

Quarterly Economic Observer

Summer 2015



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About NERI and this publication

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

This is the 14th *Quarterly Economic Observer* (QEO) of the Institute. The purpose of the QEO is to provide regular, accessible and timely commentary so as to equip trade unions and others in articulating and advancing a new economic paradigm where the old has failed. The QEO complements the *NERI Summer 2015 Quarterly Economic Facts* (QEF) which provides a set of statistical indicators to underpin our analysis. Unless otherwise stated, the data cited in this Observer are the latest available as of mid-June 2015. The final draft of this document was completed on 22nd June 2015.

This report has been prepared by staff of the Institute. 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
Quarterly Economic Observer
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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 discusses a strategic approach to fiscal policy in the Republic of Ireland (Section 4).

Outlook for the Republic

We anticipate that the Republic's economy will grow at a reasonably robust rate for the duration of the forecast period (2015 to 2017), albeit with growth moderating year-on-year. The economy remains below its potential output level, and, driven by strong but declining employment growth, is projected to grow faster than the economy's long-run average potential growth rate out to 2017.

The unemployment rate will continue to fall. We project that by mid-2016 the number of persons unemployed will have fallen below 200,000 and that by-end 2016 the number of persons employed will exceed 2,000,000.

Based on the assumptions and expectations outlined Section 3, our current projections for the Republic of Ireland include:

- Strong GDP growth of 3.7 per cent in 2015, declining marginally to 3.5 per cent in 2016.
- Consumption will continue its recovery driven by rising real disposable incomes, improving household balance sheets and a strengthening labour market while investment will grow strongly from its currently low base.
- The strengthening economy will boost the public finances with the deficit falling to around 2.4 per cent in 2015 and 1.8 per cent in 2016.
- Unemployment will steadily decrease out to 2016, with the 2015 figure averaging 9.7 per cent and the 2016 figure averaging 8.9 per cent.
- Employment growth will be close to 2.2 per cent in 2015 and 1.9 per cent in 2016.

Outlook for Northern Ireland

The outlook for Northern Ireland economy has weakened given the result of the UK general election and the negative implications for public spending and aggregate demand. The lead up to the In/Out referendum on membership of the European Union will generate significant uncertainty, delay investment decisions, and undermine the attractiveness of Northern Ireland as a location for foreign direct investment.

Strategic Fiscal Policy in the Republic of Ireland

Section 4 discusses the implications of the European Union's fiscal rules for budgetary policy in the Republic of Ireland in 2016 and beyond:

- Adherence to the medium-term budgetary objective limits the space available for increasing public spending in the Republic of Ireland to near €1.0 billion per annum until at least the end of 2018, and potentially for longer depending on how the structural budget balance is estimated in future years.
- Much of this fiscal space will be absorbed each year by demographic pressures on public spending.
- We reject as inappropriate the proposed 50-50 split between revenue and expenditure measures given the far from optimal growth and equity implications of that split and the currently low levels of government revenue and spending.
- It is our view that there is no scope for reducing the tax take in Budget 2016 given the pressures on the expenditure side.
- We argue instead that 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.
- In addition, we argue for a modest increase in social spending funded by a set of growth-friendly reforms to increase total government revenue.

1 Introduction

A long-awaited economic recovery is starting to take hold in the Republic of Ireland after years of stagnation and decline. Our expectation is for moderately robust growth in economic output and total employment over the medium-term.

Uncertainty continues to overshadow the Northern Ireland economy. The full scale and composition of the cuts to public spending is yet to be confirmed, while the North's membership of the European Union is threatened by the upcoming In/Out referendum. Our expectation is for modest economic growth over the medium-term.

In the current edition of the *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 discuss the public finances in the Republic of Ireland and critique current fiscal policy. We argue that 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.

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 outlines a strategic fiscal policy pathway for the Republic of Ireland. Section 5 concludes.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.

¹ The analysis in the 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 Introduction

Headline economic developments since 2007 are summarised in Table 2.1. The euro area economy has performed poorly since the end of 2007. The bloc has experienced three separate years of negative real output growth, with real growth failing to exceed 2 per cent in any year. While Northern Ireland and the United Kingdom (UK) have more or less regained pre-crisis employment rates the Republic of Ireland's employment rate is still a long way below pre-crisis levels and has been below the euro area average since 2009. Growth in employment in the UK is inflated by the increase in part-time work. The Republic's annual unemployment rate has been in double digits for six consecutive years. There has also been very limited price pressure in the Republic with annual HICP inflation below the ECB target for the last six years.

Table 2.1 Key Economic Trends (2007-2014)

	2007	2008	2009	2010	2011	2012	2013	2014
Employment (% of working-age population)								
Rep. Ireland	69.2	67.4	61.9	59.6	58.9	58.8	60.5	61.7
N. Ireland	68.4	67.9	64.7	66.1	67.4	67.1	66.8	68.1
UK	71.5	71.5	69.9	69.4	69.3	69.9	70.5	71.9
Euro area	65.5	65.8	64.4	64.0	64.2	63.7	63.5	63.9
Unemployment (% of labour force)								
Rep. Ireland	4.7	6.4	12.0	13.9	14.7	14.7	13.1	11.3
N. Ireland	3.9	4.4	6.4	7.1	7.2	7.5	7.5	6.4
UK	5.3	5.6	7.6	7.8	8.1	7.9	7.6	6.1
Euro area	7.5	7.6	9.6	10.2	10.2	11.4	12.0	11.6
Gross Domestic Product (% volume change over previous year)*								
Rep. Ireland	4.9	-2.6	-6.4	-0.3	2.8	-0.3	0.2	4.8
N. Ireland	4.2	-3.1	-3.0	-1.1	-0.5	-0.1	-0.6	n/a
UK	2.6	-0.3	-4.3	1.9	1.6	0.7	1.7	2.8
Euro area	3.0	0.5	-4.5	2.0	1.6	-0.8	-0.4	0.8
Harmonised Index of Consumer Prices (% annual average rate of change)								
Rep. Ireland	2.9	3.1	-1.7	-1.6	1.2	1.9	0.5	0.3
UK	2.3	3.6	2.2	3.3	4.5	2.8	2.6	1.5
Euro area	2.2	3.3	0.3	1.6	2.7	2.5	1.3	0.4

Sources: Labour market data for Rep. Ireland, United Kingdom (UK) and for the Euro area are from Eurostat (2015a) Labour Force Survey Database (Updated 3 June). Online reference codes lfsi_emp_a and une_rt_a. Labour market data for Northern Ireland (NI) is from NISRA (2015a). Real GDP growth rate data for Rep. Ireland, UK and for the Euro area are from Eurostat (2015b) National Accounts database (Updated 17 June); Online reference code nama_10_gdp. Gross Value Added (GVA) data for NI are taken from ONS Regional Trends Series (ONS, 2015a). Harmonised Index of Consumer Prices (HICP) data for Rep. Ireland, UK and the Euro area are from (Eurostat, 2015c) Prices database (Updated 17 June). Online reference code prc_hicp_a. and.

Notes: *NI output refers to GVA. Euro area refers to the 19 members of the Euro area. Labour market data for 2007-2014 represent averages for the whole year. Total employment refers to all persons in employment (ILO definition) aged 15-64 as a proportion of all persons aged 15-64. Unemployment is measured on the ILO definition basis and refers to persons aged 15-74. n/a = not available

2.2 Recent trends in the World Economy

The world economy has grown by 3.3 per cent in real terms in each of the last three years (OECD, 2015a). Average growth has been slower overall in the OECD group of advanced economies (IMF, 2015a). The United States (US) grew by a reasonably healthy 2.4 per cent last year and the United Kingdom (UK) grew by 2.8 per cent. However, the euro area grew by just 0.8 per cent and the Japanese economy shrank by 0.1 per cent. The major emerging economies had even more diverse outcomes. China grew by a robust 7.4 per cent while India grew by 7.2 per cent. On the other hand growth was minimal in Russia (0.6 per cent) and in Brazil (0.1 per cent).

World trade grew by 3.2 per cent in real terms in 2014. Overall the global economy continues to be characterised by weak investment levels as well as by high rates of unemployment in a number of countries. Scars remain from the financial and euro area crises and a number of advanced economies remain constrained by weak credit conditions and high public and private debt levels. The weakness in investment is lowering capital accumulation and is an impediment to labour productivity growth and potential output. Demand is however being supported by accommodative monetary policy, by falling energy prices and by a slowing of fiscal drag and private sector deleveraging.

Compared with the previous quarter, euro area real GDP grew by 0.4 per cent on a seasonally adjusted basis in the first quarter of 2015 following growth of 0.3 per cent in the fourth quarter of 2014 (Eurostat, 2015d). European Union (EU) growth rates in the first quarter of 2015 ranged from a high of 3.1 per cent in the Czech Republic to a low of minus 0.6 per cent in Lithuania. The US experienced negative growth (minus 0.2 per cent) in the first quarter of 2015 following 0.5 per cent growth in the previous quarter, while the UK grew by 0.3 per cent in the first quarter of 2015 following growth of 0.6 per cent in the previous quarter.

There is still some evidence of labour market slack in a number of advanced economies. In particular, unemployment remains high in the euro area with a seasonally adjusted unemployment rate of 11.1 per cent in April 2015 (Eurostat, 2015e). Even so, this rate marks an improvement on the April 2014 figure of 11.7 per cent. Unemployment in the EU as a whole was 9.7 per cent in April of this year

compared to 10.3 per cent in April 2014. The highest unemployment rates are in Greece (25.4 per cent) and Spain (23.1 per cent), with unemployment lowest in Germany (4.7 per cent) and the United Kingdom (5.4 per cent). Youth unemployment remains high in the EU. The seasonally adjusted unemployment rate was 20.7 per cent in April 2015.

Actual unemployment rates in Germany, the United Kingdom (UK), the US (5.4 per cent) and Japan (3.5 per cent) are all now likely to be close to or even below the equilibrium (structural) rates of unemployment for those countries. The most recent quarterly reading for the UK's employment rate was 72.4 per cent while Germany's employment rate was 74.1 per cent (Eurostat, 2015f). This represents the highest quarterly rate recorded for the UK this century and the second highest quarterly rate recorded for Germany.

Tighter labour market conditions have started to translate into wage growth in some countries, notably Germany, although nominal wages have yet to significantly increase in the US, and wage growth has been weak in the UK. Indeed real wage growth and labour productivity growth have both been weak in the UK since 2007 with much of the jobs growth concentrated in low productivity lower paid sectors.

Currency movements and falling oil prices have strongly influenced domestic inflation over the last year. The euro has depreciated against the US dollar as well as against a trade-weighted basket of currencies. The depreciation of the euro has been driven by divergent economic prospects, along with the European Central Bank's (ECB) highly accommodative monetary policy stance of low policy (interest) rates and the ECB's programme of quantitative easing, including the purchase of sovereign bonds. This monetary policy support has boosted equity and bond prices which in turn has increased household wealth, lowered business financing costs and helped reduce the yield on sovereign bonds. The depreciation of the euro is putting upward pressure on the euro area's core consumer inflation in 2015 and improving the euro area's trade balance, while the appreciation of the US dollar is having the opposite effects in the US.

The falling price of oil is pushing down inflation while benefiting oil importers at the expense of oil exporters. Deflation concerns persist in the euro area although flash estimates (Eurostat, 2015g) suggest that euro area annual inflation was 0.3 per cent in May, up from 0.0 per cent in April. Services (1.3 per cent) and food, alcohol and

tobacco (1.2 per cent) had the highest annual rates in May with energy contributing minus 5.0 per cent. Core CPI inflation in the US remains well below the Federal Reserve's longer-run objective of 2 per cent suggesting significant increases in the federal funds rate may still be some time away. The appreciation of Sterling has weighed on inflation in the UK with annual CPI inflation of 0.0 per cent in March due to falls in food, energy and other import prices.

The overall impact of falling input (energy) prices is positive for world economic growth. Net energy importers such as the euro area, Japan, China, India and the United States are benefiting in terms of higher net exports, investment and overall growth, while energy exporters such as Canada, Russia, Norway and much of the Middle East are experiencing a drag on growth in terms of falling exports and lower investment levels. Falling energy prices are increasing financial vulnerability in a number of countries, including Russia. Russia has been forced to raise interest rates in response to pressure on the rouble.

2.3 Recent trends in the Republic of Ireland Economy

The Republic of Ireland's economy grew strongly in 2014 (CSO, 2015a). Real GDP (i.e. excluding price effects) expanded by 4.8 per cent while real GNP grew by 5.2 per cent. Real GDP grew by 4.1 per cent compared to the previous year in both the third and fourth quarters of 2014. However, seasonally adjusted real GDP growth was just 0.2 per cent in the fourth quarter of 2014 compared with the previous quarter.

Capital formation (investment) grew by a robust 11.3 per cent in 2014, albeit from a low base as a proportion of GDP, while personal consumption increased by 1.1 per cent. This was the first increase in personal consumption after three consecutive years of decline. Government consumption increased slightly in 2014 (0.1 per cent), while total domestic demand was up 3.6 per cent during the year (Chart 2.1). Exports (12.6 per cent) and imports (13.2 per cent) both grew very strongly during 2014 with overall net exports expanding by €3.8 billion during the year. The fastest growing sector was *agriculture, forestry and fishing* (10.0 per cent) with *public administration and defence* experiencing the lowest growth (1.1 per cent).

A recovery in consumer spending is taking place after years of decline and stagnation (Chart 2.2). The volume of retail sales increased by 6.4 per cent in 2014 compared with

the previous year (4.1 per cent in value terms), while retail sales data has been very positive in the first four months of 2015 (CSO, 2015b). The volume of retail sales was up 11.9 per cent in April compared with the previous year and was up 8.3 per cent in value terms. Excluding motor trades gives us core sales. The volume of core retail sales was up 5.0 per cent in the first quarter of 2015 compared with the first quarter of 2014 and was up 7.8 per cent in April compared with the previous year.

