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An Coiste um Fhormhaoirsiú Buiséid

Réamh-Thuarascáil maidir leis an Uasdátú i dtaobh an Chláir Cobhsaíochta, 2023

Aibreán 2023

Committee on Budgetary Oversight

Pre-Stability Programme Update Report 2023

April 2023

33/CBO/019

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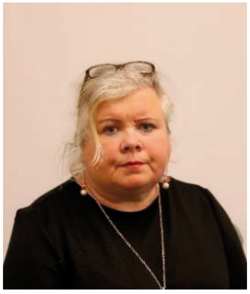

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Introduction

The Stability Programme Update (SPU) is a key part of the budgetary cycle and one of the first parts of the preparation for Budget 2024. The Committee on Budgetary Oversight undertakes ex-ante scrutiny of the SPU in order to understand the current fiscal outlook, to engage with stakeholders on these issues and to allow for greater parliamentary engagement and transparency to the budgetary process.

The Committee met with representatives from the Economic and Social Research Institute (ESRI) and the Central Bank of Ireland on 22 March 2023 as part of its pre-SPU scrutiny[1]. The Committee has also considered a number of publications and received support from the Parliamentary Budget Office as part of its pre-SPU scrutiny.

Following publication of the draft SPU and prior to the publication of the final version, the Committee plans to engage with the Minister of Finance and the Minister of Public Expenditure, NDP Delivery and Reform to discuss the draft SPU.

This report sets out some key issues facing the economy identified by the Committee and makes recommendations around areas the Committee believe should be addressed in the SPU.

Summary of Observations and Recommendations

1. The Committee notes that inflation is widely forecast to moderate in 2023 but urges Government to remain vigilant and be ready to react should higher than expected inflation persist,
2. The Committee reiterates that lower income and rural households are among the most impacted by the current inflationary pressures and that longer term measures may be required to support these households.
3. The Committee recommends that the SPU include estimates of the impact on the economy of different levels of inflation over 2023 and analyse the impact of inflation on the State’s capital expenditure programme.

[1] See appendix for links to transcripts and opening statements

4. The Committee recommends that the SPU examine the risks related to the tight labour market and how these can be mitigated.
5. The Committee notes that housing is a key issue for the Irish economy, as well as society, and has the potential be a significant drag on economic growth and on the public finances.
6. The Committee recommends that the economic and fiscal risks related to the housing sector be thoroughly examined in the SPU along with the impact of proposed policy responses on the fiscal position.
7. The Committee notes that the Irish banking sector is more resilient than in the past.
8. The Committee recommends that the SPU examine the potential risks linked to the international financial system on the Irish economy and on the Irish banking system.
9. The Committee, as it has done in a previous report, welcomes of the measure of excess corporation tax and the underlying general balance.
10. The Committee recommends that the Government continue to develop the measure of excess corporation tax in the SPU and set out a framework or set of rules of how the calculation is to be continuously monitored and refined as necessary.
11. The Committee recommends that the Government provide 5-year economic and fiscal forecasts in its upcoming SPU, to better inform policy decision-making and the context in which it is to take place over the medium-term.
12. The Committee recommends that the Government clarify the position of expenditure from the National Reserve Fund, and any other such funds, as part of the fiscal rules.
13. The Committee recommends that the Government set out, in the SPU or otherwise, options for what would be required before funds from the NRF be used and how.

Key Issues Facing the Economy

Every economy has to balance a large number of issues, that positively or negatively affect it. The Committee has identified a number of issues, outlined below, as of particular importance to the Irish economy this year. The Committee emphasises that this is not an exhaustive list and that a range of other areas will have to be considered as part of the SPU.

Inflation outlook

The common consensus appears to be that inflation will fall to more "normal" levels over the year, in large part due to the fall wholesale energy prices. The Central Bank's latest quarterly summary[2] notes that inflation remains high but is expected to slow over the year. The Central Bank expects inflation to average 5% in 2023 (based on current assumptions and subject to no further energy shocks). The ESRI's opening statement also sets out that inflation is set to be "notably lower" in 2023 than in 2022. However, despite the easing in energy prices and supply bottlenecks the international inflationary outlook is uncertain. Ibec, in its Quarterly Economic Outlook[3], also expects inflation to fall to below 4% by the end of the year.

