Navigating through strange times; priorities for the Irish economy in 2016.

Speech by Marie Sherlock, SIPTU Economist to the Magill Summer School. July 19th, 2016.

In the spirit of the summer school this week, it is worth commencing with a quote from Friel's play Translations, "confusion is not an ignoble condition."[1] Given the current economic and political environment, this is particularly apt. The major asymmetric economic and political shocks brought about by the Brexit referendum result will tremor throughout this island for a long time to come.

However, it is ignoble to insufficiently address the uncertainty and confusion that now prevails. And in particular, the Irish Government, political parties and representative groups on both parts of this island all have a major responsibility to advocate and agitate for the best possible deal for the people North and South of the border.

When we will look back, 2016 will be remembered as a year of great surprises.

The general election result which saw FG form a minority government with Independents, something we previously thought unworkable. Then we had the Brexit referendum result which many feared but didn't think probable and just as we thought we had a good handle on the performance of the Irish economy, last week the CSO released their GDP figures for 2015.

At a quick glance, the first two are indeed surprises, particularly when we consider the strong recovery and growth of both the Irish and British economies over the past six years. But for many who were out on the doorsteps, out in their communities, out in other people's workplaces, there was a realisation that for a significant share of the population, a rising tide does not necessarily lift all boats.

The reasons for both results are very different. But the responses must be similar.

In Ireland, in the UK and beyond, the growing trend of polarization in the labour market in terms of wage and job progression coupled with the inadequate access to social infrastructure, be it housing or health, has given rise to a frustration that will not be easily calmed.

In particular, failure to act at EU level will risk a catastrophic unwinding of the European Project. Developments over recent years at the EU level has seen an increased shackling of individual member states' public finances, yet little or no commensurate pooling of risk or resources to help stabilise and improve the public finances of those in difficulty. And all of this has been coupled with a political failure to explain the true benefit of migration. Already, we have seen growing

[1] Friel B. 1984. "Translations" from the collection *Brien Friel: Plays 1*. Faber & Faber; London.

frustration at the distributional costs of globalization, fiscal straightjackets and financial rescues and migration give rise to the growth of the right and the extreme right in Europe across France, Italy, Netherlands, Czech republic, Hungary and Poland and Austria.

For Ireland, the impact of Brexit will remain unknown for some time. And as with most seismic events, the trouble is only just beginning. The buildings haven't collapsed just yet, but the cracks are very visible. Already, we are seeing a 9% depreciation in sterling and are likely to see a major chill effect on investment and hiring decisions for those exporting into the UK. For the North, the referendum result brings into sharp focus major economic, social and political questions about the smooth passage of cross border trade and freedom of movement but also in terms of the EU social and investment transfers. Here in Donegal, the implications are all the more frightening given the huge interdependence between Derry city and the county.

Estimates suggest that there is a potential hit to the economy of the Republic between 0.5%-1.2%.[2] I fear the impact will be greater. We are simply unable to properly model the pace of extrication and how firms might respond in anticipation and in the face of huge uncertainty. Indeed, a key question is the shape and form that Brexit might take.

It is in this context, that I think it is fair to say that the Irish government and economy is now at a crossroads. Do we retreat into defensive mode, delay spending and investment and prepare ourselves for the inevitable hit or do we attempt to make our own economy stronger and more resilient in anticipation that major change is going to happen anyway in our main trading partners in the UK and EU and in the rest of the world?

I suspect that most of us on the panel would say it is not an either/or choice and we would agree that our great challenge over the coming months must be to secure the Irish economy. However, our point of departure might be on the course of action to be taken. This involves key choices in how bold or conservative we should be over the coming months and year in terms of fiscal, financial and general economic policy.

The first choice must be the size of the Budget to be announced this October.

The great irony for the Irish public finances is that it has more resources available to spend in 2016 and in 2017, while still driving down the deficit and debt, than is permitted under the EU Fiscal and Irish Budgetary rules, in particular the Expenditure Benchmark rule.[3]

[2] Dept of Finance. (2016). Summer Economic Statement. Government of Ireland; Dublin

[3] It is also worth noting the Government is underutilising the space technically available to it this year. Classification of AIB's €2.1bn preference share conversion as a capital transfer and therefore as expenditure, had the impact of adding to the expenditure base in 2015 and carried through to 2016. The Dept. of Finance's 2016 Summer economic statement announced revised tax revenue forecasts of €1bn more than originally projected. So far, only €540m has been spent in a supplementary budget for health and justice in May 2016 with the prospect of another

To a certain extent, the publication of the CSO's revised GDP figures will have been one of those items we will want to forget this year. As a measure of the true performance of the Irish economy, GDP finally made itself redundant last week. The figure is meaningless except that it was in part explained by the almost 50% rise in corporate tax revenues last year.