The service and production indices have shown healthy growth in the first few months of the year. The monthly services index was up 3.7 per cent in April compared with the previous year (CSO, 2015c). There were declines in *information and communication* (minus 5.2 per cent) and *administration and support service activities* (minus 3.7 per cent) while the largest positive contribution came from *wholesale and retail trade* which was up 11.9 per cent on an annual basis. The volume index of production for manufacturing industries was up an extremely robust 26.2 per cent in the first quarter of 2015 compared to the previous year and on a seasonally adjusted basis was up 10.2 per cent over the previous quarter (CSO, 2015d). The balance of payments had a current account surplus of €11.5 billion in 2014 equivalent to 6.2 per cent of GDP (CSO, 2015e) and an increase of €3.8 billion on 2013.

Chart 2.1 Quarterly trends in the value of domestic demand, Rep. Ireland, 2008 to 2014, €m (constant 2012 prices)



Source: CSO Quarterly National Accounts (2015a).

Notes: Domestic Demand = Personal Consumption + Government Consumption + Investment. Domestic demand chiefly differs from GDP due to net exports = exports – imports, and changes in values of physical stocks. Values are adjusted for seasonal variation.

Chart 2.2 Monthly trends in the volume of retail sales, Rep. Ireland, 2008 to 2015 (2005 = 100)



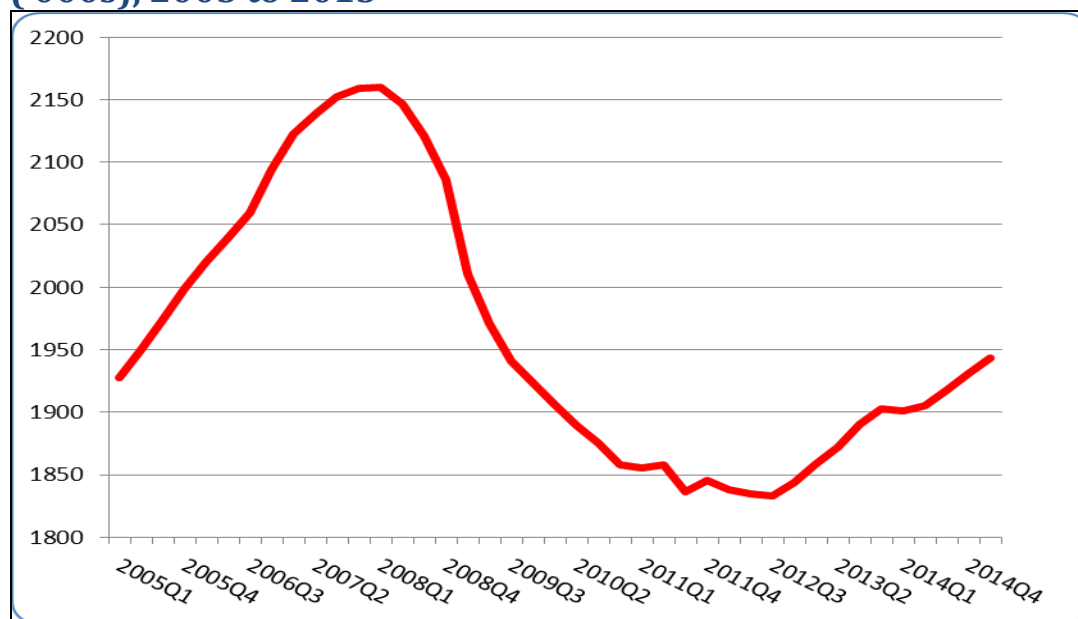
Source: CSO Retail Sales Index (2015b).

Notes: Volume of retail sales (seasonally adjusted). Index base is for 2005=100

There were 2,142,600 people in the labour force in the first quarter of 2015 (CSO, 2015f) representing a decline of 4,000 persons or 0.2 per cent over the previous year. The size of the labour force declined in five of the eight geographic regions. The labour force participation rate for persons aged 15 and over fell from 59.7 per cent to 59.4 per cent over the year to the first quarter of 2015.

Seasonally adjusted employment increased by 12,500 (0.6 per cent) in the first quarter of 2015 and the Republic's employment trend has now been upwards for three years. Net employment increased by 41,300 in the year to the first quarter 2015 and has increased by 104,500 over the previous three years. The employment rate increased from 60.8 per cent to 62.2 per cent over the year to first quarter 2015. However, the employment rate is still well below the average for EU member states (65.2 per cent) and total employment of 1,929,500 in the first quarter of 2015 represents 216,900 less people employed than during the first quarter of 2008 (2,146,400 persons) despite the population increasing in the meantime. Total employment in the first quarter of 2015 is broadly equivalent to total employment in the first quarter of 2005 (Chart 2.3).

Chart 2.3 Quarterly trends in total employment, Rep. Ireland, ('000s), 2005 to 2015



Source: CSO Quarterly National Household Survey (2015f).

Note: Total employment seasonally adjusted

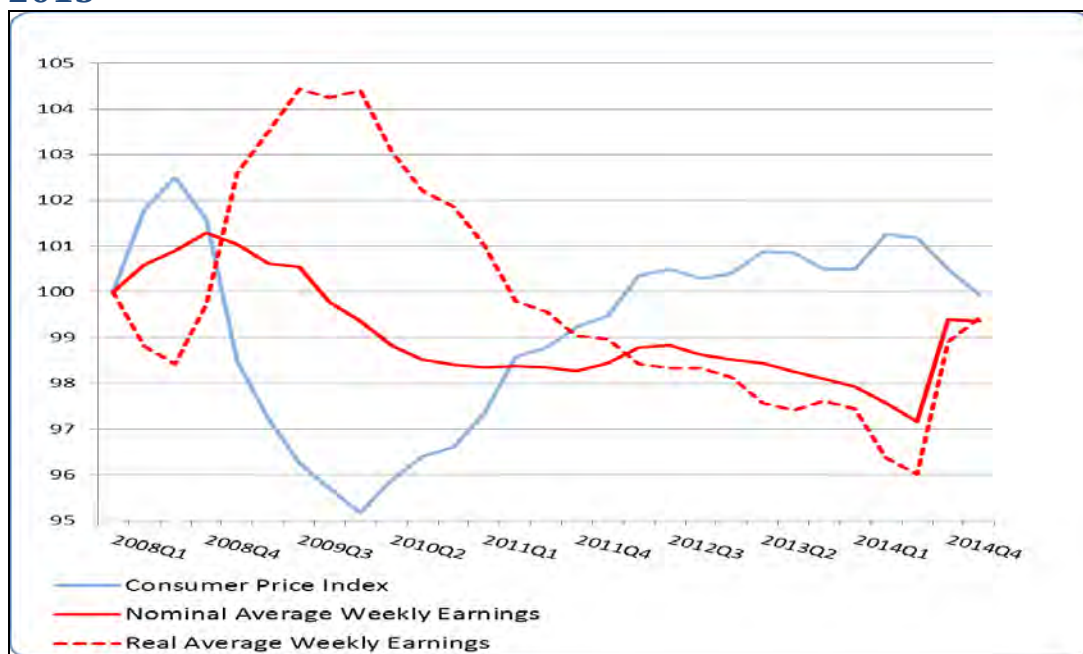
Male employment increased by 25,100 over the year to the first quarter of 2015 while female employment increased by 16,200. Full-time employment increased by 52,100 while part-time employment fell by 10,800. Employment increased in ten economic sectors over the year and fell in the other four sectors. The largest increase was in *construction* (+19,600) while the largest decline was in *professional, scientific and technical activities* (minus 6,400). Youth employment (persons aged 15-24) fell by 100 persons over the year.

The *Mid-East* (92.1 per cent) and *Dublin* (91.9 per cent) regions experienced the smallest relative declines in employment expressed as a percentage of total employment in first quarter of 2008. The worst performing regions have been the *Mid-West* (85.8 per cent) and the *West* (86.4 per cent). Most regions have seen total employment increase since early 2012, with the exceptions being the *Mid-West* and the *West*. The labour force has declined in every region since 2008 with the largest relative declines in the *Mid-West* and *Border* regions. All but one region saw total employment increase in the year to first quarter 2015. The exception was the *West* region where employment fell by 5,400.

The Republic's unemployment rate averaged 11.3 per cent in 2014 (Eurostat, 2015a) but is steadily declining. The seasonally adjusted number of persons unemployed was 209,700 in May 2015 while the seasonally adjusted rate was 9.8 per cent (CSO, 2015g). This was a decline of 40,500 and 1.9 percentage points over the previous year. The unemployment rate was 11.0 per cent for males and 8.3 per cent for females. Youth unemployment was 20.2 per cent. Long-term unemployment is high but falling and was 127,200 or 5.9 per cent in the year to first quarter 2015. The long-term unemployed make up 59.8 per cent of the total unemployed.

Preliminary estimates show that average weekly earnings were €696.03 in the first quarter of 2015. Average weekly earnings increased by 0.5 per cent in the year to first quarter 2015 but were down 0.9 per cent over the previous quarter (CSO, 2015h). The decline in weekly earnings was caused by a reduction in average weekly hours from 31.8 to 31.3, whereas average hourly earnings actually increased from €22.04 to €22.23. Average weekly earnings increased in five of the thirteen sectors, while average hourly earnings increased in seven sectors. The largest annual percentage increase in average weekly earnings was in *information and communication* (5.8 per cent). Average hourly total labour costs increased by 0.9 per cent over the year.

Chart 2.4 Quarterly trends in earnings, Rep. Ireland, 2008 to 2015



Sources: Calculated from CSO Survey on Earnings Hours and Employment Costs (2015h) and Consumer Price Index (2015i).

Notes: Index values set to 100 for Q1 2008. Seasonally adjusted.

Real average earnings are benefiting from price stagnation (Chart 2.4). Prices in May, measured by the CPI (minus 0.3 per cent) and the HICP (0.2 per cent), were little changed over the previous year (CSO, 2015i). *Transport* (minus 0.41 per cent) made the largest downwards contribution to the CPI reflecting lower petrol and diesel prices. The annual rate of inflation for services was 2.0 per cent in the year to May, while goods inflation was minus 3.1 per cent. Services, excluding mortgage interest payments, increased by 3.0 per cent in the year to May. The annual change in the CPI has been below 1.0 per cent since March 2013.

The general government deficit was €7.6 billion or 4.1 per cent of GDP in 2014 (DOF, 2015a). The gross debt ratio was €203.3 billion or 109.7 per cent of GDP at the end of 2014 and net debt was 89.9 per cent of GDP. Irish government 10-year bond yields reached a record low of 0.65 per cent in April but have since increased to 1.55 per cent.

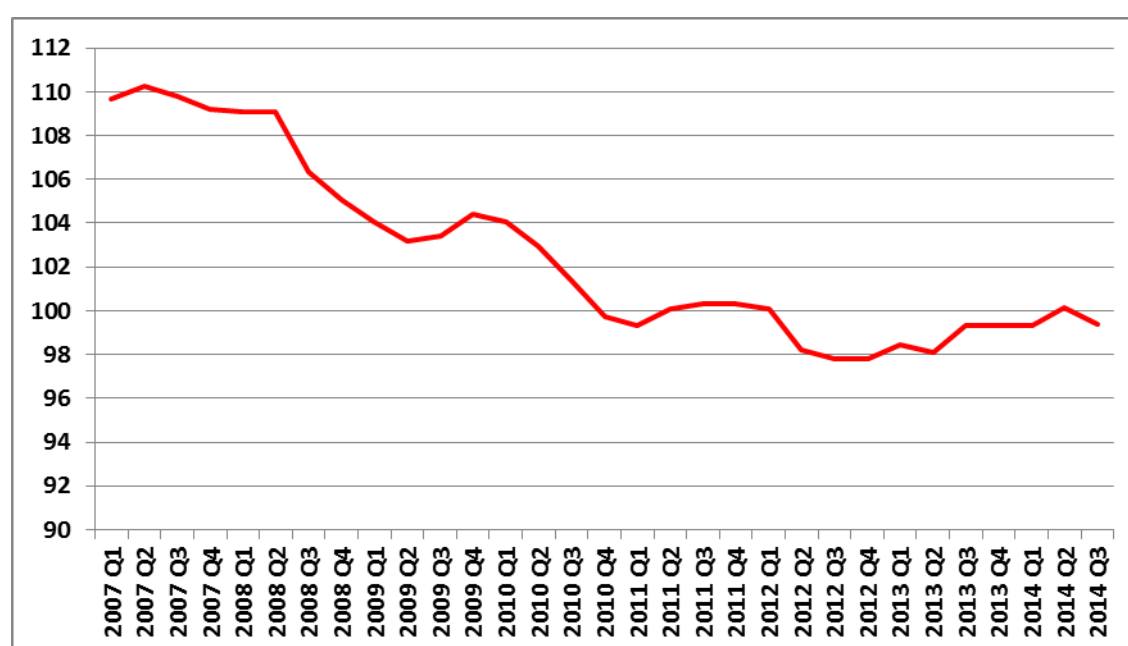
An Exchequer surplus of €641 million was recorded up to the end of May 2015 (DOF, 2015b), which compares to a deficit of €3.5 billion in the same period last year. The main factors behind the improvement are a €1.7 billion increase (10.9 percent) in tax revenues compared to the first five months of 2014, along with higher Central Bank surplus income, inflows from the banking sector and one off transactions. Net voted expenditure is €165 million lower in year-on-year terms. Tax receipts are currently €0.7 billion above projections while overall net voted (discretionary) expenditure is €306 million below profile.