The ESRI told the Committee that its new inflation forecast will be "quite a bit lower" than in its winter commentary, noting that while the energy element is reducing, food prices are rising.

It should be noted that while wholesale energy prices are falling it is likely the energy supply shock will persist. This could result in the need for further energy supports later in the year.

The ESRI outlined that inflation impacts the lowest end of the income distribution, and that the current inflationary pressures have also impacted more on rural areas. The Committee has noted this concern in previous reports and emphasised the importance of Government measures targeting support at those most affected.

[2] Available at: https://www.centralbank.ie/docs/default-source/publications/quarterly-bulletins/qb-archive/2023/quarterly-bulletin-q1-2023.pdf?sfvrsn=541f991d_5
[3] Available at: https://www.ibec.ie/influencing-for-business/economy-and-tax/quarterly-economic-outlook-q1-2023

The Central Bank addressed the impact of inflation on capital expenditure. It stressed the importance of protecting public investment and that choices will have to be made on getting the real value of investment versus addressing short-term challenges.

Questioned on the significant profit growth, rather than a wage-price spiral seen in the current inflationary period, the ESRI outlined that there is no evidence of profit gouging and noted that there is a lag for any second-round effects to hit. The Central Bank noted it is difficult to measure profit margins, but from what data is available it appears there is capacity for wages to grow.

Observations and Recommendations

1. The Committee notes that inflation is widely forecast to moderate in 2023 but urges Government to remain vigilant and be ready to react should higher than expected inflation persist,
2. The Committee reiterates that lower income and rural households are among the most impacted by the current inflationary pressures and that longer term measures may be required to support these households.
3. The Committee recommends that the SPU include estimates of the impact on the economy of different levels of inflation over 2023 and analyse the impact of inflation on the State's capital expenditure programme.

Labour Market

The Central Bank outlined that labour market conditions remain tight for 2023 and for the coming years, with an increased reliance on net inward migration required to achieve further growth. The Central Bank forecasts the average annual unemployment rate to remain below 5%. The ESRI also outlined that unemployment is at a historically low level.

The Central Bank also noted in its opening statement that while employment was 11% higher in Q4 2022 compared to 2019 levels, total hours worked has only risen by 3.7%. This indicates that the average hours worked per person has fallen in recent years.

The Central Bank explained there are a number of reasons for the tight labour market, including an increase for demand in labour and the increase in participation rates, particularly amongst women. For the Central Bank, there appears to be limited scope for further growth in the labour market from either an increase in participation or immigration. This could result in pressure on wages.

Questioned on the global layoffs in the ICT sector, the ESRI stated that the ICT sector is very dynamic, noting that the in 2022 Q2 and Q3 saw a fall of around ten thousand jobs in the sector but that these were back by Q4. The sector is undergoing an adjustment, and this will have an impact on Ireland.

The ESRI outlined the importance of the ICT sector to the Irish economy, representing:

- 20% of overall output;
- 10% of the national wage bill;
- over 6% of employment;
- 25% of corporation tax receipts

The Central Bank also addressed the job losses in the ICT sector. While noting Ireland’s reliance on the ICT sector, the Central Bank also highlighted that the announcements are relatively small in the context of the tight labour market. It was also noted that a significant number of job losses are in support services which may be more readily transferable to other industries.

A drop in the employment in ICT sectors could have a knock-on effect on income tax receipts as ICT jobs tend to be higher paying.

The Central Bank outlined that the tight labour market, and the resultant difficulty in finding qualified staff, along with the difficulty in finding accommodation for employees are significant issues for firm growth.

Observations and Recommendations

4. The Committee recommends that the SPU examine the risks related to the tight labour market and how these can be mitigated.

