Opening Statement – Oireachtas Committee on Budgetary Oversight

Karina Doorley, Muireann Lynch, Kieran McQuinn, Wendy Disch

ESRI

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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. Muireann Lynch, Dr. Kieran McQuinn and Ms Wendy Disch. We are grateful for the opportunity to appear before the Committee today to provide our views on Budget 2023 and additional one-off measures for 2022.

The economic and fiscal position

Despite unprecedented uncertainty in the global economy, both domestic and international sources of growth have demonstrated a certain degree of resilience for the year to date. We expect modified domestic demand to register positive growth in 2022 and 2023 of 4.4 and 3.7 per cent.

The relatively strong performance of the domestic economy so far this year is particularly evident in the labour market and the Government exchequer returns. Unemployment is now set to reach 4 per cent by the end of the current year, while taxation receipts are increasing across all the main headings.

Over the winter months, there is a distinct possibility that energy costs are likely to increase further. This would put significant pressure on many households as they confront this and other sizeable increases in the cost of living. Consequently, the Government may decide to provide further additional support to those households most affected. This could result in a significantly greater expenditure being incurred by the Government in 2023 than is now officially forecast. Based on the significant increases in tax receipts and likely trends in expenditure observed for the year to date, we now believe the public finances will witness a surplus in the General Government Balance (GGB) of 0.5 per cent of GDP in 2022. In 2023, we believe the Government will run a more modest surplus, however that forecast could well be revised somewhat in light of developments in international energy markets.

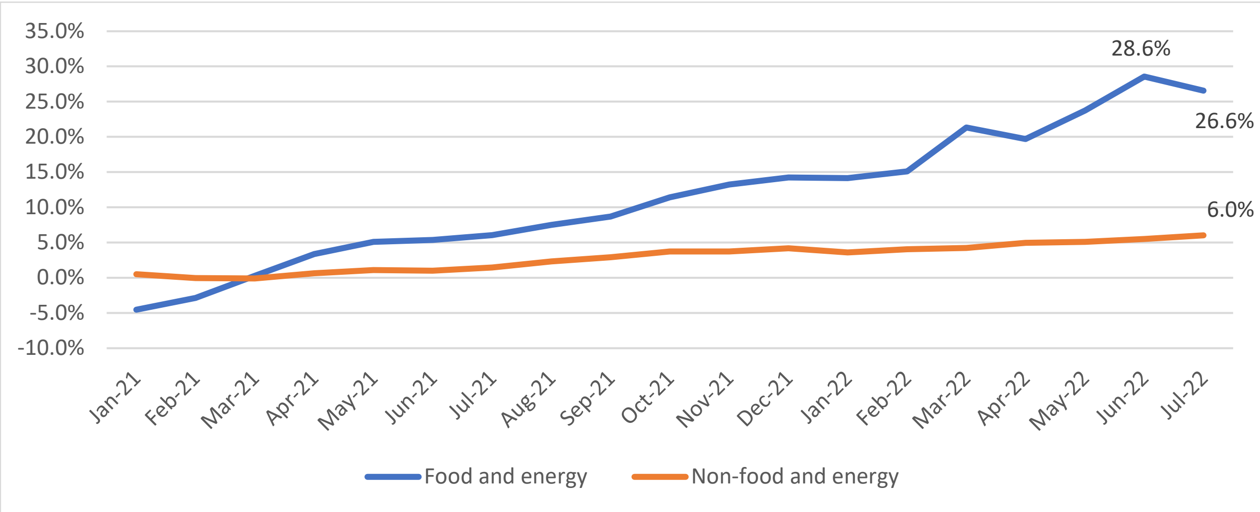
Developments in global inflationary pressures have contributed to significant downward revisions in global output and are likely to continue to feed through into domestic prices. Inflation in Ireland and the Euro Area stood at 9.1 and 8.9 per cent, respectively, in July.

