth; employment and equity goals can best be achieved by prioritising use of the available fiscal space to increase public capital investment levels; and increase spending on education and research and development, as well as on measures to reduce barriers to employment such as through childcare subsidies.

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