Housing Sector

The ESRI stated that the key issue in the housing sector is the lack of supply. The Central Bank agreed, highlighting the imbalance between supply and demand as the key issue in the housing sector. The ESRI also noted that the pandemic created further issues for supply.

Questioned on the cost of construction, the ESRI noted that the Government does not have control over many aspects but emphasised that the use and regulation of land is an area where government intervention can be effective.

The ESRI outlined that increases in interest rates can have an instant impact on demand as it impacts the amount people can borrow. As a result, it expects house prices to increase at a reduced rate. The ESRI further elaborated that while the increase in interest rates could reduce demand for home purchases, it could lead to increased pressures on the rental market.

The ESRI outlined housing affordability (proportion of income on housing cost) is a structural issue.

The Central Bank outlined that Ireland has one of the highest public expenditures on housing across the EU, emphasising that it is not necessarily about spending more but about an integrated solution to increase supply.

The ESRI stated that the issues in the housing market create wider concerns across the economy. For example, the ESRI noted that it impacts on decisions by multinationals and on Ireland's competitiveness.

Questioned on the potential for a site value tax, the ESRI agreed that there is a lack of good data on land prices and noted that a lot of the evidence around land hoarding is anecdotal. However, it also noted that there ae some tentative early signs that the Residential Zoned Land Tax is having some effect.

The ESRI noted that the rationale for a site value tax is to have a higher tax on development land and introduce a cost penalty for holding land that is ready to be developed.

As outlined in a later section, Irish banks have been more conservative in their lending since the financial crisis. As a result, the ESRI noted there are some issues with the access to credit (for both homebuyers and builders) and the stated there is a growing recognition in the need for the State to play a bigger role in providing finance for home building and perhaps on the mortgage side.

Questioned on the mortgage rules, the Central Bank outlined their importance in avoiding a feedback loop between housing prices and credit, and for enforcing sustainable lending standards. It was also stated that given the lack of supply, increased ability to borrow would increase house prices.

The Central Bank also addressed access to credit issues, outlining that mortgage lending is growing. It was however stated that credit demand from SMEs was subdued, however survey results do not attribute this to a lack of access to credit but rather a range of other factors such as lack of staff and a preference to avoid debt.

Observations and Recommendations

5. The Committee notes that housing is a key issue for the Irish economy, as well as society, and has the potential be a significant drag on economic growth and on the public finances.
6. The Committee recommends that the economic and fiscal risks related to the housing sector be thoroughly examined in the SPU along with the impact of proposed policy responses on the fiscal position.

Financial Sector/International Banking

In the weeks prior to the Committee's pre-SPU engagement, a number of issues across the global financial system.

The Central Bank outlined to the Committee that the Irish banking system is resilient, with good capital and liquidity buffers, stable funding structures based on domestic deposits and subject to prudent lending standards.

The ESRI also outlined that Irish domestic financial institutions have been conservative since the financial crisis. As a result, and due to changes in European regulation, the Irish banking sector is more stable and better capitalised than it has been in many years.

The Central Bank assured the Committee that it continually assesses potential external shocks and engages with the financial sector to ensure it is also assessing the potential risks.

Responding to questions about the failure of the Silicon Valley Bank (SVB), the Central Bank outlined that there were particular characteristics of the bank that led to its collapse. The ESRI also noted that the current issues in the US banking system appear to be a typical maturity mismatch.

The Central Bank further explained that the differences in the US and EU regulatory regimes. As SVB was a smaller US bank it was not subject to the full standards and regulations as is the case with EU banks.

The failure of SVB could have an additional knock-on effect for Ireland if it leads to an increase in the global risk premia for the ICT sector, which would have a longer-term impact on investment decisions potentially impacting on investment in Ireland.

The ESRI noted that the current issues in the international financial system could raise some concerns for the for Ireland, particularly from an investment perspective

Questioned on the impact of the financial sector on corporation taxes, the ESRI stated that it highlights the constant concern around the concentration of Ireland's corporation tax receipts.