Drivers of global inflation: food and energy

The areas experiencing the most acute inflation globally and in Ireland are food and energy. In light of these developments, we have divided the Irish CPI into two main indices: food and energy related items, and non-food and energy items. Food and energy items have accelerated rapidly over the past year, reaching a high point of 28.6 per cent per annum in June 2022.

Despite signs that food and energy-related price growth may be slowing, prices of non-food and energy items have continued to increase. As of July 2022, prices of these items had increased 6.0 per cent on an annual basis, suggesting that inflation is becoming more broadly based. As noted recently by Schnabel (2022)[1], it is not expected that the inflationary pressures in the Euro Area experienced recently will disappear soon and it will take some time until inflation returns to the target rate of 2 per cent.

Figure 1. Inflation in Food and Energy and Non-food and Energy items (Y-on-Y %) Ireland



Distributional effects of Inflation

Due to differences in the composition of household expenditure, inflationary pressures are heterogeneous across households. Figure 2 shows the diverging inflation rates across income deciles and highlights the disproportionate effect of price increases on lower-income households. The lowest income households experienced inflation just above 10 per cent in June. Contributions of food and energy costs are largely responsible for the varying rates of inflation. Food and energy costs contribute to over 40 per cent of Consumer Price Index (CPI) for the bottom two-fifths of households, with energy costs alone contributing over one third of CPI amongst the bottom fifth.

[1] Schnabel I. (2022). Interview with European Central Bank (ECB) board member. Available at: https://www.ecb.europa.eu/press/inter/date/2022/html/ecb.in220818~a2a774e937.en.html