The number of mortgage accounts for Principal Dwelling Houses (PDH) in arrears is falling (CBI, 2015a) with 104,693 such accounts in arrears during the first quarter. Some 14.1 per cent of PDH mortgages by value are in arrears of more than 90 days. Irish residential property prices rose by 15.8 per cent in the year to April with prices increasing by 20.2 per cent in Dublin over the same period (CSO, 2015j). House prices rose by 0.6 per cent nationwide in April over the previous month (1.0 per cent in Dublin). Household net worth rose by 4.3 per cent during the last quarter of 2014 and is now at its highest level since 2008 (CBI, 2015b). Household net worth was €600.8 billion or €130,331 per capita. Household debt fell by 1.6 per cent over the quarter to stand at €157 billion. Household debt as a proportion of disposable income (a measure of debt sustainability) declined by 3.7 percentage points during the quarter, falling to 168.7 per cent. This is the lowest level since 2005.

2.3 Recent trends in the Northern Ireland Economy

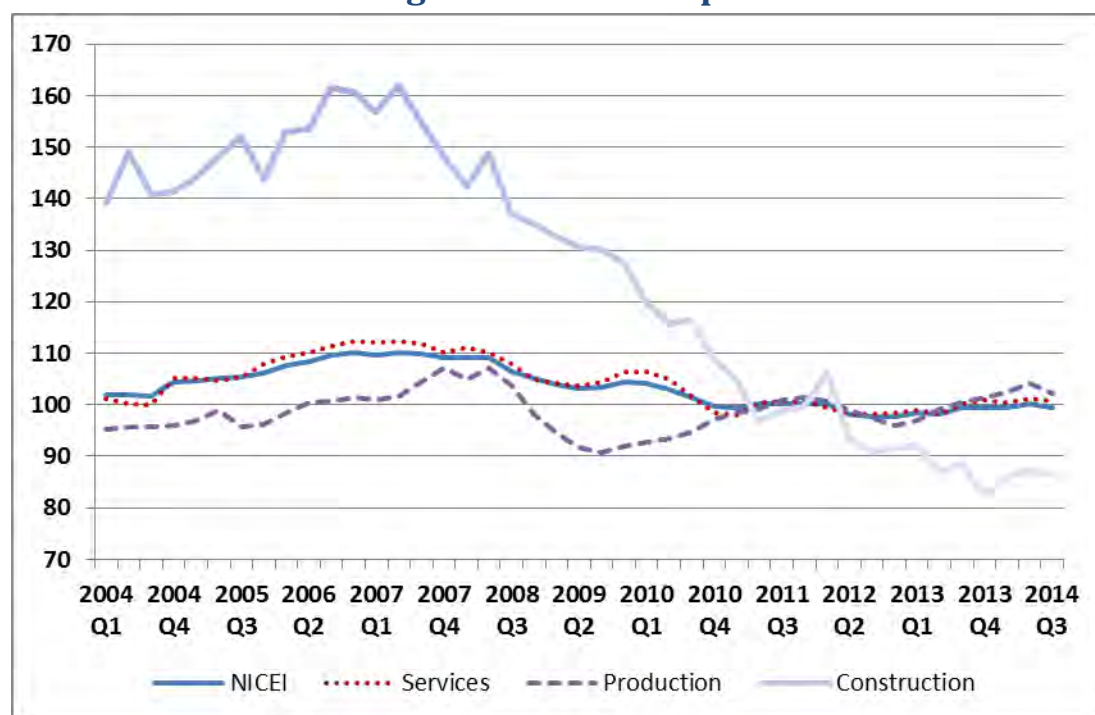
Economic recovery in Northern Ireland (NI) has been patchy. The latest figures for the Northern Ireland Composite Economic Index (NICEI) indicate the NI economy shrank by 0.7 per cent in the third quarter of 2014. Growth in the second quarter was revised up to 0.8 per cent (NISRA, 2015b). This follows two quarters of flat growth leaving the overall NICEI just 0.1 per cent above the previous year.

Chart 2.5 Trends in the NI Composite Economic Index (NICEI), 2007-2014



Source: NISRA (2015b) NI Composite Economic Index.

The most recent data for NI shows a drop of 11 per cent in the number of loans for home purchases and a 4 per cent drop in the value of such loans (CML, 2015). There were declines of 0.6 per cent and 1.8 per cent in the services and production sectors respectively, each contributing a 0.3 per cent reduction in overall growth. While the decline in the production sector in this quarter is larger it follows consistent growth in the previous six quarters. Excepting a mild upturn in early 2013 the services sector has remained essentially flat since 2011. The services sector has seen the largest increase in employment since 2007 (NISRA, 2015b) and stagnant output would indicate a worrying trend for productivity in that sector and for the economy as a whole.

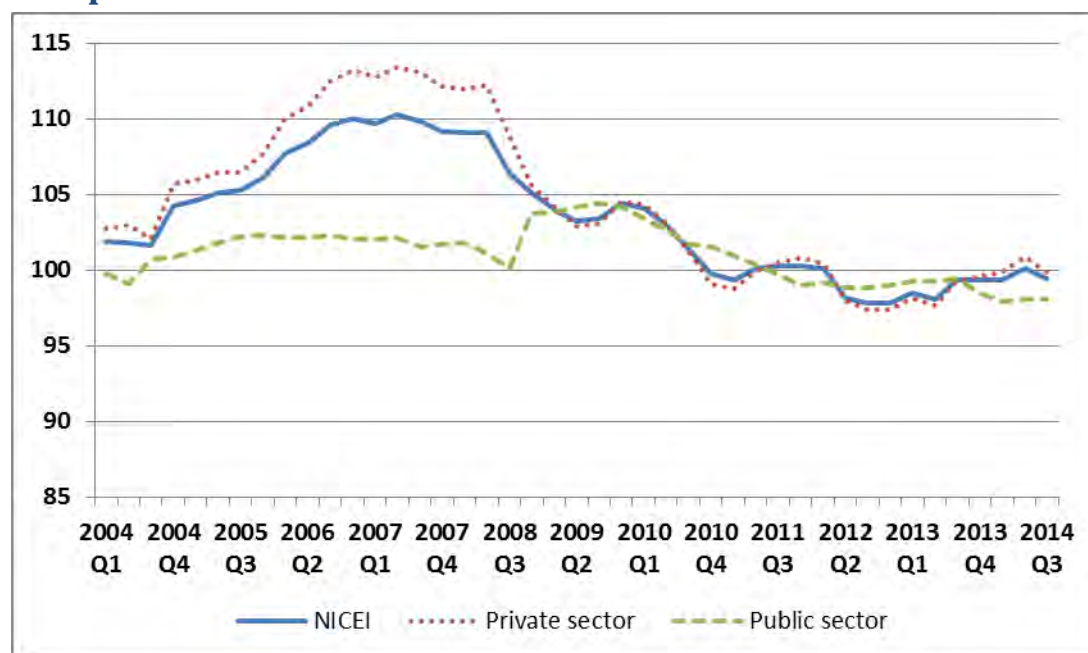
Chart 2.6 Sectoral changes in the NI Composite Economic Index

Source: NISRA (2015b) NI Composite Economic Index

The trends in public and private sector activity display the central challenge for the NI economy over the medium term. After a small surge in activity in 2009, public sector activity has been in gradual decline and, as Chart 2.7 illustrates, private sector activity has followed a somewhat similar course. A boost in private sector activity in the second quarter was wiped out in the third. Overall activity has been flat for the year ending in Q3 2014. Northern Ireland faces the prospect of at least another three years of contraction in public spending.

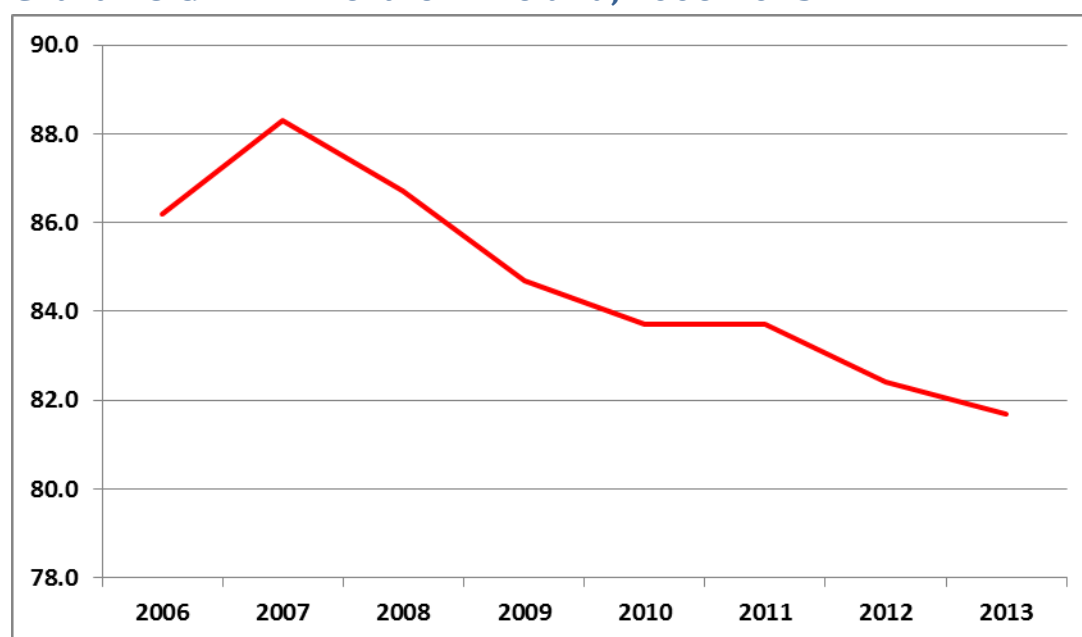
The most up to date information on economic activity is survey data from the Purchasing Managers Index (PMI) for Northern Ireland. The PMI reports expectations and intentions of firms in various industries and sectors. The latest data showed a return to growth in private sector activity (Ulster Bank, 2015a). However this followed contraction of the PMI in the first four months of the year.

Chart 2.7 Public and private sector performance in the NI Composite Economic Index



Source: NISRA (2015b) NI Composite Economic Index

Although there were reductions in economic activity both quarter on quarter and year on year the labour market has seen some modest improvement in recent months (NISRA, 2015a). While unemployment in the first quarter of this year was up 6,000 or 0.5 per cent on the last quarter of 2014 it was down nearly 8,000 or just under 1 per cent since the first quarter of 2014. Increases in employment are now concentrated in full-time employees, with both part-time and self-employment in decline. Wages performed poorly in 2014 and this trend has fed into decreasing household incomes. The Resolution Foundation (2015) found that Northern Ireland household incomes experienced the largest fall in the UK between 2007 and 2014 and are now the lowest of any UK region. Official statistics for Gross Household Disposable Income confirm this trend up to 2013.

Chart 2.8 GDHI in Northern Ireland, 2006-2013

Source: ONS (2015a) Regional Gross disposable household income1 (GDHI) per head indices at current basic prices

The jobs market delivered mixed news in the second quarter of the year. Financial and professional services consolidated previous gains with Grant Thornton creating 70 new jobs in Belfast. There was considerable optimism surrounding the capacity of a renewable energy storage facility in Co. Antrim to create up to 500 jobs. The scheme designed by Gaelectric would require a £300m investment, but could also bolster energy security within Northern Ireland. However Bombardier announced they would be seeking a further 220 job cuts from their Belfast operation. In addition, job creation in the private sector needs to be set in the context of developments in public sector employment over the next number of years and the plan to reduce public sector employment by 20,000.

With no indications that the private sector has the capacity to even replace the contraction in public spending and in public sector employment, the prospects for the Northern Ireland economy in the short and medium term remain bleak.

3 Economic Outlook

3.1 Introduction

This section of the QEO outlines our basic assumptions for the main trading partners of the Republic of Ireland and Northern Ireland as well as our baseline expectations for the economies of both parts of the island of Ireland. The main risks to the baseline forecasts are considered and we also discuss the implications of the outcome of the United Kingdom (UK) election for both economies on the island.

The outlook for Northern Ireland is weak given the result of the UK general election and the negative implications for public spending and aggregate demand in the economy. The lead up to the In/Out referendum on membership of the European Union will generate significant uncertainty and delay investment decisions and the attractiveness of Northern Ireland as a location for foreign direct investment. Our baseline projection for the Northern Ireland economy is for moderate employment growth although this will be tempered by austerity and delayed investment in 2016.

NERI projections for economic growth, the labour market and the public finances are presented out to 2017 for the Republic of Ireland. We anticipate that the Republic's economy will grow at a reasonably robust rate for the duration of the forecast period, albeit moderating in later years. The economy remains below its potential output level, and, driven by strong but declining employment growth, is projected to grow faster than the economy's long-run average potential growth rate out to 2017. The unemployment rate will continue to fall. We project that by mid-2016 the number of persons unemployed will have fallen below 200,000 and that by-end 2016 the number of persons employed will exceed 2,000,000. The general government balance will remain in deficit over the forecast period, albeit declining steadily year-on-year.

3.2 Macroeconomic Assumptions for the Global Economy

Growth prospects for both economies on the island of Ireland are dependent on the economic performance of the wider global economy as well as future trade and competitiveness patterns. While true for all economies it is particularly the case for small open economies with very large export sector such as the Republic of Ireland.

The Republic's main trading partners are the euro area, the United Kingdom (UK) and the United States (US). The IMF (2015a) forecasts world trade volume will grow by 3.7 per cent in 2015 and 4.7 per cent in 2016.

