Opening Statement – Oireachtas Committee on Budgetary Oversight

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Introduction

Let me begin by thanking the Chair for the invitation to the ESRI to appear before the Committee. I am Dr. Karina Doorley, and I am joined by my colleagues Dr. Niall Farrell and Dr. Kieran McQuinn. We are grateful for the opportunity to appear before the Committee today to provide our views on inflation.

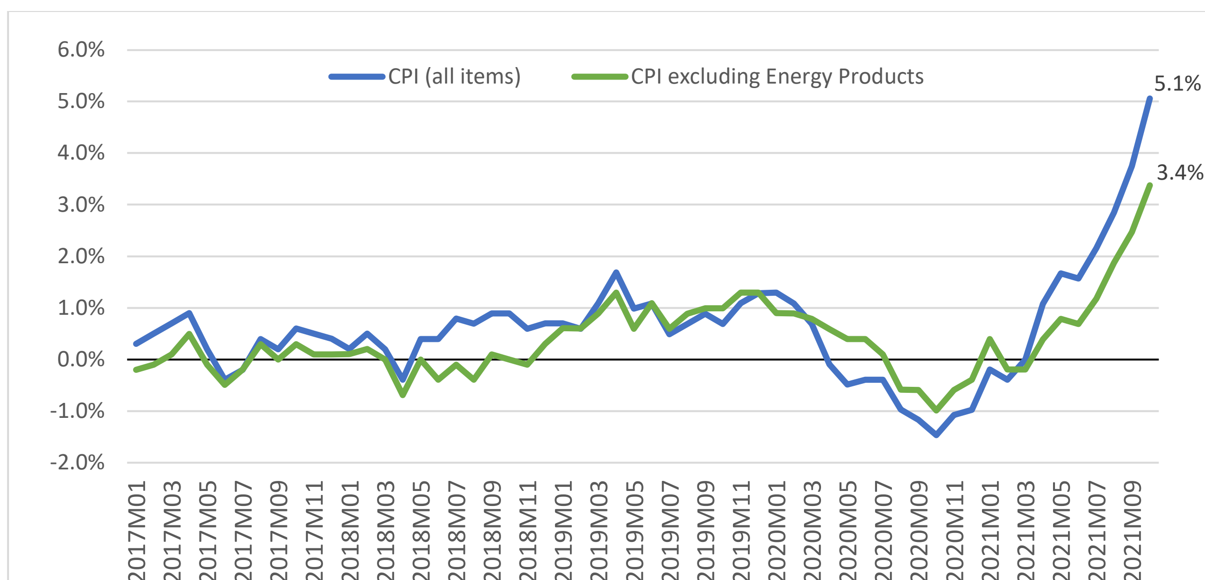
The post-pandemic circumstances that we are currently facing are just as unprecedented as the pandemic itself. Understanding the inflationary pressures currently being experienced across most western economies requires us to first recount the deflationary pressures of last year. These base effects combined with the uneven responses of global supply and demand along with the pressures in international energy markets are the main drivers of the inflation currently being experienced.

Macroeconomic impacts

At the onset of the COVID-19 pandemic and its accompanying public health restrictions, a significant portion of the economy came to a halt as households remained indoors and paused normal activities. This disruption led to a sharp contraction in the demand for goods and services typically consumed by households and consequently, prices declined in 2020 and early 2021. These declines are key to understanding the magnitude of inflation now; after a period of deflation, even a modest increase in prices due to increased demand can result in significant rates of inflation.[1] It is worth plotting the annual change in the consumer price index (CPI) of all products as well as the CPI excluding energy products since 2017.

Figure 1. Annual Rate of Change in the Consumer Price Index (CPI): 2017M1 – 2021M10 (%)

[1] For example, the rate of inflation in Q32021 is nearly 3 per cent per annum compared to 2 per cent between Q3 2021 Q32019 – CSO HICP



It is useful to see the effects that energy products have had on CPI throughout 2021. Since March, CPI excluding energy products has remained significantly lower than overall CPI. In October, CPI excluding energy products stood at 3.4 per cent compared to 5.1 per cent for overall CPI. Prior to 2021, two issues which immediately stand out from the graph are the relatively low and stable rate of inflation over the period 2017-2020 (at a time when the Irish economy was growing strongly) and the sharp deflation which took place during 2020.