Figure 2. CPI (June 2022) by Household Income

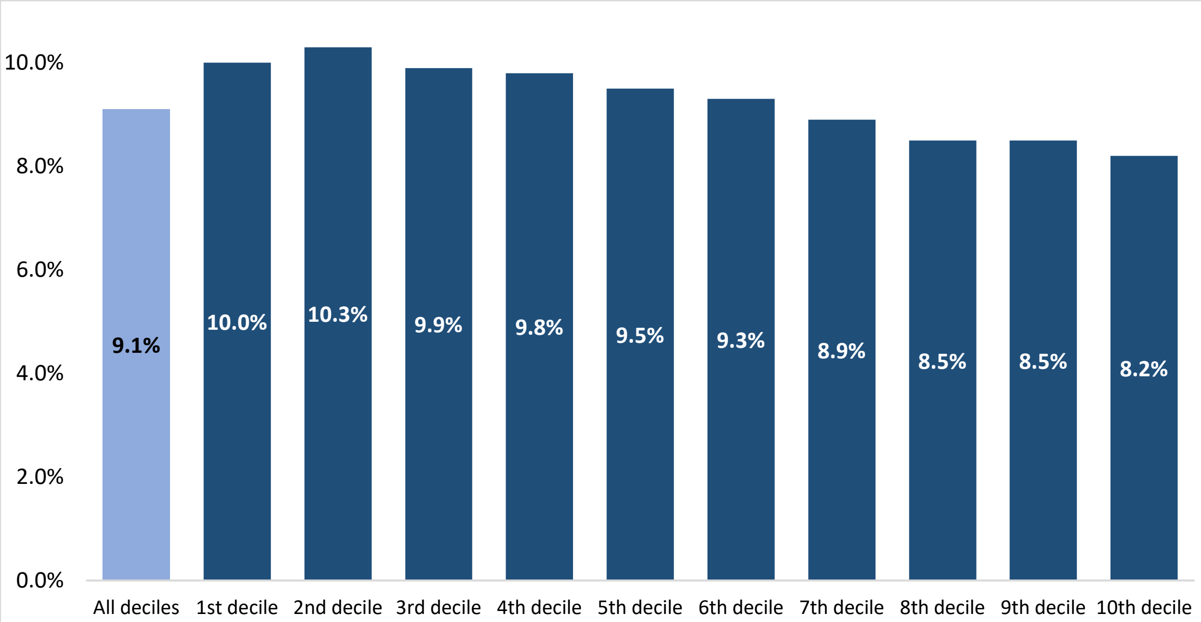
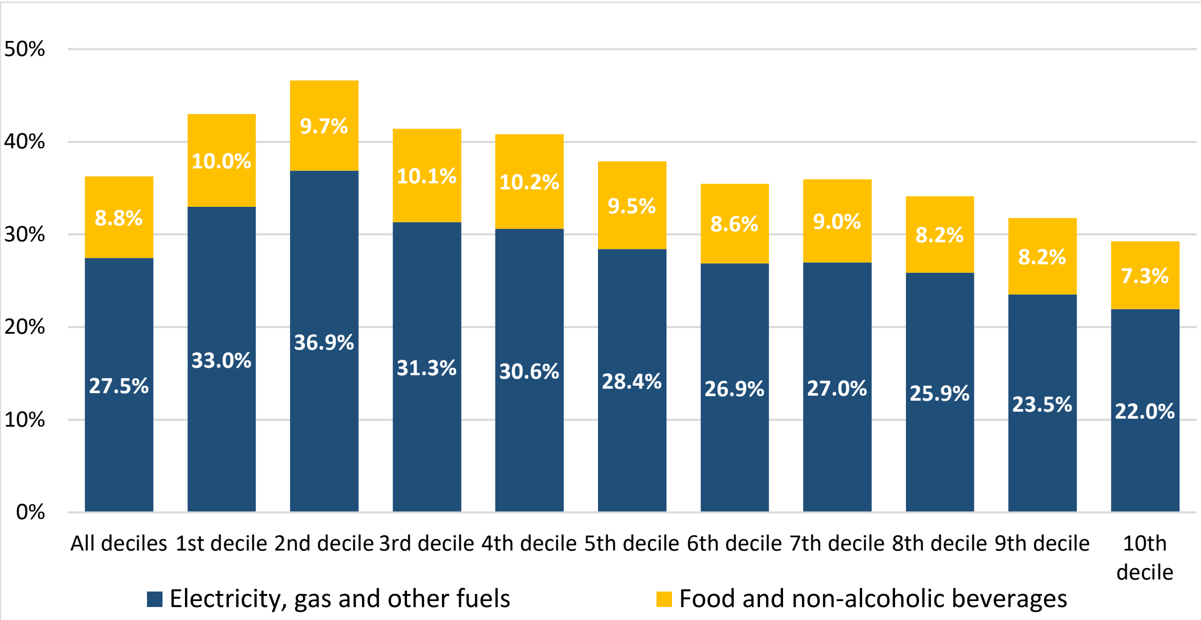


Figure 3. Food and Energy Contribution to CPI by Household Income (June 2022)



Budget 2023

Inflation presents challenges in the context of Budget 2023, particularly given the uncertainty inherent to economic growth and inflation projections for the next few years. It is useful to consider the change in real incomes experienced by households over the last year. When Budget 2022 was announced, it was framed as a cost-of-living budget which would help to cushion the impact of inflation on household real incomes. At the time, inflationary forecasts for 2022 ranged between 2.2 and 2.9%. Most tax and benefit parameters were increased by factors in the region of this projected inflation rate. This would have left most households no worse off in real terms had projections for inflation been correct. However, inflation has far exceeded these forecasts over the course of 2022, averaging 7.2 per cent.