Observations and Recommendations

7. The Committee notes that the Irish banking sector is more resilient than in the past.
8. The Committee recommends that the SPU examine the potential risks linked to the international financial system on the Irish economy and on the Irish banking system.

Economic and Fiscal Outlook

The Central Bank outlined that the public finances improved significantly over 2022 due to strong revenue growth. Income tax and VAT increased strongly but corporation tax drove the overperformance.

The Central Bank expects the General Government Balance (%GNI*) to be 2.7% in 2023 and 4.8% in 2024, though this does not take into account the Department of Finance's estimate of excess corporation tax.

The Central Bank expects the general government debt ratio to decline significantly over the coming years and despite the increase in borrowing rates debt dynamics are expected to remain favourable.

While higher interest rates lead to an increased cost of government borrowing, the Central Bank outlined that the NTMA have used the period of low interest rates to manage the maturity of Irish debt.

The ESRI has also revised its expectations for the public finances upwards and is forecasting a significant surplus in the General Government Balance and a further reduction in debt to GDP.

The Central Bank outlined that the outlook for domestic demand has improved slightly, as inflation is now expected to be lower than previously thought.

The ESRI stated that it is now forecasting modified domestic demand (MDD) to grow more strongly in 2023 that it had expected at the end 2022.

The Central Bank noted that investment is likely to remain strong due to the multinational sector, however consumption will remain slow over the first half of the year.

The Central Bank outlined its view that from a macro perspective fiscal supports should be targeted, temporary (so as not to add permanent vulnerabilities) and tailored (for example at energy efficiency). It was also noted that at the beginning of the sharp increase in energy costs, quick action was warranted it is important to now improve the targeting of measures.

Discussing the excess corporation taxes receipts, the ESRI noted it is difficult to accurately calculate as it, and the Government, does not have access to firm level data. The ESRI outlined the importance of having a framework for calculating the for the calculation of the excess corporation tax receipts as it is currently unclear how they are calculated.

The Central Bank also discussed excess corporation taxes. It outlined that they are almost entirely dependent on the tax planning decisions of a small number of firms, the ending of which is completely outside the control of the State. The Central Bank warned of the danger of the excess receipts becoming part of the permanent current expenditure.

The high inflationary pressures also impacts on Government spending as more spending is required to maintain the level of public services and ensure that real welfare payments, pensions and public sector pay do not fall.

The Central Bank noted the importance of fiscal policy being in a position to act counter-cyclically.

Observations and Recommendations

9. The Committee, as it has done in a previous report, welcomes of the measure of excess corporation tax and the underlying general balance.
10. The Committee recommends that the Government continue to develop the measure of excess corporation tax in the SPU and set out a framework or

set of rules of how the calculation is to be continuously monitored and refined as necessary.

11. The Committee recommends that the Government provide 5-year economic and fiscal forecasts in its upcoming SPU, to better inform policy decision-making and the context in which it is to take place over the medium-term.

National Reserve Fund (NRF)

The ESRI stated that given the structure of the Irish economy and the impact of international developments on it, there is a good case for always having a reserve fund of some kind to respond to unforeseen events. The Central Bank agreed, noting the importance of building resilience during good times.

The ESRI noted it is important that we understand how and when the NRF can, or should, be used. The Central Bank made similar comments, outlining the importance of how the funds are used.

Spending on infrastructure projects is one option for the NRF, however the ESRI cautioned that putting large amounts of additional spending into the economy comes with risks, notably increasing inflationary pressures. The ESRI further advised it is important to ensure the economy has the productive capacity to take the additional investment.

The Central Bank suggested some form of national pension fund would be one way of using the funds to address future pressures.

The ESRI also noted that clarity around how the NRF fits into the fiscal rules is needed.

Observations and Recommendations

12. The Committee recommends that the Government clarify the position of expenditure from the National Reserve Fund, and any other such funds, as part of the fiscal rules.

13. The Committee recommends that the Government set out, in the SPU or otherwise, options for what would be required before funds from the NRF be used and how.