The underlying strength and resilience of Ireland's domestic economy throughout the COVID-19 pandemic has made it uniquely vulnerable to inflationary pressures. Ireland alone across the EU registered positive GDP growth in 2020, while the more indicative measure of Irish economic activity, modified domestic demand, is set to grow at a faster pace than output growth across most other European countries. The strength of the underlying economy means that demand is growing more rapidly in Ireland, resulting in greater inflationary pressures.

Meanwhile, the rebound in demand is coinciding with a sluggishness in international supply. For example, shipping firms, expecting a slowdown in trade during lockdown periods, idled the global fleet by over 10 per cent. When households (especially in America) began to spend their pent-up savings and government-provided pandemic payments, shipping firms and manufacturers were ill-prepared to meet the global surge in demand. Instead, producers have found themselves unable to keep up with orders, container ports have faced significant backlogs, and shipping rates have rocketed. [2] These strains on supply chains are another pandemic-induced pressure point on price inflation.

While these issues are being felt globally, one area in which inflationary pressures are particularly pronounced in Ireland is the property market. After transport costs, housing and fuel costs were the second largest increase in the CPI according to the latest CSO data. Much like other goods and services, the housing market has experienced robust demand along with a slowdown in supply during the pandemic. Housing demand was largely unaffected during COVID-19, due to the provision of significant Government welfare assistance. Indeed, the perceived increase observed in the savings rate of Irish households may have actually

[2] "A perfect storm for container shipping", *The Economist,* 16 September 2021, https://www.economist.com/finance-and-economics/a-perfect-storm-for-container-shipping/21804500

contributed to an increase in housing demand. Consequently, house price inflation in August of this year is just under 11 per cent per annum. It should also be said that rental inflation is experiencing increases. With more and more people expected to return to urban areas as work-places re-open, it is likely that rental pressures will continue to grow over the next 6 to 9 months.

Unfortunately, issues concerning the supply-side of the housing market stem from pre-Covid vulnerabilities in the Irish economy as well as the effects of the pandemic. Housing supply, already falling short of demand before 2020, suffered additional slowdowns as the public health measures contributed to a physical delay in housing construction. The slowed pace of construction is further hampered by a marked increase in the costs of construction inputs due to supply chain disruptions. These factors are constraining housing supply at a time when a significant imbalance already existed between supply and demand in the Irish market.

Energy

European commodity prices have experienced unprecedented growth in recent months. While oil prices have risen, primarily due to production lagging growth in demand, rising gas prices have been the primary driver. Gas prices in October 2021 were 400% more expensive than April 2021, leading to European wholesale electricity prices rising by an average of 200% (ACER, 2021). This growth has been driven by a rapid increase in demand, due to economic recovery, which has been met with constraints on supply.

A number of factors have contributed to European supply constraints. International investments in oil and natural gas have declined in recent years as a result of two commodity price collapses (2014/15 & 2020), while policies to scale up clean energy sources and technologies to fill the gap have been lagging (IEA, 2021). In addition to this, supply has been further constrained by maintenance work which was shifted from 2020 to 2021. Large-scale storage facilities usually provide a buffer during tight market conditions. However, a cold winter in 2020/21 and planned closure of certain storage facilities resulted in depleted European stocks leading into Autumn/Winter 2021. Finally, international competition for gas imports has further compounded fuel price growth in Europe.

In terms of energy pricing, international trends are likely to lead to sharp upward pressure on energy prices in Ireland. For gas and electricity, current information suggests that this will persist during Winter 2021/22 and that prices may fall in Spring 2022. Oil prices will be primarily determined by the production decisions of international producers.

Budget 2022

Budget 2022 contained measures directed at maintaining household standards of living. On the taxation side, tax credits and bands were increased by more than forecast inflation.[3] While the standard-rate band has been raised in some recent Budgets, this marks the first increase in the personal and PAYE tax credits since 2008 and means that the after-income tax purchasing

[3] At the time the Budget was announced, the Department of Finance (2021a) forecast HICP inflation of 2.2% in 2022, somewhat below the 2.9% forecast of the Central Bank (2021a) and the 2.5% (CPI) forecast in the ESRI Autumn QEC.

power of those earning enough to pay income tax will rise slightly in real terms, so long as the inflation outturn is similar to forecast levels.