The OECD (2015a) projects that global real GDP growth will be 3.1 per cent in 2015 and 3.8 per cent in 2016. The forecast is underpinned by lower oil prices, supportive monetary conditions, less drag from fiscal consolidation and improving financial sector conditions although concern is expressed at the slow recovery in investment. NIESR (2015) forecast global growth of 3.2 per cent in 2015 and 3.8 per cent in 2016. The IMF (2015a) projects global growth of 3.5 per cent in 2015 and 3.8 per cent in 2016. Investment weakness remains a concern, particularly in advanced economies.

The growth outlook for many emerging large economies is subdued. The sharp drop in oil prices is a boon to oil importers but is increasing financial vulnerabilities for oil exporters. A slowdown is expected for emerging economies reliant on commodity and energy exports. Brazil is affected by fiscal consolidation, drought and weak private sector investment, while prospects for Russia are weakened by lower oil prices and geopolitical tensions. Growth is expected to slow in China as the authorities seek to slow down credit growth and investment as the economy matures. This will generate negative spillovers for East Asia. Tightening monetary policy in the US will add to financial vulnerabilities for many emerging economies.

Seasonally adjusted real GDP grew by 0.4 per cent in the euro area in the first quarter of 2015. A moderate economic expansion is forecast in the short term. Growth will be assisted by the fall in oil and other input prices, the depreciation of the euro against the US Dollar and UK Sterling as well as reduced fiscal drag from austerity. The European Central Bank's programme of quantitative easing will support consumption and investment as well as boosting competitiveness and net exports through depreciation of the currency. Even so, deleveraging in the public and private sectors continues to hamper demand while legacies from the recession including low investment, high unemployment and hysteresis scars suggest the output potential of the euro area will remain somewhat subdued over the medium-term. The IMF (2015a) is projecting euro area real GDP growth of 1.2 per cent in 2015 and 1.5 per cent in 2016 while the European Commission (2015a) is projecting growth of 1.3 per cent in 2015 and 1.9 per cent in 2016. The Commission is projecting an average euro area unemployment rate

of 11.0 per cent in 2015 and 10.5 per cent in 2016. The seasonally adjusted unemployment rate was 11.2 per cent in April.

The ECB's 2.0 per cent inflation target is unlikely to be achieved before 2017 and the key ECB interest rates are unlikely to be changed from their historic lows in 2015. Annual inflation (HICP) was 0.0 per cent in the euro area in April. Inflation should stay low for several months. However the quantitative easing programme (which will boost aggregate demand) and weakening of the Euro will exert some inflationary pressure in the euro area as 2015 continues. Energy prices should increase gradually over the next two years and this will put upward pressure on inflation and wage demands. The ECB Survey of Professional Forecasters implies average inflation expectations of 0.1 per cent in 2015, 1.2 per cent in 2016 and 1.6 per cent in 2017 (ECB, 2015). Spare capacity will keep wages subdued in 2015.

The Commission (2015a) projects real GDP growth in the UK will be 2.6 per cent in 2015 and 2.4 per cent in 2016, while the IMF (2015a) is projecting similar growth estimates of 2.7 per cent in 2015 and 2.3 per cent in 2016. The Bank of England (2015) external forecasters project annual real GDP growth rates of close to 2.5 per cent for the next three years. However, in our view short-term prospects may be overstated with fiscal drag likely to impede growth in 2015 and beyond. The uncertainty surrounding the EU referendum may drag on investment in 2015-2016 while the strength of Sterling and the weakness of the euro area will negatively affect net exports. In addition, unemployment is already low so productivity gains will have to do much of the lifting to increase growth. This may be difficult to achieve. CPI inflation was 0.0 per cent in March although this reflects falling energy prices and the BOE forecasts inflation will have returned to the 2 per cent target by end 2016.

Prospects are somewhat brighter for the US economy despite the weak first quarter growth figures. The IMF (2015a) forecasts real GDP growth of 3.1 per cent in 2015 and again in 2016. Falling oil prices and reduced fiscal drag are both supporting growth in investment and personal consumption. However, the Fed is expected to increase interest rates in the second half of the year and this will diminish domestic demand, while the strengthening of the US Dollar is an impediment to net exports. The unemployment rate should continue to fall over the next few years while CPI inflation will increase gradually over the next few years from its currently low rate (0.2 per cent in March).

3.3 Macroeconomic Projections for the Republic of Ireland

Economic Activity

Real GDP growth was 4.8 per cent in 2014 while real GNP growth was 5.2 per cent. The GDP deflator was 1.3 per cent meaning nominal GDP increased by 6.1 per cent in 2014 to €185.41 billion. Investment (11.3 per cent), exports (12.6 per cent) and imports (13.2 per cent) all grew very strongly in 2014. Personal consumption grew modestly (1.1 per cent) after three consecutive years of decline. We are projecting that real GDP growth will be 3.7 per cent in 2015, 3.5 per cent in 2016 and 3.1 per cent in 2017 (see Table 3.1). The economy is most likely still operating below its long-run potential suggesting capacity for above trend growth in the short-term.

Our optimistic growth outlook for 2015 is based on a number of factors. These include the expected boost to consumption and investment from the ECB's programme of quantitative easing as well as the mild stimulus announced in Budget 2015. The depreciation in the value of the euro against the US dollar and UK Sterling will provide a strong boost to net exports while the lower energy prices will have a positive effect on the economy by increasing real disposable income. A gradual decline in the savings rate will lead to an increase in personal consumption as improving household balance sheets and falling unemployment help to buttress consumer confidence. The most recent labour market, retail sales and exchequer returns data supports the narrative of an economy in recovery. In addition, the main survey indicators of economic performance are suggestive of strong growth in 2015 and 2016.

Our analysis of above trend GDP growth continues into 2016 on the back of further improvements in the labour market as well as strong growth in investment from its currently low base. We forecast that nominal GDP will exceed €194 billion in 2015 and will be marginally in excess of close to €204 billion in 2016. We expect that GDP growth will marginally exceed trend in 2017.

As always our projections for GDP growth come with caveats. Conroy (2015) points out that macroeconomic data in the Republic of Ireland is extremely volatile and prone to substantial revision. The Republic is a small open economy with a large financial sector and a large multinational sector and the behaviour of a few large multinationals can have an outsize effect on macroeconomic aggregates given the small size of the

Irish economy. The national accounts have been distorted in recent years through effects such as the patent cliff in the pharma sector and contract manufacturing, and are decoupled on an ongoing basis from real activity by the tax planning behaviour of multinationals. Our year-on-year growth projections are based on the assumption of no similar major distortions to real GDP in the next three years. 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, (Rep. Ireland)

	2014	2014	2015	2016	2017
Real Output		<i>Percentage real change over previous year</i>			
Gross Domestic Product	€185.4bn	4.8	3.7	3.5	3.1
Personal Consumption	€85.6bn	1.1	2.2	2.0	2.1
Government Consumption	€26.0bn	0.1	1.1	1.6	1.3
Investment	€30.4bn	11.3	10.0	8.7	7.4
Exports	€207.8bn	12.6	5.5	4.2	4.1
Imports	€168.0bn	13.2	5.8	4.3	4.4
Earnings		<i>Percentage nominal change over previous year</i>			
Average Hourly Earnings	€21.68	-0.6	0.9	1.5	1.8
Government Finances		<i>Percentage of GDP</i>			
General Government Balance	-€7.6bn	-4.1	-2.4	-1.8	-1.0
Gross Debt	€203.3bn	109.7	106.3	101.2	99.4
Labour Force		<i>Percentage change over previous year</i>			
Employment	1,913,900	1.7	2.2	1.9	1.7
		<i>Percentage of Labour Force</i>			
Unemployment	242,817	11.3	9.7	8.9	8.5

Notes: Projections for Gross Domestic Product and its components refer to real economic activity; Investment refers to Gross Domestic Fixed Capital Formation; Average hourly earnings represent the average value over the four quarters; Employment and unemployment represents the average value over the four quarters. Projections do not reflect the recent move to record trade in aircraft on a change of economic ownership basis (CSO, 2015k). This methodological change will lead to an increase in imports in the National Accounts, with an offsetting increase in Capital Formation.

Sources: NERI estimates for 2015-2017; 2014 data is from CSO National Accounts (2015a), CSO Earnings, Hours and Employment Costs Survey (2015h), Government Finance Statistics (DOF, 2015a) and CSO Quarterly National Household Survey (2015f).

Personal Consumption

We expect that personal consumption will grow by 2.2 per cent in 2015, by 2.0 per cent in 2016 and by 2.1 per cent in 2017. Growth in personal consumption will mainly be driven by the increasing numbers in employment, modest wage growth and higher real disposable household income, while the ECB's quantitative easing programme,

falling energy prices and improving household net worth will also boost growth in consumption. Budget 2015 will provide a mild net boost to consumption in 2015. Average weekly earnings increased by 0.5 per cent in the first quarter of 2015 compared to the previous year (CSO, 2015h) and the low inflation environment is helping to preserve the value of real incomes. Household debt measured as a proportion of disposable income is now at its lowest level since 2005 (CBI, 2015b). Household debt should gradually become less of a drag on consumption with the savings rate likely to fall as less and less debt as a proportion of income is paid off over the next few years. In addition, rising house prices and household net worth should eventually filter through into higher levels of consumption in the future.

Retail sales data has been very positive in 2015 with the volume of retail sales increasing by 11.9 per cent in April 2015 compared to the previous year (CSO, 2015b). If motor trades are excluded the volume of retail sales increased by 7.8 per cent. The end-May 2015 outturn for VAT receipts is up 9.5 per cent on the previous year while Excise receipts are up 4.5 per cent (DOF, 2015b). The *KBC/ESRI Consumer Sentiment Index* decreased marginally from 98.7 in April to 98.5 in May. Even so, consumer sentiment remains strong and well-above the long-run average suggesting healthy growth in personal consumption over the next few months (ESRI, 2015a).

Table 3.2 Range of Projections for Annual Change in Real GDP, (Republic of Ireland)

	2015	2016	2017	2018	2019	2020
NERI (June)	3.7	3.5	3.1	-	-	-
Department of Finance (April)	4.0	3.8	3.2	3.2	3.0	3.0
Central Bank of Ireland (April)	3.8	3.7	-	-	-	-
European Commission (May)	3.6	3.5	-	-	-	-
IMF (April)	3.9	3.3	-	-	-	2.5
OECD (June)	3.5	3.3	-	-	-	-
ESRI (June)	4.4	3.7	-	-	-	-

Sources: DOF: Stability Programme Update 2015 (DOF 2015a); CBI: Quarterly Bulletin 02 2015, (CBI 2015c); European Commission: European Economic Forecast Spring 2015, (EC, 2015a); IMF: World Economic Outlook April 2015 (IMF 2015a); OECD: Economic Outlook, (OECD 2015a); ESRI: Quarterly Economic Commentary, Summer 2015 (ESRI, 2015b)

Government Consumption

Changes in government consumption reflect demand pressures. However, government consumption is very much a policy instrument and aggregate spending is ultimately a policy choice. The government has outlined its intentions for government consumption

in its Spring Economic Statement (DOF, 2015c). The Statement assumes that government consumption will increase by 1.1 per cent in real terms in 2015, by 1.6 per cent in 2016, and by 1.0 per cent in 2017. Given stated commitments we anticipate that growth in government consumption will be somewhat larger in 2017 (1.3 per cent). Political commitments made in advance of the impending general election could exert upward pressure on government consumption in 2016 and 2017.

Investment

Investment is the most volatile component of GDP with potential for sharp swings from year to year. We are projecting that gross domestic fixed capital formation (investment) will grow robustly over the next few years. Growth is forecast at 10.0 per cent in 2015, 8.7 per cent in 2016 and 7.4 per cent in 2017. Low interest rates and cost of capital along with improving private sector balance sheets and access to credit will support investment in 2015 and 2016. Improvements in the public finances will help support modest increases in levels of public capital investment. Public capital investment is well below optimal levels at just 2 per cent of GDP.

The Republic's investment-to-GDP ratio (16.4 per cent in 2014) has been amongst the lowest in the EU for each of the last five years (European Commission, 2015b) and the current ratio is well below the long-run historical average. This suggests above trend capacity for volume growth in investment in machinery and equipment over the medium term as firms replenish capital stock levels depleted since the start of the economic crisis. Years of subdued investment in housing combined with increased housing pressures in urban areas suggest house building will grow strongly over the forecast horizon. The Construction PMI was a healthy 63.3 in May with the reading for commercial activity and housing activity particularly strong and the reading for civil engineering activity marginally positive (Ulster Bank, 2015b). This was the twenty first month of continuous expansion.

Net Exports

We are projecting the volume of exports will grow by 5.5 per cent in 2015 before subduing to a closer to trend 4.2 per cent in 2016 and 4.1 per cent in 2017. The post horizon projections are for lower growth rates. Exports grew extremely strongly in 2014. We anticipate that future growth in exports will be more in line with external demand indicators adjusted for movements in exchange rates and other elements of competitiveness. Exports will benefit from the euro's depreciation against the US Dollar and the UK pound with the openness of the Republic's economy making it particularly well placed to benefit from a declining euro. Exports will also benefit from reasonably strong performances in the United States and the United Kingdom although this will be partially offset by the weaker performance of the euro area. The *Investec Manufacturing PMI* (2015) was 57.1 in May suggesting positive sentiment and improving business conditions in the exporting sector with output and new orders both up strongly.

We project growth in the volume of imports will be 5.8 per cent in 2015, 4.3 per cent in 2016 and 4.4 per cent in 2017. The expansion in exports combined with the high import content of Irish exports will help drive growth in imports broadly in line with external demand indicators over the forecast horizon. Growth in imports in 2015 will be driven by the expected increases in real disposable household income, domestic consumption and investment. Investment growth will increase demand for goods imports while income growth will increase demand for service imports including tourism. On the other hand the depreciation of the euro will dampen demand for tourism imports.

