Opening Statement – Oireachtas Committee on Budgetary Oversight

Wendy Disch, Kieran McQuinn and Conor O'Toole, ESRI

22/03/2023

Introduction

Let me begin by thanking the Chair for the invitation to the ESRI to appear before the Committee. I am Dr. Kieran McQuinn, and I am joined by my colleagues Dr. Conor O'Toole and Wendy Disch. We are grateful for the opportunity to appear before the Committee today to provide our views on the present economic and fiscal situation and to discuss some key issues and risks which the medium-term fiscal strategy should consider. Our research draws heavily on our Quarterly Economic Commentary which is our main short term macroeconomic surveillance publication.[1] The most recent commentary was published in Winter 2022 and Spring 2023 is due for publication in two weeks time.

Economic outlook

The pace of growth across most western economies in the first quarter of 2023 has been stronger than many had previously expected. Better-than-anticipated economic activity and a modest decline in inflationary pressures has abated fears about an international recession that had emerged towards the end of 2022.

Given these developments, we have revised upwards a number of indicators from our Winter outlook. International trade is expected to continue to grow robustly through 2023, while high savings levels and a slowdown in inflation are likely to contribute to higher than anticipated consumption activity this year. Modified investment, which had grown very strongly throughout 2022, is expected to grow at a slower pace in 2023, however it will also contribute to growth in the present year. Additionally, improvements in the labour market have continued into the first few months of 2023, with historically low rates of unemployment. Given these combining factors, we now believe modified domestic demand (MDD) will grow more strongly in 2023 than we anticipated at the end of 2022.

[1] https://www.esri.ie/publications/quarterly-economic-commentary-winter-2022

Some of the main reasons for the better-than-expected outlook has been the easing of energy prices experienced across western economies to date in 2023 and the improvements in supply bottlenecks. However, the overall international outlook for inflation in 2023 is still somewhat uncertain. While energy related pressures are clearly abating, there is growing evidence of second round effects with estimates of core inflation and food prices still remaining quite high. The presence of second round effects may have implications for the proposed response of monetary authorities to the inflation issue. Nonetheless, inflation rates both from an international and domestic perspective are set to be notably lower in 2023 than had been expected at the end of 2022.

A crucial issue for the Irish domestic economy over the next 12 to 18 months is the extent to which domestic sources of inflation may well intensify as the economy continues to grow in a robust manner and replace energy-related pressures as the main driver of inflation. In particular, the historically low levels of unemployment are likely to contribute to an acceleration in earnings growth which may further add to domestic inflationary pressures.

We also believe that the domestic macroeconomic outlook is quite favourable for 2024. This is particularly the case if inflationary pressures continue to abate next year and monetary authorities begin to ease off on policy rate tightening which has occurred through 2022 and into 2023.

Concentration risks, overheating & the housing market

From a macroeconomic perspective as the Irish economy emerges relatively unscathed from recent challenges such as Covid-19 and inflationary pressures, there is a significant risk that the country may face overheating challenges particularly in the face of a historically tight labour market.

In that regard the proposal by the Commission for Taxation for a site value tax (SVT) is of particular note.[2] The general case for such a tax has been made in Kumhof et al. (2021)[3]. They argue that tax reform in general should shift taxes away from productive labour and capital, where they reduce incentives to work and save, and onto land, where they do not distort any such incentives. In an international context, such a policy, Kumhof et al. (2021) and Wolf

[2] See Proposed site value tax (2022). Commission on taxation and welfare secretariat. Progress paper.

[3] Kumhof M., Tideman N., Hudson M., and C. Goodhart (2022). Post-Corona balanced fiscal stimulus: The case for shifting taxes onto land. CEPR discussion paper no. 16652.

(2023)[4] argue, would provide sustainable Government revenue over the medium-term while not adversely impacting overall economic activity.