Unlike income tax credits and bands, most of the corresponding thresholds for PRSI and the USC were held fixed in nominal terms, amounting to an effective PRSI and USC increase for many taxpayers.

Although most excise duties were frozen in cash terms (amounting to an effective cut given rising prices), Tobacco Products Tax was increased. There was also a well-flagged increase to the carbon tax. A carbon tax is the most efficient way of incentivising carbon abatement, with a large literature finding that such taxes would reduce emissions in Ireland with few wider economic costs (e.g. FitzGerald and McCoy, 1992; FitzGerald et al., 2002; Bergin et al., 2004; di Cosmo and Hyland, 2013; Conefrey et al., 2013; de Bruin and Yakut, 2018; 2019).[4] However, there is also widespread recognition that carbon taxes can have distributional consequences because lower-income households spend a disproportionate share of their incomes on carbon-intensive goods, in particular heating fuel. As a result, a carbon tax can have a regressive impact in the absence of an accompanying package of compensation measures. One should therefore consider the impact of the carbon tax increase on households' incomes in conjunction with other changes to the tax and welfare system.

On the welfare side, Budget 2022 saw increases to most social welfare payments. There were significant above forecast-inflation increases in the Fuel Allowance and the additional payments made to those living alone or with dependent children in receipt of social welfare payments. Recipients of these benefits are more likely to be at risk of poverty and to spend a high share of their income on fuel than social welfare recipients living with other adults, making the measures well-targeted at mitigating the adverse impacts of the carbon tax increase on vulnerable low-income households (Bercholz and Roantree, 2019; O'Malley et al., 2020). There were smaller increases in the main social welfare payments for working-age couples without children.

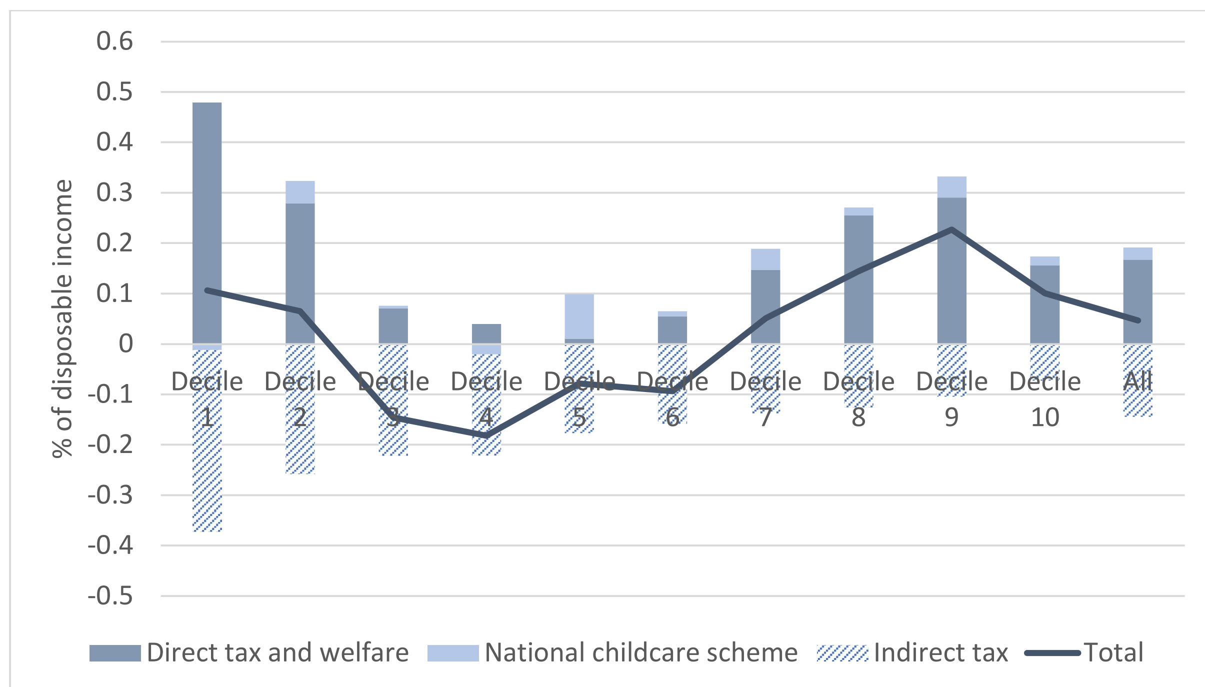
There was also a substantial increase in funding for the providers of registered childcare - accounting for around half of all childcare in Ireland - who commit to freezing their prices. Changes to the National Childcare Scheme (NCS), which subsidises registered childcare, were also announced. The Universal subsidy – which current pays 50c per hour for children under 3 – will be extended to cover children up to age 15 and the hours covered by the NCS for children in school or pre-school will be increased.