Labour Market

Employment increased by 2.2 per cent in the first quarter of 2015 (CSO, 2015f) with employment increasing in ten of the fourteen sectors. In the context of still remaining slack in the economy we are projecting strong employment growth of 2.2 per cent in 2015, declining marginally to 1.9 per cent in 2016 and 1.7 per cent in 2017. The employment growth will be driven by the anticipated improvements in domestic demand. In particular the anticipated increase in investment will boost employment growth in the construction sector. The overall recovery in consumption should

increase employment in the retail sector and the accommodation and food services sector. We expect that total employment will exceed 2,000,000 sometime around the middle of 2016.

The unemployment rate was 9.8 per cent in May and we are forecasting the unemployment rate will average 9.7 per cent in 2015, 8.9 per cent in 2016 and 8.5 per cent in 2017. Unemployment should fall below 200,000 sometime in early 2016. However, the scarring effect of the recession and the high-rate of long-term unemployment suggest that the equilibrium structural rate of unemployment is higher now than it was before the recession. We expect participation in the labour force to increase modestly over the medium-term with annual growth rates of less than 1 per cent. Table 3.3 shows a range of baseline projections for unemployment made by other institutions. Our unemployment and employment projections are broadly consistent with that of other forecasters.

Table 3.3 Projections for Unemployment as a Per Cent of the Labour Force, (Rep. Ireland)

	2015	2016	2017	2018	2019
NERI (June)	9.7	8.9	8.5	-	-
Department of Finance (April)	9.6	8.8	8.4	7.8	7.3
Central Bank of Ireland (April)	9.8	8.7	-	-	-
European Commission (May))	9.6	9.2	-	-	-
IMF (April)	9.8	8.8	-	-	-
OECD (June)	9.9	9.2	-	-	-
ESRI (June)	9.6	8.3	-	-	-

Sources: See Table 3.2.

Average weekly earnings increased by 0.5 per cent in the first quarter compared to the previous year while average hourly earnings increased by 0.4 per cent over the same period. We project average hourly earnings will increase by 0.9 per cent in 2015, by 1.5 per cent in 2016 and by 1.8 per cent in 2017. The economy-wide growth in weekly and hourly earnings will depend on the changing composition of employment across the economy. The still high rate of unemployment combined with the absence of significant inflationary pressures and weak labour demand will dampen growth in average hourly earnings across the economy as a whole. Earnings growth will vary from sector to sector reflecting sectoral differences in the tightness of labour supply but will begin to rise across the economy from 2016 onwards provided the unemployment rate continues to fall.

Public Finances

In light of our projections for economic output and the labour market, as well as our assumptions for Budget 2016, we are projecting that the government's general budget deficit will fall to 2.4 per cent of GDP in 2015, to 1.8 per cent in 2016 and to 1.0 per cent in 2017. The reductions in the numbers unemployed will lead to reduced expenditure on income supports while more people employed and modestly rising wages will generate additional direct and indirect revenue flows. In nominal terms the deficit will be close to €2 billion by the end of 2017 assuming a €1.2 billion fiscal expansion in Budget 2016, a no change policy for Budget 2017 and Irish Water passing its market capitalisation test. We project that the gross debt to GDP ratio will fall to 106.3 per cent of GDP in 2015, to 101.2 per cent in 2016 and to 99.3 per cent in 2017.

Risks to the Outlook

There is a wide range of downside risks to our baseline projection including deflation in the euro area, an increase in interest rates and the cost of capital, an appreciation in the value of the euro, a slowdown in world trade, financial instability in energy exporters arising from lower energy prices, the impact on Irish exports of austerity in the UK, a worsening geopolitical climate particularly viz-a-viz the Ukraine and Middle-East crises, Brexit (see Box 3.1) and Grexit. A negative outcome in the Greek crisis is particularly concerning as it could undermine faith in the European project, push sovereign bond yields higher and create financial market instability. The outcome of the OECD's Base Erosion and Profit Shifting project might reduce inward multinational investment to the Republic. Rising energy prices would reduce real household disposable income with negative consequences for consumption and investment. Rising interest rates would be particularly damaging to growth given the still high private and public sector debt overhangs. An appreciation in the value of the euro would slow export growth. The potential for classification of Irish Water within general government represents a downside risk to our projection for the deficit.

Faster than expected growth in the euro area represents a potential upside risk, particularly if the ECB's quantitative easing programme is maintained. A faster than

expected fall in the savings rate on the back of rising consumer confidence would boost domestic demand. Finally, a change in national level fiscal policy to substantially increase the public capital investment to GDP ratio represents another upside risk to the medium-term growth forecast.

Box 3.1 Result of UK General Election – Considerations for the Republic of Ireland

The UK General Election held on the 7th of May this year resulted in a majority Conservative government, the first such administration to take office for 18 years. Whilst the Conservatives under David Cameron had been in power since 2010, the coalition with the Liberal Democrats prevented them from bringing forward a number of policies. Chief among these was the decision to hold an “In/Out” referendum on UK membership of the EU. The UK government have signalled their intention to hold this referendum before the end of 2017, following a series of negotiations. The negotiations are intended to tackle a number of policy differences between the UK government and the EU so that the UK electorate will be presented with the option of remaining in a “reformed EU” or secession from the same.

Quite obviously this policy poses a number of challenges for Northern Ireland and these challenges are analysed in Box 3.2. However the referendum also has significant implications for the Republic of Ireland. The UK is the Republic’s most important trading partner in terms of value and volume of goods imported and exported (marginally ahead of the US). The value of Irish Exports to the UK was over £3bn in the first three months of this year out of a total export value of over £17bn (ONS, 2015b & CSO, 2015l). Indeed the UK exports more to the Republic than it does to China, India and Brazil combined, the Republic of Ireland being one of the few European countries with which the UK has a positive balance of trade. Of course strong trading links between the Republic and the UK predate entry to the common market in 1973, but membership of the single market has strengthened that relationship and a UK exit would likely have a negative impact on trade.

Even if UK voters elect to remain within the EU, the negotiations on the existing UK-EU relationship pose some challenges for the UK-ROI relationship. One of the key policy demands of the UK government will be restrictions on freedom of movement within the EU in order to reduce UK net immigration. The UK and the Republic of Ireland enjoy a Common Travel Area which entails close co-operation on matters of immigration and security. If the UK were to tighten immigration rules, this may have an unintended impact on migration patterns in the Republic of Ireland. The UK government is also seeking powers for member states to restrict access of EU migrants to a series of state benefits which may impact on working conditions for recent Irish emigrants to the UK.

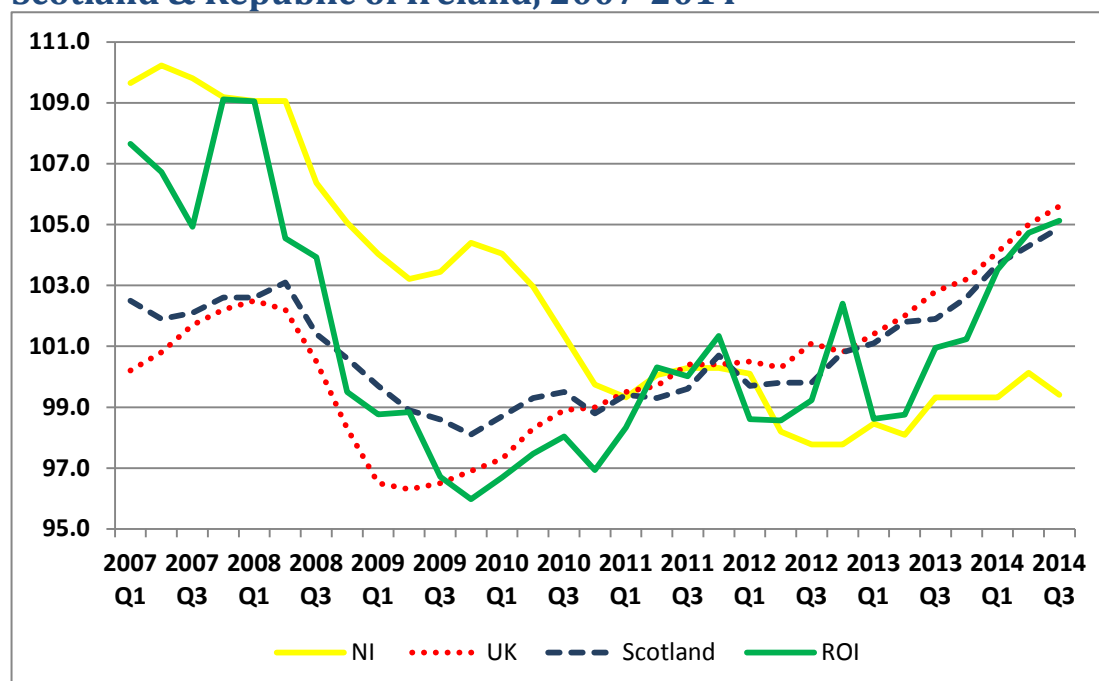
Much of the outcome for the Republic of Ireland will depend on the circumstances which surround the outcome of either a yes or a no vote. If the UK remained a member of the European Free Trade Area in the event of an “OUT” vote, the damage to trading links may be limited. However attention needs to be paid to the reforms to the EU that are made in order to secure an “IN” vote, and just how these might impact on the Republic. Finally, the uncertainty in the run up to the vote may lead to delays in investment decisions.

3.4 Macroeconomic Outlook for Northern Ireland

Macroeconomic Outlook

Northern Ireland's recent economic performance has been poor compared with that of its nearest neighbours. The rate of recovery in the Republic is particularly noteworthy given the scale of the downturn experienced in the Republic is comparable to the experience in Northern Ireland. Positive headwinds from recovery in the UK and the Republic do not appear to be stimulating a discernible recovery in the Northern Ireland economy.

Chart 3.1 NI Composite Economic Index and GDP for UK, Scotland & Republic of Ireland, 2007-2014



Source: NISRA (2015b) Northern Ireland Composite Economic Index

Note: Base year 2011

While the UK and the Republic have made employment gains in the last few years, the performance in Northern Ireland has been more modest. The UK economy has seen substantially larger falls in public sector employment but has managed to sustain increasing levels of overall employment. Northern Ireland has also failed to replicate the export performance of the Republic despite an aggressive foreign direct investment strategy. Incomes in Northern Ireland are now the lowest of any region in the UK or the Republic of Ireland, while real wages remain in decline. All of this points to a significant malaise within the Northern Ireland economy. In recent years it has

been commonplace and perhaps comforting to see Northern Ireland's economic difficulties in the context of a global economic crisis that hit the UK and the Republic of Ireland particularly hard. However this analysis may be misleading as it distracts from the possibility that the central weakness of the Northern Ireland economy is self-contained. The outcome of the recent general election creates particular challenges for the Northern Ireland economy (see Box 3.2).

Box 3.2 Result of UK General Election – Considerations for Northern Ireland
The election of a Conservative Government poses immense policy challenges for Northern Ireland (NI). The programme of austerity is now likely to continue and intensify. The Block Grant in Northern Ireland, the combined total of current and capital departmental spending, has fallen by 9.4 per cent or just over £1bn in real terms since 2010 (HMT, 2014). The Chancellor has already highlighted cuts to departmental spending and will outline the full scale of public expenditure reductions in a supplementary budget in July. Further cuts to departmental budgets will add increased pressure to the NI Executive budget for 2015/16 which remains in limbo due to the absence of a Welfare Reform Bill. The stated purpose of the current set of welfare reform proposals is to reduce Annually Managed Expenditure in Northern Ireland in line with the per capita savings that similar reforms were projected to make in Great Britain. The Conservatives have pledged to introduce additional measures to save a further £12bn in welfare spending over the life of parliament. Given that Executive parties have been unable to agree on whether or how to introduce the reforms to date, it is unclear how a share of the further £12bn in cuts could be implemented within Northern Ireland. Even if agreement was reached on existing proposals the Executive will quickly become engaged in further budget cuts. This will threaten the Executive's stability. The instability created by a referendum on UK membership of the EU also bodes ill for the NI economy in the short term. Northern Ireland would be heavily impacted by a UK exit from the EU in terms of funding for Agriculture and infrastructure not to mention trading links with the Republic. However the uncertainty surrounding the referendum itself may also have an impact, discouraging long-term investment by firms within Northern Ireland and possibly deferring any Foreign Direct Investment seeking access to the Single Market. In summary the outlook for Northern Ireland's public finances has deteriorated with the election of the Conservative government and consequently the outlook for political stability in Northern Ireland has worsened too. The uncertainty surrounding UK membership of the EU could also jeopardise prospective job creation over the next two years.

Productivity growth is a key structural weakness in the NI economy. UK productivity performance in the last number of years has been lacklustre yet Northern Ireland has fallen further behind it. Without any strategic plan to tackle this central weakness it is likely that a recovery of the scale of its nearest neighbours will continue to elude Northern Ireland. Table 3.4 outlines a variety of economic forecasts for Northern

Ireland. Nearly all project an easing of employment growth in 2016 while few project a significant acceleration of output growth within the next two years.

Table 3.4 Overview of recent economic projections for NI

	2014	2015	2016
Economic Activity	n/a		
EY (GVA)	-	1.4	1.5
PWC (GVA)	-	1.7	-
Danske Bank (GVA)	-	2.2	2.2
NICEP	-	1.9	1.1
Employment	0.3		
NERI		1.1	0.6
Danske Bank	-	0.8	0.2
EY	-	-0.1	0.5
UUEPC	-	0.7	0.6
Unemployment (%)	6.4		
EY		6.3	6.2

Sources: EY: Economic Eye, Winter (2014); PWC: NI Economic Outlook April (2015); Danske Bank Quarterly Sectoral Forecast Q1 2015 (March 2015) UUEPC Spring Outlook (May 2015)

Note: 2014 is an outturn while 2015 and 2016 are forecasts. Gross Value Added (GVA) differs from GDP by the difference between taxes and government subsidies.