In such a context, increasing taxation levels in the domestic economy is a viable policy option to temper inflationary pressures. From a competitiveness perspective, any such increases in taxation should be on unproductive forms of economic activity such as land and not on labour or capital. Therefore, we believe that the adoption of a SVT could be a useful mechanism in helping to control overheating pressures which the economy may experience over the medium-term. It would target an unproductive asset such as land while not impacting either labour or capital in the economy.

Much of the growth in the domestic economy in recent times has been due to the performance of key multinational sectors. In particular the pharmaceutical and ICT sectors have seen significant increases in both value added and employment over the past 3 years. As noted in successive Commentaries, the exceptional performance of these sectors does leave the domestic economy vulnerable to a significant correction or decline in either sector. This concentration risk is particularly evident in terms of corporation tax receipts – we will discuss this issue more in the public finances section.

One area where the domestic economic is likely to face continued pressure over the medium-term is in the housing market. The impact of high housing costs in an Irish context has been documented in Corrigan et al. (2019)[5]. Housing supply levels reached a 15 year high in 2022 of 29,000 units. While the number of units supplied in 2023 is likely to be less than this owing to the reduced number of commencements in 2022, the underlying trend is an upward one as far as completions is concerned. However, in light of new population estimates which will be available in 2023Q3, it is now likely that the structural demand for housing is likely to be revised upwards somewhat. This means that the demand for housing is likely to exceed the supply over the medium-term. As a result, house price inflation and along with increases in rents are likely to continue, albeit, in the case of house prices, at a slower pace than was the case in 2022.

The Government has committed to increase the funding available for housing construction generally; something necessary owing to the funding gap in the housing market identified for

[4] Wolf M. (2023). The case for a land value tax is overwhelming. Financial Times article, 5th February. Available online at: https://www.ft.com/content/fadfbd9e-29ca-4d53-b69a-2497cc3ed95d

[5] Corrigan E., Foley D., McQuinn K, O'Toole C. and R. Slaymaker (2019). Exploring affordability in the Irish housing market. Economic and Social Review, Vol 50, pp. 119 - 157, No 1, Spring.

example by Duffy et al. (2016)[6]. However, it is important that every effort is still made to reduce the cost of building a house and avoid adding to inflationary pressures in the housing market.

Public finances:

Alongside the better-than-anticipated growth outlook for this year, we also anticipate further improvements in the public finances. We have revised upwards our expectation for the public finances in 2023, with a significant surplus expected in the General Government Balance and a further reduction in debt to GDP. This surplus is inclusive of the expectation that funds continue to be set aside for the National Reserve Fund (NRF), which was established in Budget 2023. While strong growth is anticipated across a number of tax headings, the growing vulnerability of the public finances to concentration risks is particularly apparent, as the ICT[7] and pharma-related sectors continue to account for the majority of corporation tax receipts. We welcome the establishment of the NRF, however there are a number of issues concerning its implementation and operation, which we believe should be outlined. For example, there should be greater clarity concerning the calculation of tax receipts that the Government deems windfall in nature. The amount of taxation revenues being diverted to the Fund are substantial in nature. Also, some clarity is required in terms of potential uses of the Fund in areas such as pensions, climate change, housing and health. Related to this, it should also be established how the Fund can operate in conjunction with any changes that are proposed to the European Union fiscal rules.

Concluding remarks

We thank the Committee again for the opportunity to discuss our assessment of the macroeconomic and fiscal situation. We look forward to answering any questions that you may have.

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[6] Duffy D., Foley D., McInerney N. and K. McQuinn (2016). Demographic change, long-run housing demand and the related challenges for the Irish banking sector, Chapter in Ireland's Economic Outlook: The Economic and Social Research Institute, December.

[7] For reference, see: Conefrey, T., Keenan E., Michael O'Grady M. and D. Staunton (2022). The Role of the ICT Services Sector in the Irish Economy, Signed Article in Quarterly Bulletin: The Central Bank of Ireland, March.