Opening Statement – Oireachtas Committee on Budgetary Oversight

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Introduction

Let me begin by thanking the Chair for the invitation to appear before the Committee to provide our views on the economic outlook ahead of Budget 2025. I am Dr. Conor O'Toole and I am joined by my colleague Dr. Karina Doorley. We will be publishing our next Quarterly Economic Commentary on the 26th of September but we will aim to give some insight into the recent trends that will underpin those forecasts.

Short term outlook

To frame the discussion around the appropriate Government budgetary policy, it is critical to understand the current macroeconomic context. The last number of years have seen the Irish economy perform particularly strongly even after experiencing repeated external shocks. This economic strength has come through both growth in the multinational sector but also a robust performance domestically. It is typically difficult to get an accurate picture of the domestic economy due to the distortion of key indicators by the multinationals but, none the less, most domestic indicators are performing relatively well.

In our latest published Commentary, we expected GDP to rebound this year following the multinational-led decline in 2023. However, the most recent quarterly national accounts again displayed considerable volatility from multinational transactions which provides challenges in gauging the overall trend in this aggregate indicator.

In contrast to volatility in these trends, the indicators for the domestic economic continue to point to a robust performance and an economy operating at, or close to, capacity. Modified domestic demand (MDD), which captures underlying investment and consumption levels in the economy is set to increase by over 2 per cent in 2024, and potentially increase further next year.[1]

[1] The latest ESRI nowcast estimate, (see Egan and Kren (2024) for details), shows that MDD is currently growing at 2.5 per cent. Household spending is also set to rise robustly this year and next.

One of the main reasons for the expected continued growth in the domestic Irish economy is the strong performance of the labour market and a quicker than expected decline in consumer price inflation. Employment levels are forecast to continue to grow this year and next with the unemployment rate remaining near to 4 per cent over the forecast horizon. This is despite the strong increase in population levels which have occurred recently. Exchequer receipts, another accurate indication of the Irish economy, are also continuing to register strong increases. The buoyant labour market, and moderating inflation rate are likely to lead to increases in real incomes. This will boost household spending power on aggregate for this year and next. All of these indicators point towards a domestic economy that is growing strongly and operating with little slack.

Longer term challenges

While the current economic outlook is positive, there are a number of longer-term challenges which will impact the potential growth rate and likely require significant state resources. These include infrastructure bottlenecks in housing, the requirement to invest in climate-related actions, and population aging.

Over the past number of years, it is clear that Ireland has been producing insufficient levels of housing for a growing population. While previous estimates[2] suggested that around 35,000 units per annum had been required to deal with demographic demand, new estimates, by the ESRI[3] and others based on updated population data, clearly point towards housing requirements being revised upwards notably. Many of these new units will be needed for low-income households and affordable housing thus requiring significant policy interventions and substantial state investment levels. A policy focus on supply-side reforms and planning efficiencies is likely to yield positive impacts in the medium to long term. Alongside the housing requirements are the very acute investment needs to transition the economy away from fossil fuels and towards renewables as discussed in Barrett & Curtis (2024).

Budgetary Policy Outlook

The present budget occurs at a time when the domestic economy is performing very close to capacity. The recent substantial improvement in the public finances does present a certain

[2] Bergin, Adele and Garcia-Rodriguez, Abian, (2020), Regional demographics and structural housing demand at a county Level, Economic and Social Research Institute (ESRI).

[3] Bergin, A., and Egan, P. (2024). Population projections, the flow of new households and structural housing demand, ESRI Research Series 190, Dublin: ESRI, https://doi.org/10.26504/rs190

opportunity for policy-makers. In areas such as housing, healthcare and climate change it is clear that significant investment by the State is required if infrastructural bottlenecks are to be addressed. However, addressing these bottlenecks at full employment with capacity constraints poses a risk to inflation. As was noted in Barrett and Curtis (2024)[4] in the ESRI review of the NDP priorities, adding additional demand to a capacity constrained economy will increase construction inflation through wage and other channels. However, if investments can take place which deal with infrastructure bottlenecks, both the long-term productivity and potential output of the economy can be raised.

To create space in the economy for such investments, the targeting of investment priorities (be they in housing, health or climate-action) should be shifted towards those with low domestic labour intensity or high import content in the investment phase. Given infrastructure bottlenecks need to be addressed, restraint is needed in other areas of fiscal policy in order to create the space for the investment that is necessary. In particular, taxation policy must be particularly prudent if the risk of increasing inflation is to be avoided.

The ongoing risk of relying on increasing corporation taxes, if directed for current expenditure, continues to rise as their share of overall tax receipts continues to rise. It is imperative that these receipts are increasingly targeted towards the longer terms investment funds to ensure buffers are available to deal with long term economic challenges, to support infrastructural development and to have funds available if the windfall elements decline. To re-emphasis, the use of the windfall element to cover current expenditure is not advisable.

Household incomes

The ESRI's distributional impact analysis of Budget 2024 last year revealed that it would result in average real income gains across the income distribution.[5] However, most of these gains came from temporary changes to the tax and welfare system, including the provision of energy credits and once-off top-up payments to recipients of social welfare. Considering only permanent changes to the tax-benefit system, we estimated that the purchasing power of low-income households has been eroded over the last four years as a result of successive below-inflation increases to social welfare.

[4] (2024). The National Development Plan in 2023: priorities and capacity, ESRI Survey and Statistical Report Series 123, Dublin: ESRI, https://doi.org/10.26504/sustat123

[5] Doorley, K., Duggan, L., Simon, A., and Tuda, D. (2023). Distributional impact of tax and welfare policies: Budget 2024, QEC Special Article, Dublin: ESRI, https://doi.org/10.26504/QEC2023WIN_SA_Doorley

More recent ESRI research, carried out for the fourth annual report of the Poverty, Income Inequality and Living Standards research program, highlights that material deprivation, or the inability of households to afford essentials, increased markedly between 2022 and 2023, especially for children.[6]

Permanent above-inflation changes to welfare will be needed if policy-makers wish to maintain the real incomes of low-income households when temporary measures expire. Targeted measures, such as a second tier of child benefit, as suggested by Roantree & Doorley (2023)[7] may also be needed to achieve the reductions in child poverty envisaged by the Child Poverty and Well-being Programme Office of the Department of the Taoiseach.

In conclusion, while the public finances appear in a robust position, there are notable risks and careful use of the budget surpluses over the coming years will be needed to deal with bottlenecks while not overheating the economy. We thank you for your time and we look forward to any questions you may have.

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[6] Roantree, B., Maître, B., and Russell, H. (2024). Poverty, income inequality and living standards in Ireland: Fourth annual report, Jointly-published Reports 7, Dublin: ESRI , https://doi.org/10.26504/jr7

[7] Roantree, B., and Doorley, K. (2023). Poverty, income inequality and living standards in Ireland: Third annual report, Jointly-published Reports 4, Dublin: ESRI and Community Foundation Ireland, https://doi.org/10.26504/jr4