4 Strategic Fiscal Policy in the Republic of Ireland¹

4.1 Introduction

This section discusses the implications of the domestic and EU fiscal rules for budgetary policy in the Republic of Ireland in 2016 and beyond. Adherence to the medium-term budgetary objective limits space for loosening the fiscal stance to not much more than €1.0 billion until at least the end of 2018 and potentially longer depending on how potential output and the structural budget balance are estimated in future years. Much of this fiscal space will be absorbed by demographic pressures on public spending. We reject as inappropriate the proposed 50-50 split between revenue and expenditure measures given the far from optimal growth and equity implications of that split and the currently low levels of government revenue and spending. We argue instead that 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. In addition, we argue for a modest increase in social spending funded by a set of growth-friendly reforms to increase total government revenue.

4.2 Overview of the Public Finances

Our current projections for economic growth and the exchequer finances imply a deficit close to 2.4 per cent of GDP in 2015. This falls comfortably within the 2.9 per cent ceiling allowed under the Republic's Excessive Deficit Procedure. Interest payment on the public debt is running close to 3.5 per cent of GDP which translates into a primary surplus close to 1.1 per cent of GDP. Even so, Budget 2016 will take place with a deficit in the public finances and a high debt to GDP ratio which we forecast will be close to 106 per cent of GDP (see Table 3.1). Based on our projections for growth, combined with the budgetary package announced in the Stability Programme Update (DOF, 2015a), we anticipate a deficit close to 1.8 per cent of GDP in 2016. In nominal terms we estimate the deficit will be close to €4.5 billion in 2015 and €3.5 billion in 2016, with the final amounts sensitive to the pace of economic growth in both years. Recent estimates for the public finances are shown in Table 4.1 and Table

¹ Parts of this section are derived from sections of a forthcoming research paper entitled '*Strategic Fiscal Policy and Economic Growth*' (McDonnell, 2015). The NERI acknowledges the input of external reviewers and their comments and suggestions prior to publication.

4.2. The IMF (2015b) forecasts deficits up to 2018 while government projections (DOF, 2015a) suggest deficits persisting until 2019.

Table 4.1 Public Finance Estimates and Projections, IMF

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Overall Balance (% of GDP)													
Ireland	0.2	-7.0	-13.9	-32.4	-12.6	-8.0	-5.7	-3.9	-2.4	-1.5	-0.6	0.0	0.0
Euro area	-0.6	-2.1	-6.2	-6.1	-4.1	-3.6	-2.9	-2.7	-2.3	-1.7	-1.3	-0.9	-0.3
Primary Balance (% of GDP)													
Ireland	0.8	-6.3	-12.4	-30.0	-9.7	-4.4	-1.9	-0.3	0.6	1.4	2.4	2.8	2.9
Structural Balance (% of potential GDP)													
Ireland	-9.7	-13.0	-11.0	-8.9	-6.5	-5.0	-4.0	-2.8	-2.0	-1.4	-0.6	0.0	0.0
Primary Structural Balance (% of potential GDP)													
Ireland	-9.0	-12.3	-9.6	-6.5	-3.7	-1.5	-0.3	0.7	1.0	1.5	2.4	2.8	2.9
Gross Debt (% of GDP)													
Ireland	24.0	42.6	62.2	87.4	111.1	121.7	123.3	109.5	107.7	104.9	101.5	97.2	93.5
Euro area	65.0	68.6	78.4	83.9	86.5	91.1	93.4	94.0	93.5	92.4	90.9	89.0	86.7

Source: IMF: Fiscal Monitor April 2015 (IMF 2015b)

Notes: Estimates are based on Budget 2015 policies. The primary balance excludes net interest payments. The structural balance is sometimes known as the full employment budget balance or the cyclically adjusted balance. It is an estimate of the budget balance that would obtain under current policies if actual output were equal to potential output. It excludes financial sector support, and corrects for real output, equity, house prices, and unemployment.

Table 4.2 Public Finance Projections, Dept. Finance, (% GDP)

	2014	2015	2016	2017	2018	2019
General Government Balance	-4.1	-2.3	-1.7	-0.9	-0.1	0.7
Primary Balance	-0.1	1.1	1.5	2.2	2.9	3.6
Structural Balance	-4.0	-2.6	-2.3	-1.3	-0.3	0.8
General Government Balance, €m	-7,630	-4,610	-3,580	-2,055	-290	1,645
Underlying Primary Balance, €m	-115	2,365	3,290	4,830	6,665	8,535
Revenue	34.9	34.3	33.2	32.6	32.2	31.9
Expenditure	39.0	36.6	34.9	33.6	32.3	31.2
<i>Of which Interest Expenditure</i>	4.0	3.5	3.2	3.2	3.1	2.9
Gross Debt	109.7	105.0	100.3	97.8	93.6	89.4

Source: DOF: Ireland's Stability Programme April 2015 Update, (DOF 2015a).

Notes: Underlying balances exclude once-off or temporary measures such as asset sales and bank bailouts. Figures are based on an assumed €1.2 billion package of tax cuts and spending increases in Budget 2016 with no policy changes assumed thereafter (DOF, 2015c).

The Republic's gross debt to GDP ratio was 109.7 per cent (€203.3 billion) at the end of 2014. This is the fourth highest ratio in the EU. Government bonds accounted for €116.3 billion of this debt with EU-IMF programme funding accounting for a further €60.2 billion. The floating rate bonds arising from the swapping of the IBRC promissory notes make up €24.5 billion of the government bond debt. Financial sector support associated with the financial crisis (not including asset purchases by the

National Asset Management Agency) amounted to 36.3 per cent of 2014 GDP, with recovery to date of 6.5 per cent of 2014 GDP. The debt ratio is now on a downward trajectory, albeit from a high base and we are forecasting that the gross debt to GDP ratio will fall marginally below 100 per cent in 2017.

The Republic's net debt to GDP ratio was the sixth highest of twenty seven advanced economies in 2014 (IMF, 2015b). The IMF is projecting a net debt ratio of 85.5 per cent in 2015, falling to 71.7 per cent by 2020. The yield on ten-year Irish government bonds recently fell to below 1 per cent and was 1.63 per cent as of mid-June, while the interest burden is estimated at close to 10 per cent of general government revenues in 2015, down from 13 per cent in 2013. Even so, the Republic's debt burden remains onerous – in GNP terms the debt ratio will be in excess of 128 per cent in 2015. Debt sustainability remains uncertain given the elevated level of public debt and the vulnerability to an increase in the cost of borrowing and to a fall-off in economic growth.

Irish fiscal policy

The government's Spring Economic Statement (DOF, 2015c) assumes an expansionary budgetary package of €1.2 billion in new discretionary measures in 2016. The scale of the package is close to 0.6 per cent of 2016 GDP and is to be split evenly between expenditure increases and tax cuts despite spending cuts accounting for two thirds of the cumulative €30 billion in total fiscal consolidation between 2008 and 2014.

The medium-term budgetary trends outlined in the government's Stability Programme Update (DOF, 2015a) will further harden the Republic's position as a low tax and spend economy by European standards. IMF projections show government revenue falling from 34.7 per cent of GDP in 2014 to 31.3 per cent in 2019 (Table 4.3). Department of Finance (DOF) projections tell a similar story. Discretionary expenditure on public services relative to the size of the economy will be substantially lower in 2019 than it was prior to the crisis. This implies intense pressure on key public services such as education and health. DOF projections (Table 4.2) show the level of 'primary expenditure' as a per cent of GDP (the total less interest payments) falling from 35.0 per cent in 2014 to 28.3 per cent in 2019 while total revenue will fall from 34.9 per cent to 31.9 per cent over the same period. The government's forecasts

show that capital spending will remain at historically low levels for the foreseeable future and well below the long-run optimal level.

Absent a change in policy direction, the Republic's low tax and spend model will become even more firmly entrenched. The current policy direction has profoundly negative implications for the Republic's capacity to provide Western European levels of public services. Sustainable fiscal policy is as consistent with high levels of revenue and spending as it is with low levels of revenue and spending and as such the current fiscal plan can be understood as a pure political economy choice.

Table 4.3 Revenue and Expenditure Estimates and Projections, IMF (% GDP)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Revenue													
Ireland	36.2	35.0	33.7	33.6	33.5	34.2	34.8	34.7	33.7	33.1	32.4	31.7	31.3
Euro area	44.5	44.2	44.2	44.1	44.6	45.9	46.5	46.7	46.5	46.4	46.4	46.4	46.4
<i>Ireland (% of GNP) – NERI Estimate</i>									39.4	39.1	38.6	38.4	38.2
<i>Ireland (% of IFAC Hybrid) – NERI Estimate</i>									37.0	36.5	35.9	35.3	35.1
Expenditure													
Ireland	36.0	42.0	47.6	66.1	46.1	42.2	40.5	38.5	36.1	34.5	33.0	31.7	31.3
Euro area	45.1	46.3	50.4	50.2	48.7	49.5	49.4	49.4	48.7	48.1	47.7	47.3	46.9
<i>Ireland (% of GNP) – NERI Estimate</i>									42.4	40.8	39.4	38.3	38.2
<i>Ireland (% of IFAC Hybrid) – NERI Estimate</i>									39.6	38.0	36.6	35.3	35.1
Sources:	IMF: Fiscal Monitor April 2015 (2015b); NERI calculations												
Notes:	Projections for Ireland are based on Budget 2015 policies. IFAC 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.												

The Irish Fiscal Council (IFAC, 2012) has developed a hybrid measure of Ireland's fiscal capacity intended to reflect the diminished fiscal capacity of the proportion of Irish GDP that is in excess of GNP. The Republic is found to be a low tax and spend jurisdiction, regardless of whether GDP, GNP or the IFAC hybrid is used as the basis for comparison with other countries. The Republic's hybrid revenue rate is projected at 79.6 per cent of the Euro area average in 2015 while the Republic's hybrid expenditure rate is projected at 81.3 per cent of the Euro area average (Table 4.3). The expenditure gap between the Republic and the Euro area is projected to widen over the period out to 2019. IFAC (2014) point out that the current budgetary plan implies considerable pressures on government services, public investment and social payments, that public spending in Ireland is already at the lower end of the spectrum, and that budgetary projections will leave the primary government expenditure share of economic output at a very low level historically.

4.3 Analysing the Scale of the Budgetary Adjustment

The Republic is expected to successfully exit the corrective arm of the Stability and Growth Pact (SGP) at the end of 2015. From 2016 onwards the Republic's budgetary policy will be subject to the requirements of the preventive arm of the SGP as well as being subject to national budgetary rules. The preventive arm of the SGP is assessed under two pillars.

The first pillar is the *structural balance rule*. Any country not at its Medium-Term Budgetary Objective (MTO) is required to achieve a minimum improvement in the structural balance of more than 0.5 percentage points per annum. The *Fiscal Responsibility Act 2012* (Irish Statute Book, 2012) says that the lower limit of the MTO shall be an annual structural balance of the general government of minus 0.5 per cent of gross domestic product at market prices, except where the debt to GDP ratio is significantly below 60 per cent, in which case the lower limit is reduced to minus 1 per cent. A balanced budget in structural terms is a balanced budget after adjusting for the cyclical position of the economy and is calculated net of one-off factors such as asset sales and bank bailouts. The structural balance will remain constant if expenditure grows in line with potential GDP; will improve if expenditure grows below potential GDP, and will deteriorate if expenditure grows faster than potential GDP.

The second pillar is the *expenditure benchmark rule*. The expenditure benchmark places a cap on the net growth rate of public expenditure for a particular year. The rate is set equal to the economy's medium-term potential GDP growth rate, called the reference rate, and from 2016 onwards will be updated yearly based on a forward and backward looking ten year average for growth in nominal potential GDP. The reference rate for 2016 is estimated at 1.9 per cent (DOF, 2015a) with an assumed GDP deflator of 1.5 per cent. Thus if the Republic was deemed to have achieved its MTO it would be permitted to have nominal expenditure growth of 3.4 per cent in 2016.

Public expenditure may only grow faster than the reference rate if new '*Discretionary Revenues Measures*' are taken which structurally increase government revenue, for example an increase in a tax rate. On the other hand measures that structurally cut government revenue, for example a cut in a tax rate, will reduce, on a one-for-one basis, the amount by which net public expenditure is allowed to grow each year.

Part of the expenditure benchmark rule entails the use of a convergence margin which is applied to every country in the preventive arm that is not already at its MTO. The convergence margin ensures that the allowable growth in net expenditure will be less than the reference rate. The Republic's MTO requires annual improvement of 0.5 percentage points in the structural balance until the lower limit of minus 0.5 per cent is reached. The convergence margin is scaled appropriately for each country so that the required 0.5 percentage point improvement is achieved over the year. Applying the convergence margin to the Republic reduces permitted nominal expenditure growth by 1.8 percentage points in 2016.

This means that the Republic's nominal permitted expenditure growth under the fiscal rules is close to 1.6 per cent (€1 billion) in 2016. Finally, the €1 billion is reduced by the additional carryover impact of €0.3 billion into 2016 arising from taxation changes made in Budget 2015 (IFAC, 2015).

Structural deficits and output gaps

The convergence margin reduces the available fiscal space by close to €1 billion. To determine whether the convergence margin is required we must first estimate the size of the economy's structural deficit. However, the structural deficit cannot be directly observed and measuring it requires estimating the output gap – i.e. the cyclical position of the economy. If there is a negative output gap (i.e. where the economy is operating below potential) the structural balance will be better than the actual budget balance, and if there is a positive output gap (i.e. where the economy is overheating) the structural balance will be worse than the actual budget balance.