However, the revision is of critical importance in that it has the potential to greatly change the budgetary arithmetic for 2017 and beyond. The structural budget deficit now drastically deteriorates as the figures show Ireland to be very much overheating. However, on the positive side, the large increase in GDP significantly expands the potential expenditure base. Those urging caution will remind me of the elaborate EU semester process and that we simply cannot change anything for this year. Key metrics such as the reference rate and the convergence margin are fixed in the preceding Spring.

The reality is that, technically, the Irish Government now has much more fiscal space available than previously thought while remaining compliant with the rules.

Quite puzzlingly, the Government has been quick to clarify this revision will have no impact on the Budget. I understand the need to contain expectations and indeed there are many pent up ones out there. However, the Government's position is now inconsistent. Minister Noonan complained publicly about the very significant methodological difficulties for Ireland in calculating the fiscal rules which in turn excessively constrain any spending plans until Ireland reaches its structural balance medium term objective.[4] Yet when we are essentially gifted additional space by another methodological quirk, the view is to ignore it.

I appreciate that the Government are currently sowing the seeds of a campaign to have the EU fiscal rules altered to treat capital investment separate to current expenditure and to instigate a type of golden rule. And for this, they have our support. Its impact would be hugely significant; allowing a shift level increase in our capital investment spending to maintain and invest in new physical and capital infrastructure.

But at a time where there is such great need to significantly up investment into our economic and social infrastructure, we cannot afford a protracted debate, where a change could be a year or more away. And arguably, with the uncertainty surrounding Brexit likely to freeze corporate investment, expansion and hiring decisions, the argument for public investment is all the greater now.

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supplementary budget in October to accommodate full payment of the Christmas Bonus, worth approximately €267m, as no provision was made in Budget 2015 for this.

[4] Irish Independent. June 28th, 2016. Noonan takes swipe at Europe over fiscal rules. http://www.independent.ie/business/irish/michael-noonan-takes-swipe-at-europe-over-fiscal-rules-34838919.html

Ireland's public investment rate is projected to be just 2.3% as share of GDP, approximately half of level necessary and the depreciation of our capital stock is set to reach unprecedented levels due to the failure to reinvest. The fiscal rules do make some allowance for capital investment, but this is of little help owing to the design of the four year average.[5]

If other EU governments read the warning signs emitted by the Brexit result, the appetite to play ball with the fiscal rules may well diminish in future months. And it's not clear that a change to the treatment of public investment in the rules would resolve the problems of those already in breach.

The EU Council has seen fit to permit both Spain and Portugal additional time to meet their 3% general government deficit target and France has breached the rules for the past 8 years. Contrast this with Ireland where our general government deficit is expected to be negligible in 2016 and is on course to generate surpluses from 2018.

Some will argue that this is a short sighted and imprudent grab at the public finances- designed to repeat the mistakes of yesteryear. It is nothing of the sort. Instead this argument is all about ensuring the long term fiscal stability of the country- if we fail to invest now in those bottlenecks in the Irish economy, then we condemn ourselves to a lower potential growth path in future years. The argument here isn't about largescale increases in current expenditure- although they are not sustainable at current levels in terms of providing for increased demographic pressures, a shift level increase in health services demanded due to the increasing incidence of chronic conditions amongst the general population and additional workforce requirements. This is about ensuring adequate productive capacity for the future.

We are currently living through a housing crisis in Ireland, where housing supply is less than a third of what it needs to be. By its very definition, a crisis demands exceptional, abnormal measures, not reliance on the conventional supports and incentives to the private and voluntary sector. I welcome the ongoing efforts by Government to tackle this, but it is becoming increasingly obvious that the nut will not be cracked in the absence of a major stepping up of directly provided public investment in this area.

When we consider the new lows that Irish bonds yields have recorded in recent weeks, it makes no sense whatsoever that we would fail to avail of historically low interest rates that are currently prevail. Those arguing against such a course fail to recognize that borrowing today for tomorrow does not necessarily lump future generations with massive debt. Public investments that yield a

[5] The four year averaging is designed to accommodate once off increases in capital investment and in effect, is of little benefit to a member state such as Ireland that requires a shift level increase in capital investment to maintain and replace existing infrastructural provision. Even with the inclusion of the four year rule, there remains an inherent bias against capital investment relative to current spending, as the rule forces the full capital cost to be realised on the government's accounts over the short period of four years as opposed to being discounted over much longer period as is used in traditional accounting conventions.

higher social return than financial cost, particularly when discounted over a period of time, means that our children will be better off, not worse off!