In our post-budget analysis, the ESRI compared the direct and indirect tax and welfare measures announced in Budget 2022 to a price-adjusted set of policies which would have kept household purchasing power constant in real terms. Figure 2 illustrates the impact of Budget 2022 across the distribution of household income, adjusted for family size, with the population divided into ten equally sized groups (deciles) ordered from lowest- to highest- income, left-to-right. The effect of direct tax and welfare measures, indirect tax measures and changes to the National Childcare Scheme are shown separately with the total effect represented by the solid blue line.

[4] This goes back as far as Baumol and Oates (1971) and Weitzman (1974). See Metcalf (2019) for an accessible summary of this literature and discussion of arguments in favour of a carbon tax over cap-and-trade schemes, namely less administrative complexity, damaging price volatility and potential for adverse policy interactions.

The overall effect of Budget 2022 compared to price-adjusted polices is that, on average, disposable income is virtually unchanged. There are small average gains in the lower two deciles and upper four deciles which are counteracted by small income losses in the middle four deciles. Although increases to the carbon tax and tobacco duty disproportionately affect lower income households, these also gain from above inflation increases to core social welfare payments and supplements for those living alone or with dependents. These increases are sufficiently large to offset the impact of increases to indirect taxes for the lowest-income fifth of households and will leave poverty slightly lower than had all welfare payments and tax bands kept pace with inflation. While the above inflation 'indexation' of income tax bands and credits will also compensate higher income households for the increases in indirect taxation, most Universal Social Charge and PRSI bands were not changed. The effect of this is to reduce the after-tax purchasing power of lower earners who do not earn enough to pay income tax - though some of these will gain from an increase to the minimum wage.

Figure 2. Distributional effect of Budget 2022 compared to a price-indexed Budget



Outlook and policy response

From a policy perspective, it is important to recognise that the current and forecast inflationary pressures are essentially of a temporary or transitory manner. The surge in demand will abate as consumers unwind savings and slowly regress to their pre-pandemic savings ratio. Firms will continue to improvise and navigate through the supply chain disruptions until global trade returns to normal levels. While monetary authorities and forecasters generally may underestimate these inflationary pressures this does not mean that the same authorities should react in a somewhat hasty manner by prematurely increasing policy interest rates. That, as noted by Goodhart and Pradhan (2021)[5], could result in monetary authorities threatening the nascent economic recovery which is apparent across countries.

[5] Goodhart C. and M. Pradhan (2021). What may happen when central banks wake up to more persistent inflation? Vox CEPR Policy Portal, October.

If inflation in 2022 is in line with forecasts, the direct and indirect tax and welfare measures announced in Budget 2022 will compensate most households for rising prices. If inflation exceeds forecasts, the increases to some targeted welfare measures like the Fuel Allowance, Living Alone allowance and Qualified Child increases may not be enough to insulate low-income households from rising prices.

The European Commission has published a Toolbox discussing measures of support for consumers in the face of a temporary rise in energy prices. Suggested interventions include: the temporary deferral of bill payments; adjustments to VAT and levies; and short-term adjustments to social payments to aid the vulnerable. In an Irish context, short-term adjustments to social transfers and facilitating the deferral of bill payments are likely to be the most effective policy options as (1) taxes and levies comprise a lesser proportion of total electricity expenditure in Ireland relative to many EU countries and (2) many social payments are already targeted towards vulnerable households.