Estimates of the output gap are uncertain and usually subject to substantial revision even years after the fact. There is a notable lack of consensus regarding the current size and direction of the Irish economy's output gap. The OECD (2015b) estimate that, given the scale of underemployed resources, the economy will be operating at 1.9 per cent below its potential in 2015 and 0.7 per cent below its potential in 2016, with a structural deficit of 1.5 per cent of potential output in 2016. The IMF (2015b) estimate the economy will be operating below its potential until 2017 with a structural deficit of 2.0 per cent in 2015 and 1.4 per cent in 2016 (Table 4.1).

On the other hand the European Commission (2015a) estimate the economy is already operating close to its post-recession potential and that despite high unemployment the economy was actually marginally overheating as early as 2014. The Commission estimates the economy will be operating 0.9 per cent above potential in 2015 and 0.8 per cent above potential in 2016, with a structural deficit of 3.3 per cent in 2016. The government's own projections (DOF, 2015a) are based on the Commission mandated harmonised methodology. These projections suggest there will be a positive output gap by the end of 2015 (Table 4.2), with a structural deficit of 2.3 per cent in 2016.

The Commission's methodology for estimating structural parameters has been critiqued by Klär (2013) and by Bergin and Fitzgerald (2014), while Daly (2014) argues it is clear that aggregate demand in the Irish economy is still significantly below potential. Bergin and Fitzgerald (2014) note that applying the Commission's methodology to the Republic would imply a huge current account surplus over the medium-term, which they argue would not be sustainable. They largely attribute the current deficit in the government's finances to the economy producing well below its long-run equilibrium – i.e. they attribute the deficit to mainly cyclical factors and the operation of the automatic stabilisers.

The Commission methodology implies that the equilibrium (structural) rate of unemployment in the Republic is in excess of 10 per cent in 2015. This figure does not appear plausible and is probably a substantial overestimate. The Commission's methodology appears flawed because it is overly pro cyclical with estimates for structural unemployment too closely following recent trends in actual unemployment.

Daly (2014) argues that the most plausible estimates of the output gap are based on production function estimates rather than on statistical trending techniques and that production function estimates indicate the economy was running an output gap of between 5 per cent and 10 per cent of GDP in 2014. Byrne and McQuinn, (2014) use a growth accounting framework to argue there was considerable slack in the Irish economy at end-2014 across all the channels of growth (labour, capital and total factor productivity), although using the same growth accounting framework leads the ESRI (2015b) to argue the Irish economy will be almost at potential by the end of 2015.

The economy's still high unemployment rate, combined with a very large current account surplus and the evident lack of domestic inflationary pressure in the economy,

cumulatively suggests that actual output is somewhat below potential output in 2015. If this analysis is correct it means the 2015 structural balance measured in potential output terms is somewhat better than the 2015 budget balance measured in GDP terms. We estimate the structural deficit in the public finances will be less than 1.5 per cent of potential GDP in 2016 assuming a budgetary package along the lines described in the Spring Economic Statement (DOF, 2015c). We also estimate the structural deficit would have been virtually eliminated by the end of 2016 were a neutral fiscal stance with no new policy measures pursued in Budget 2015 and in Budget 2016.

Our lower estimate for the structural deficit suggests a convergence margin will no longer be required post 2018 assuming improvement in the structural balance of 0.5 percentage points is achieved in both 2017 and 2018. This is because the Republic will have achieved its MTO at the end of 2018. The implication is that from Budget 2019 onwards nominal permitted expenditure growth should be set equal to the reference rate.

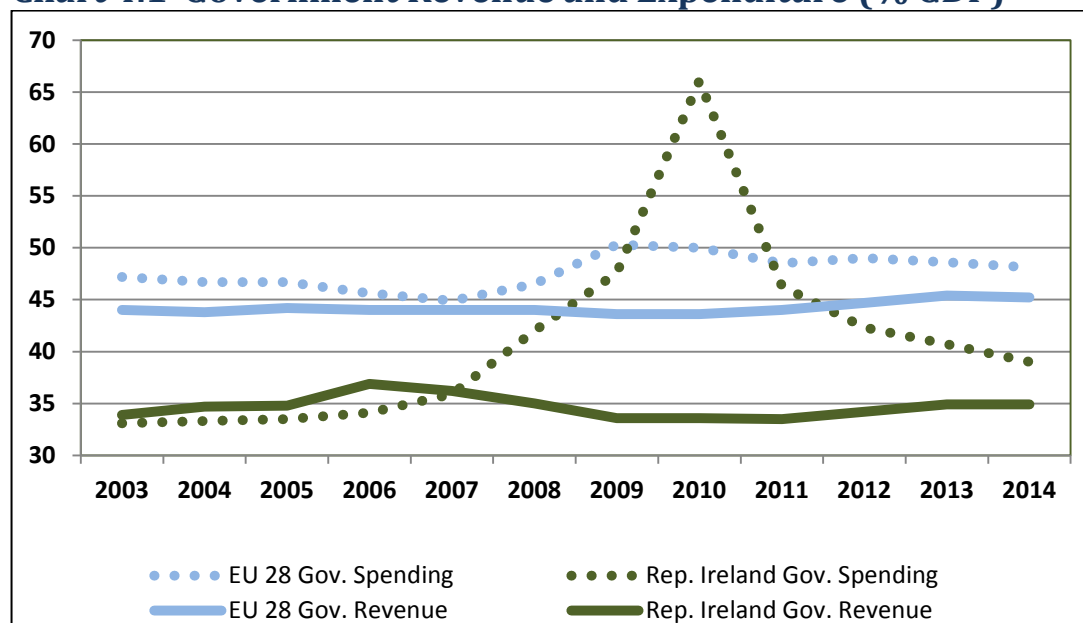
4.4 Engineering the Budgetary Adjustment for Growth and Equity

The fiscal parameters remain highly constrained and it is crucial any new policy measures enacted in Budget 2016 adhere as closely as possible to the twin public policy goals of growth and equity. Before considering changes to the composition of revenue and expenditure it is useful to first consider the starting position. Chart 4.1 shows government revenue and expenditure in the Republic and the EU (Eurostat, 2015h). Public spending in the Republic has been well below the EU average in recent years with the exception of 2010, although the high level of spending in that year was a consequence of extremely large one-off costs associated with the bank bailout. The IMF (2015b) estimates that public spending as a percentage of GDP (30.9 per cent) will be just two thirds of the Euro Area average (46.6 per cent) by 2020.

The Republic collects a below average amount of taxes across each of the three main tax bases (consumption, labour and capital). The gap between the Republic and the EU is most pronounced for taxes on labour (Table 4.4) with the extremely low level of social security contributions responsible for 70 per cent of the total revenue gap (in GDP terms) between the Republic and the rest of the EU in 2012 (Eurostat, 2014).

Increasing employer social security contributions to the EU average would close over half the entire revenue gap (in GNP terms) between the Republic and the EU.

Chart 4.1 Government Revenue and Expenditure (% GDP)



Source: Eurostat: Government revenue, expenditure and main aggregates (2015)

Table 4.4 Tax Revenues (% GDP)

		2007	2008	2009	2010	2011	2012
Taxes on Consumption	Ireland	11.3	10.9	10.1	10.3	9.8	10.0
	EU	11.0	10.8	10.7	11.1	11.2	11.2
Taxes on Labour	Ireland	10.7	11.2	11.7	11.5	12.1	12.2
	EU	19.1	19.5	19.9	19.7	19.8	20.1
Taxes on Capital	Ireland	9.4	7.4	6.3	6.2	6.3	6.5
	EU	9.3	8.9	7.8	7.7	7.9	8.2
Social Security Contributions (SSCs)	Ireland	5.0	5.4	5.7	5.7	4.8	4.4
	EU	12.2	12.5	12.8	12.6	12.7	12.7

Sources: Eurostat: Taxation Trends in Europe Annual Report 2014 (2014); NERI calculations

Notes: Data for EU represents weighted averages; Taxes on labour includes employers' SSC and payroll taxes as well as employees' SSC and personal income tax.

Table 4.5 Implicit Tax Rates, (% of potential tax base)

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

Source: See Table 4.4

Note: See Table 4.4. Not all EU countries report data for the implicit tax rate on capital.

The Implicit Tax Rate (ITR) provides a good measure of the effective average tax burden on different types of economic income or activities as it expresses aggregate tax revenues as a percentage of the potential tax base. Ireland has a relatively high ITR on consumption but very low ITRs on labour and on capital (Table 4.5). The ITR on labour was 74.5 per cent of the Euro area average in 2012.

Growth friendly fiscal policy

The growth process is driven by the accumulation of human and fixed capital together with the production of new knowledge, often created through investment in Research and Development (R&D), along with the diffusion of existing knowledge (Snowdon and Vane, 2005). Growth friendly fiscal policies are those policies that boost the amount of labour inputs employed as well as policies that boost average labour productivity (see McDonnell, 2015 for a more detailed discussion). 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. Of particular interest from a growth perspective 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.

The OECD (2015c) identifies public investment and education spending as the expenditure measures most strongly related to long-run economic growth. Education spending is crucial for human capital formation and generates positive externalities for the wider economy while public capital investment has a positive effect on fixed capital accumulation and the economy's productive capacity. Bom and Ligthart (2014) conducted a meta-analysis of 68 studies and found that public capital has positive long run effects on output. The IMF (2014a) finds that increased public infrastructure investment raises output in the short term because of demand effects and in the long term as a result of supply effects. Net benefits are particularly high during periods of economic slack, where the cost of borrowing is low, and where investment efficiency is high.

Knowledge production is crucial to long-run economic growth. Both education spending and investment spending are positively associated with innovation and

knowledge based growth although the strength of this relationship depends on the actual composition of the spending. The public sector can directly invest in R&D through the creation and support of research institutions such as universities, and invest indirectly through expenditure on R&D inputs such as human capital. One way to increase the productivity of knowledge production itself is to invest in human capital. This is because human capital is a complement to the production and exploitation of ideas. A second way to increase the productivity of knowledge production is for governments to support and invest in those technologies which themselves reduce the cost of knowledge search and the diffusion of useful ideas, for example high speed broadband. Public spending on R&D (GERD), and public spending on gross fixed capital formation (investment), is low compared to the rest of the EU (Table 4.6). This may impede the Republic's output potential in the long-run. The NERI (2014), the Fiscal Council (2014), the IMF (2014b) and Crafts (2014) have all identified the problem of low public capital investment levels in the Republic.

Table 4.6 Public Spending on R&D and Capital Formation

% GDP			% GDP		
R&D Expenditure (GERD)	Ireland	1.6	Fixed Capital Formation	Ireland	2.0
	EU	2.0		EU	2.9
Source:	Eurostat: Total R&D expenditure, (GERD) (2015i); Eurostat: General Government Data, Spring 2015 (2015h)				
Notes:	Latest data for GERD is 2012. Data for public capital investment are 2015 estimates.				

Family supports and in-kind public health services are also positively associated with long-run growth. Childcare and family supports, as well as healthcare services, decrease the risk of child poverty. This boosts the formation of human capital resulting in higher output per capita in the long-term (Cournede, Goujard and Pina 2013). In addition, low cost childcare provision will boost potential output by increasing labour force participation rates for primary carers. There is an economic case for increasing public spending in all four of these areas (education, public investment, family supports and healthcare) particularly given the relatively small envelope for public spending in the Republic compared to other advanced EU economies.

On the other hand defence spending and business subsidies are negatively associated with long-run economic growth, although defence spending is already low in the Republic. Business subsidies are particularly deleterious to long-run growth as they distort resource allocation and competition and reduce productive potential (Ford and

Suyker, 1990; OECD, 2001). 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 over the long-term are recurrent taxes on immovable property and other property taxes. This includes taxes on inheritances and gifts as well as net wealth taxes. There is evidence to suggest that taxes on property, wealth and passive income have minimal negative consequences for long-run economic growth and smaller employment effects than taxes on labour income and consumption (Johansson et al, 2008). Well-designed taxes on property should have a minimum of exemptions or reliefs (McDonnell, 2013). As the share of property taxes in GDP is small there may be significant scope for tax increases.

Fiscal policy can also be used to boost potential growth through gradual elimination of tax expenditures over time. Tax expenditures damage growth by distorting resource allocation, by creating inefficiencies in production and consumption, and by diverting economic activity toward rent-seeking behaviour. For example mortgage interest relief with no or minimal taxation of owner-occupied rental services favours investment in housing assets over other more productive forms of capital and this damages growth in the long-term (Cournede, Goujard and Pina, 2013).

Equity considerations

It is possible to balance fiscal policy in favour of greater equity (i.e. wealth or income equality) with only limited or even positive impact on potential growth (Rawdanowicz, Wurzel and Christensen, 2013). Effective ways this can be done include reducing tax expenditures and increasing taxes on net wealth, wealth transfers, and property, most notably immovable property such as land and housing (Johansson et al, 2008). Household wealth tends to be much more highly concentrated than household income and property based taxes are likely to be equity enhancing when considered from a lifetime income perspective. Tax expenditures tend to favour high-income households and their reduction would improve equity while lowering tax distortions and benefiting growth. Taxing wealth transfers is particularly important for inter-generational equity while favourable tax treatment for property and the income from property tends to be highly regressive.

Increasing progressive taxes on capital and labour income will also enhance equity although care is required around the design of these taxes to ensure they don't become distortive. It is often better to eliminate tax expenditures and schemes that provide preferential tax treatment than it is to increase rates. 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 particular, most transfers are progressive and increasing them enhances equality while reducing deprivation rates.