If anything, there are two critical lessons from the 2000's that we must now apply when assessing our economic and fiscal position. Firstly, we cannot allow an over-reliance on cyclically sensitive tax revenue sources that increase disproportionately to all other sources. As a share of total taxation corporation tax is now back at 2006 boom time levels but still only accounts for 15% of overall receipts. When we compare with 2006, where stamp duty, CGT and corporation tax accounted for 30% of revenues, the risk of a tax revenue collapse now from a downturn is much smaller as the tax base is so much more dependent on income tax.[6] This is not to say that we ignore all of the corporate tax increase. The Dept. of Finance has recorded a significant share of that corporate tax increase as structural both last year and this year.

The second key lesson from the 2000's is not about the pace of growth of current and capital expenditure, rather it must be about requiring a much greater focus on the quality of spending allocations.

The second key challenge over the medium term will relate to wage progression.

Again there will be an understandable desire to push the pause button. And the chill effect of Brexit on many Irish companies will extend beyond investment and hiring decisions to include pay negotiations. But let me be clear. SIPTU as the largest public and private sector union in the country will not allow its workers to be scapegoated by Brexit. Similar to that of the awful recession years, we will work with those companies that are genuinely hit. Our key priority has always been for the retention of jobs. But we will resist all attempts by those who piggy back on this general uncertainty.

In debates about the Irish economy in recent months, there has been a trend emerging that pits infrastructural investment against increases in pay. This simply cannot be an either/or choice.

Investment in public infrastructure is important to sustaining and increasing the productive capacity of the Irish economy. This in turn is important so that we can remain competitive relative to our main trading partners. And this competitiveness depends on sustainable public finances, which in turn are largely built on strong domestic consumption which depends on high employment levels and decent living standards. The alternative is that high unemployment and high social welfare spending weigh heavily on the public finances. This positive feedback loop

[6] The composition of the tax base has shifted significantly between 2000, 2006 and 2016 where income tax as the largest tax receipt has moved from 34% of the total share in 2000, to 27% in 2006 and back up to 40% in 2015. This doesn't necessarily suggest a narrowing of the tax base as there has been a shift from dependence on "fairweather" taxes to more cyclically inelastic taxes such as income and property.

between wages, employment, domestic consumption and economic competitiveness is critical when thinking about the importance of investment and wages.

Relative to strong employment growth since 2012, wages have increased at a much more moderate pace. The distribution of these improvements is critical to broad based growth. However, the evidence to date suggests that as expected, wage growth has not been uniform. An analysis of the data in CSO's quarterly Earnings and Labour cost survey suggests that average weekly gross wages of professional and managerial occupations have surged ahead by 4.8% between 2012 and 2015, whereas those in sales and clerical occupations slipped by 3.4% and there was an even more pronounced slide in the wages of those production and general operative roles of 7.9%.[7]

In stark contrast, those working in clerical, sales and production roles, particularly in the manufacturing sector and who are SIPTU members will have had annual pay increases of 2% negotiated for them over the past two years.

The reasons for this polarised wage trend are likely to be complex- a combination of tighter margins, increased casualization in certain sectors with a surge in profitability in others. In this context, it's my view that the future of wage negotiations has to be sectoral. Such is the environment for wage bargaining that bringing some employers to the table is a massive feat in itself, for others it is a case of driving the hard bargain. And the Government has a critical role to play in facilitating this over the coming years.

Public sector pay will undoubtedly be a source of increased agitation over future months and we await the Government appointed commission on Public Sector pay with interest. SIPTU and other unions have made their position very clear- we are seeking the unwinding of FEMPI. But there is no doubt that this will have to be done in a very carefully managed way. There are very few of us who would wish to see very decently paid public servants receive sums in excess of over €14,000 or indeed former Taoisigh and office holders receive major windfalls greater than that while the lower and middle ranks of public servants get very little.[8]

If we have learned anything since 2011 and the political environment that currently prevails, it is this; that the majority of people in this country want a fair, well distributed recovery. SIPTU's priority for public sector workers is to push for equitable pay progression particularly for low and middle income earners and that this has to be done in tandem with a gradual unwinding of FEMPI off of our Statute books.

[7] Source: own calculations based on CSO's Quarterly Earnings and Labour Costs Survey.

[8] Calculation based on outstanding pay reductions (between pay and pension service pension reduction) to be restored to employee earning €100,000.

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