A number of extra policy measures were introduced this year to help households with rising inflation. Budget 2022, together with the February cost of living package and the excise duty cut on petrol and diesel have resulted in average household income gains of around 1.5% of disposable income, with higher gains (of around 2.5%) for lower income households.[2] Some households may also have benefited from wage increases for one or more members this year. The Central Bank of Ireland has predicted nominal earnings growth of 2.3% per employee, on average, in 2022. Low income and elderly households, which contain fewer earners on average, will benefit less from this development. Wage growth is expected to be outpaced by inflation, resulting in real income losses across the income distribution.[3]

One option available to policymakers to compensate households for rising inflation is indexation of the tax and welfare system. Indexing tax and benefit parameters in line with price growth would keep the purchasing power of households reliant on welfare constant. It would also help to cushion the incomes of working households by reducing the tax paid on their earnings. Indexation in line with wage growth would keep the distribution of income constant and reduce the incidence of households losing eligibility for social welfare, childcare subsidies, medical cards, etc. because of inflation-driven wage increases. The Fiscal Council estimates that if the Government were to compensate households for unexpected inflation in 2022 and projected inflation in 2023, this would cost almost €7 billion. This is in excess of the total core current spending increase of €4.9 billion set out in the Summer Economic Statement for 2022 and 2023 combined.[4]

Indexation of all tax and welfare parameters leaves less scope for targeted measures. Given prospects for sustained high levels of inflation, particularly in relation to energy, policymakers may wish to consider greater targeting of measures to limit the cost of future supports and the risks of fuelling further inflation. The groups most exposed to inflation are those on fixed incomes such as social welfare and pensions, with little prospect of wage growth. Increases to welfare payments, the fuel allowance, and even lump-sum payments like the household electricity credit (which represents a larger proportion of disposable income for low- compared to high-income households) are well targeted at those most affected by inflation. These types of measures have advantages over indirect tax cuts on energy as they do not disincentivise investment in energy-saving technology.

Measures to specifically target low-income earning households could include the expansion of the Working Families Payment - both in value and scope - and increases in the exemption limits for PRSI and USC. Broader based tax cuts would benefit middle- and higher-income households.

Energy

In relation to energy, the existence of windfall gains in energy markets and the potential taxation of same has been raised in the context of record energy prices. The majority of the

[2] The cut to the VAT rate on electricity and gas is not included in this calculation.
[3] Quarterly Bulletin No.2 2022 (centralbank.ie)
[4] Pre-Budget-Statement-2023.pdf (fiscalcouncil.ie)

windfall gains being made in the global energy sector at present accrue to fossil fuel companies, as they continue to extract fossil fuels at relatively fixed cost yet sell them at greatly increased prices. In Ireland, fossil fuel extraction is limited to the Corrib field, which is small and dwindling. Any potential windfall gains are therefore limited to non-gas fired generation, including coal generation and renewable generation, in the electricity sector. Estimating the magnitude of this windfall gain is challenging, and so the potential gain from a windfall tax is also difficult to estimate, and may also vary greatly year on year as companies vary and shift their activities in response. There is some evidence that some energy companies are using greater than expected profits on the generation side to offset losses on the supply side, which puts downward pressure on customer prices. Taxing windfall gains in the generation sector only may therefore place some upward pressure on consumer prices.

In relation to the energy outlook, prices are likely to remain high or increase over the winter, leading to further pressure on households and businesses. Energy security continues to be a concern, with the electricity supply in particular coming under pressure this winter and next. Balancing net demand with supply in realtime will be increasingly challenging and may only be possible with active participation from the demand side, whether domestic or industrial. The prospect of further reductions or a complete shut down of Russian gas to Europe remains an open possibility, which may result in gas rationing across Europe. Despite the fact that Ireland does not source gas directly from Russia, curtailment of supply across Europe may result in the need for rationing. In this case, gas-fired electricity generators would be prioritised, in order to avoid further pressure on electricity supplies. Large industrial gas users would be first to see their gas supply reduced, before any impact on households and small businesses.

Conclusion

Despite significant uncertainties in the global economy, the Irish economy is in a relatively strong position in the run-up to Budget 2023. This affords the opportunity for some targeted spending to mitigate some of the impact of inflation on those worst affected by it, particularly in the area of energy. The extent and nature of any support will, inevitably, be a function of further increases in energy costs. However, the Government must take care to ensure that any package that is adopted minimises the possibility of additionally stimulating the inflationary pressures which are present.