4.5 NERI Proposals

The government's decision to limit yearly improvements in the structural balance to the minimum amount required is to be welcomed. Even so, adherence to the MTO limits the annual space for loosening the fiscal stance to close to €1 billion per annum until at least the end of 2018, and possibly even longer. However, we do not agree that the proposed 50-50 split between revenue and expenditure measures is appropriate given the far from optimal growth and equity implications of a 50-50 split and the Republic's low levels of government revenue and spending. It is our view that there is no scope for reducing the tax take in Budget 2016 given the pressures on the expenditure side.

For illustrative purposes Table 4.7 describes an alternative €1.2 billion package to that proposed in the Spring Economic Statement. Demographic pressures will cost a minimum of €300 million in additional resources in 2016 (DOF, 2015a) while the public sector pay agreement accounts for a further €300 million. In addition, we propose allocating €250 million towards a set of anti-poverty measures including resources to increase social transfer rates to help offset inflation's erosion of the living standards of the most vulnerable in society, along with additional resources for the aid budget, mental health services, and community supports in deprived areas.

Subsidised childcare would increase potential output in a number of ways. It would incentivise labour force participation by carers, which would improve the size and quality of the available workforce, and would reduce labour costs by easing upward pressure on wage demands. The currently low level of social contributions has already been highlighted and we propose the introduction of a third band of employer's PRSI

on the portion of salaries above €100,000, the yield from which would be hypothecated to a childcare fund and used to provide state subsidies for childcare.

Tax expenditures are damaging to growth while taxes on immovable property, wealth and passive income are growth and employment friendly (Johansson, 2008) compared to other taxes. We propose the introduction of a modest net wealth tax, non-indexation of the property tax bands, and reduction in the generosity of reliefs for Capital Acquisition Tax (CAT), as well as reform of the overall system of tax reliefs pending a thorough review of the existing system.

Table 4.7 Illustrative Budgetary Package, (€ millions)*

Yield		Cost	
Taxes on wealth and property	550	Spending commitments	600
<i>Introduce a net wealth tax</i>	<i>250</i>	<i>Demographic pressures</i>	<i>300</i>
<i>Non-indexation of property tax bands</i>	<i>50</i>	<i>Public sector pay agreement</i>	<i>300</i>
<i>Reform CAT related tax expenditures</i>	<i>50</i>		
<i>Reform other tax expenditures</i>	<i>200</i>		
Anti-fraud measures	100	Anti-poverty measures	250
<i>Tax compliance measures**</i>	<i>100</i>	<i>Social transfers and development aid</i>	<i>250</i>
		R&D and Capital Expenditure	1,000
		<i>Capital spending</i>	<i>800</i>
		<i>R&D</i>	<i>200</i>
Total yield	650	Total cost	1,850
		Net Cost	1,200

Notes: Figures are indicative and rounded to the nearest €50 million. CAT refers to Capital Acquisitions Tax. Net cost does not include an additional €1 billion in off-the-books public investment.

*In addition, it is proposed that €150 million 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 a submission from the Revenue Commissioners arguing that allocating €6.5 million to increase audit, investigation and compliance resources would yield €100 million per annum.

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 of available resources. The Republic's productive infrastructure already lags that of Western Europe in a number of respects. There are infrastructural needs in housing, telecoms, transport, energy, schools and sanitation. We propose an €800 million increase in the capital budget along with an additional €200 million of resources for R&D. We also propose an off-books investment of €1 billion per annum to be used on projects with a commercial return. The cost of borrowing is historically low and financing investment can be

centralised and leveraged through an independent strategic investment bank or fund. Strategies for investment and innovation based growth along with strategies for financing that investment will be discussed in the next edition of this publication. Our proposals would cumulatively raise public capital investment by €1.8 billion in 2016 thereby increasing the public capital investment ratio to close to 3 per cent of GDP.

Using O'Farrell's (2013) estimates we find that, when compared to the fiscal strategy outlined in the Spring Economic Statement, the NERI budgetary package, as described in Table 4.7, would deliver a more benign outcome in 2016 in terms of GDP growth and the public finances. Ignoring the impact of the €1 billion off-book public investment stimulus we estimate that GDP growth would be 0.4 per cent higher under the NERI package compared to the government's package while the general government deficit would improve by 0.1 per cent (Table 4.8). The off-book programme of public investment, if implemented, would further boost GDP growth in 2016 while simultaneously boosting potential output.

Table 4.8 Estimates for Output and the Public Finances under Different Budget Plans, (Percentage Point Difference)

	NERI Plan vs. Government Plan
GDP Growth	+0.4
General Government Balance	+0.1
Sources:	O'Farrell (2013); NERI calculations
Notes:	See O'Farrell (2013) for a discussion of methodology/caveats surrounding the estimates. NERI Plan refers to Table 4.7 but assumes no €1 billion off-book investment package. Government Plan refers to the €1.2 billion adjustment signalled in the Spring Economic Statement (€0.6 billion of direct tax cuts and €0.6 billion of expenditure increases). The expenditure adjustment is assumed to be divided equally between public sector pay and demographic pressures as per Table 4.7.

4.6 Conclusion

Fiscal policy should be guided by the short, medium and long-term needs of society (e.g. sustainable growth, low unemployment, poverty reduction and well-being) and not just by an arbitrarily set threshold for the deficit. While the economics of the fiscal rules can be debated it is nevertheless a legal fact that the Republic is constrained by the need to adhere to its MTO. Within those constraints we outline an alternative approach to fiscal policy. We argue that long-run economic growth, employment and equity goals will best be achieved by prioritising use of the available fiscal space to increase public capital investment levels, while simultaneously legislating for an increase in social spending funded by reforms to increase total government revenue.

5 Conclusion

Economic growth has returned to the Republic of Ireland along with employment growth and improving public finances. Our medium-term outlook is for reasonably robust growth in output and employment. However, the outlook is less positive for Northern Ireland. Economic growth will be hampered by the impending cuts to public spending while political uncertainty persists given the forthcoming In/Out referendum on EU membership.

Our analysis in Section 4 has focussed on the public finances in the Republic of Ireland and discusses the implications of the EU's fiscal rules for budgetary policy in the Republic of Ireland in 2016 and beyond. Adherence to the medium-term budgetary objective limits the space available for loosening the Republic's fiscal stance to around €1.0 billion annually until at least the end of 2018, and potentially longer depending on how the structural budget balance is estimated in future years. Much of this fiscal space will be absorbed by demographic pressures on public spending.

We reject as inappropriate the proposed 50-50 split between revenue and expenditure measures given the far from optimal growth and equity implications of that split and the currently low levels of government revenue and spending. We argue instead that 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. In addition, we argue for a modest increase in social spending funded by a set of growth-friendly reforms to increase total government revenue.

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7 Appendix

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

	2010	2011	2012	2013	2014
Total Expenditure					
Consumption €m	82,447	82,969	82,467	83,334	85,619
Investment: private and public €m	26,106	24,841	26,923	26,541	30,400
Government current spending €m	26,437	26,111	25,922	25,956	25,967
Exports €m	157,811	167,086	182,506	184,056	207,792
Imports €m	-129,023	-132,398	-147,079	-147,694	-168,083
Domestic Demand €m	134,421	134,701	135,600	136,668	143,835
Total Income					
GDP €m	164,928	171,042	172,755	174,791	185,412
GNP €m	138,503	138,915	141,229	147,505	158,438
Income from Agriculture €m	2,586	3,202	3,019	3,027	n/a
Income non-Agriculture: Wages €m	69,440	69,465	69,519	71,854	n/a
Income non-Agriculture: Other €m	57,882	63,645	63,648	61,706	n/a
Employment					
Labour Force	2,196,700	2,173,700	2,165,800	2,182,100	2,172,400
Labour Force Participation Rate %	61.0%	60.4%	60.2%	60.7%	60.4%
Employment	1,886,100	1,845,600	1,841,300	1,899,300	1,926,900
Employment full-time	1,459,700	1,411,300	1,395,000	1,448,600	1,474,700
Employment part-time	426,400	434,300	446,300	450,700	452,200
Underemployment	112,500	140,800	147,600	139,300	124,300
Unemployment	310,600	328,100	324,500	282,900	245,500
Unemployment %	14.1%	15.1%	15.0%	13.0%	11.3%
Long-term Unemployment	152,600	191,700	193,000	165,100	139,200
Long-term Unemployment %	6.9%	8.8%	8.9%	7.6%	6.4%
Migration					
Immigration	41,800	53,300	52,700	55,900	60,600
Emigration	69,200	80,600	87,100	89,000	81,900
Net Migration	-27,500	-27,400	-34,400	-33,100	-21,400

	2010	2011	2012	2013	2014
Public Finances					
Total General Gov. spending €m	103,544	76,550	69,844	70,371	n/a
Total General Gov. revenue €m	55,149	55,331	56,623	58,866	n/a
General Gov. Balance €bn	-48.40	-21.22	-13.22	-11.50	n/a
General Gov. Gross Debt €bn	144.2	190.1	210.2	215.3	203.3
General Gov. Gross Debt % GDP	87.4%	111.2%	121.7%	123.2%	109.7%
Earnings and Prices					
Average earnings € per week	693.70	687.67	691.93	677.13	670.53
Average earnings % change	n/a	-0.9%	0.6%	-2.1%	-1.0%
Private sector av. earn. % change	n/a	-2.5%	1.0%	-1.3%	-1.1%
Public sector av. earn. % change	n/a	0.7%	1.2%	-1.2%	-0.6%
Inflation CPI %	-1.0%	2.6%	1.7%	0.5%	0.2%
Inflation HICP %	-1.6%	1.1%	2.0%	0.5%	0.4%
Inequality and Poverty					
Gini coefficient	31.4	31.1	31.2	31.3	n/a
Quintile ratio	4.8	4.9	5.0	4.8	n/a
Relative poverty %	14.7%	16.0%	16.5%	15.2%	n/a
Consistent poverty %	6.3%	6.9%	7.7%	8.2%	n/a
Deprivation rate %	22.6%	24.5%	26.9%	30.5%	n/a
Sources:	CSO Quarterly National Accounts; CSO National Income and Expenditure; CSO Quarterly National Household Survey; CSO Population and Migration Estimates; CSO Earnings and Labour Costs; CSO Consumer Price Index; CSO SILC Reports; and Eurostat online database.				
Notes:	Earnings and labour market data are for Q3 in all years. Domestic Demand is Total Domestic Demand. National accounts data reported at current market prices.				

Appendix 7.2 Overview of recent economic trends– Northern Ireland

	2010	2011	2012	2013	2014
Total Expenditure					
Personal consumption £m	-	-	-	-	-
Investment: private and public €m*	9,353	7,332	-	-	-
Government consumption £m	-	-	-	-	-
Exports £m	5,438	5,910	5,627	5,985	5,924
Imports £m	5,417	5,774	5,690	5,821	5,955
Domestic Demand £m	-	-	-	-	-
Total Income					
GVA £m	31,444	31,961	32,444	32,841	-
GNP £m	-	-	-	-	-
Income from Agriculture £m	373	374	385	-	-
Income non-Agriculture: Wages £m	17,420	17,890	18,287	-	-
Income non-Agriculture: Other £m	13,651	13,697	13,772	-	-
Employment					
Labour Force	841,000	862,000	865,000	865,000	873,000
Labour Force Participation Rate	59.8%	61.0%	60.8%	60.5%	60.7%
Employment	765,500	781,500	780,000	776,500	795,000
Employment full-time	598,000	611,000	597,000	594,000	618,000
Employment part-time	177,250	185,000	194,000	199,000	194,000
Underemployment	27,000	32,000	41,500	43,000	34,000
Unemployment	60,000	62,500	65,000	65,000	56,000
Unemployment rate %	7.1%	7.2%	7.5%	7.5%	6.4%
Long-term Unemployment	26,000	27,500	33,000	34,500	30,000
Long-term as % of Unemployed	42.9%	44.1%	50.7%	53%	53.5%
Migration					
Immigration	24,544	23,724	23,255	23,100	24,381
Emigration	23,394	25,218	24,570	25,438	22,810
Net Migration	1,150	-1,494	-1,315	-2,338	1,571

	2010	2011	2012	2013	2014
Public Finances					
Total General Gov. spending £m	18,840	19,081	19,350	19,834	-
Total General Gov. revenue £m	-	-	-	-	-
General Gov. Balance £m	-	-	-	-	-
General Gov. Debt nominal £m	-	-	-	-	-
General Gov. Debt % GDP	-	-	-	-	-
Nominal earnings and Prices					
Average earnings £ per week	354.4	354.6	360.1	365.2	359.6
Average earnings % change	-0.1%	0.1%	1.6%	1.4%	-1.5%
Private sector av. earn. % change	0.6%	0.1%	-2.3%	2.5%	0.4%
Public sector av. earn. % change	6.5%	1.9%	5.4%	-1.7%	2.3%
Inflation CPI %	-	-	-	-	-
Inflation HCPI %	-	-	-	-	-
Inequality and Poverty					
Gini coefficient	-	-	-	-	-
Quintile ratio	-	-	-	-	-
Relative poverty %	22%	20%	21%	19%	-
Consistent poverty %	20%	20%	23%	20%	-
Deprivation rate %	-	-	-	-	-
-					
Sources:	HMT Public Expenditure Analysis 2014; HMRC RTS; ONS Gross Value Added (Income Approach); LFS Quarterly Supplement; NISRA Northern Ireland Migration Flows; NISRA Annual Survey of Hours and Earnings; Department of Social Development Poverty Bulletin				
Notes:	Where cells are blank the data are unavailable. *Investment as Gross Fixed Capital Formation (estimated)				

Notes

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