Appendix 1: List of Committee Meetings

Meeting Date	Witnesses
Wednesday 22 March[4]	**Economic and Social Research Institute (ESRI) *Opening Statement*[5]** • Professor Kieran McQuinn • Dr Conor O'Toole • Ms Wendy Disch **Central Bank of Ireland *Opening Statement*[6]** • Mr. Vasileios Madouros • Dr Robert Kelly • Dr Martin O'Brien

[4] Transcript available at: main.pdf (oireachtas.ie)
[5] Available at: 2023-03-22_opening-statement-dr-kieran-mcquinn-research-professor-economic-and-social-research-institute_en.pdf (oireachtas.ie)
[6] Available at: 2023-03-22_opening-statement-vasileios-madouros-deputy-governor-monetary-and-financial-stability-the-central-bank_en.pdf (oireachtas.ie)

Appendix 2: Orders of Reference

219. (1) There shall stand established as soon as may be, following the reassembly of the Dáil subsequent to a General Election, a Standing Committee, to be known as the Committee on Budgetary Oversight, to examine and, where it considers it appropriate, report to the Dáil on—

(a) the overall fiscal position, including—

(i) the aggregated position on revenue and expenditure and the General Government Balance, including structural targets;

(ii) medium-term projections for the public finances;

(iii) macro-economic forecasts and developments;

(iv) general fiscal governance including the application of fiscal rules and risks to the fiscal position; and

(v) matters arising from the introduction of a supplementary Estimate or Estimates that, in its opinion, have or may have significant budgetary implications: Provided that the Committee shall advise the appropriate Committee or Committees of any decision on its part to undertake such consideration and the reason or reasons therefore;

(b) public expenditure policy, including—

(i) the expenditure position having regard to the Government Expenditure Ceiling and the expenditure benchmark under the Stability and Growth Pact;

(ii) Ministerial Expenditure Ceilings applying to individual Estimates or groups of Estimates for the Public Services where significant variations from the expenditure profile could potentially impact on the overall fiscal position; and

(iii) the adequacy of planned and actual aggregate levels of capital expenditure and the policies and practices in relation to capital expenditure, including public procurement policy and public private partnership policy, intended to ensure the achievement of value for money.

(c) Exchequer receipts policy.

(2) The Committee may consider a matter of public policy with significant impact on the budgetary position or on the overall fiscal position: Provided that prior to the commencement of such consideration, the Cathaoirleach of the Committee shall consult with the relevant sectoral Committee established pursuant to Standing Order 95.

(3) The Committee may also consider the overall framework for parliamentary engagement throughout the course of the budgetary cycle and may make recommendations thereon to the Committee on Standing Orders and Dáil Reform for that Committee's consideration under Standing Order 119(1)(b): Provided that, in so doing, the Committee shall consult with—

(a) the Committees established pursuant to Standing Order 95 on any recommendations which, in the opinion of the Committee, impact on their role or remit; and

(b) the relevant Minister or Ministers on any recommendations which, in the opinion of the Committee, impact on the role or remit of a Department or Departments, and shall notify the results of such consultations to Committee on Standing Orders and Dáil Reform.

(4) The Committee shall have the following powers:

(a) power to send for persons, papers and records as defined in Standing Orders 96(3) and 99;

(b) power to take oral and written evidence and submissions as defined in Standing Order 96(1) and (2);

(c) power to appoint sub-Committees as defined in Standing Order 96(4);

(d) power to engage consultants as defined in Standing Order 96(14);

(e) power to travel as defined in Standing Order 96(15).

(5) Every report which the Committee proposes to make shall, on adoption by the Committee, be laid before the Dáil forthwith, whereupon the Committee shall be empowered to print and publish such report, together with such related documents it thinks fit.

(6) The Committee shall consist of fifteen members, none of whom shall be a member of the Government or a Minister of State, and four of whom shall constitute a quorum: Provided that—

(a) the Committee and any sub-Committees which it may appoint shall be constituted so as to be impartially representative of the Dáil; and

(b) the provisions of Standing Order 106 shall apply to the Committee

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