Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

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Gobharnóir / Governor

Mr Jack Chambers T.D.
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Upper Merrion Street
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Dear Minister,

RE: Budget 2025

I am writing to you in advance of this year's Budget, in line with the Central Bank's mandate to provide analysis and comment to support national economic policy development.

The Irish economy has rebounded well from the economic effects of the pandemic and Russia's invasion of Ukraine. Swift domestic policy action was a major contributor to this rebound, with little sign of scarring. The economy has moved to a new phase as activity is expected to be broadly in-line with its medium-term potential. These generally favourable conditions provide a good backdrop for attention to turn more decisively towards strengthening that potential. Budget 2025 and the medium-term direction for fiscal policy that Government must set are key to achieving this.

Current economic and fiscal conditions imply that budgetary policy is now in a good position to:

- Address capacity constraints in terms of housing and broader infrastructure that are currently limiting the scope for sustainable growth in living standards;
- Maintain an appropriate fiscal stance that does not add unnecessarily to overall demand in the economy, nor work at cross-purposes to monetary policy; and

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- Reduce structural vulnerabilities in the economy and public finances arising from the concentrated nature of the tax base, the requirements to address climate change and the additional demands related to the ageing of the population.

Success across all of these outcomes will entail trade-offs and require credible choices to be made around tax and expenditure, cognisant also of the significant resources required to at least maintain the existing level of public services. Striking the right balance to avoid the risks of overheating and damaging the competiveness of the economy is necessary, so that it can deliver sustainable growth in living standards for the community over the longer-term.

Economic outlook

As outlined in our latest Quarterly Bulletin (published on 18 June), rising real incomes for Irish households, an increase in residential construction, a normalisation of activity in MNE-dominated sectors and a gradual increase in world demand are expected to support moderate growth of just over 2 per cent per annum in the Irish economy out to 2026. Labour market conditions are stabilising as the gap between supply and demand narrows, and the unemployment rate is anticipated to remain around its currently low level. Inflation has eased significantly, driven by the developments in the more globally-determined prices for energy and other industrial goods. More domestically-determined price growth, such as for services, has proven more persistent. Despite domestic price pressures remaining relatively high, both headline and core inflation are expected to hover around 2 per cent over the next two years. This benign outlook is predicated on above average productivity growth, no escalation of geopolitical tensions impacting on commodity prices and supply chains, and an appropriate fiscal stance.

The anticipated path for inflation in Ireland broadly corresponds with that for the euro area as a whole. At our meeting on 6 June, the ECB's Governing Council decided to reduce the level of monetary restriction by lowering the key monetary policy rates by 25 basis points. This was informed by the euro area inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission. In order to ensure that euro area inflation sustainably returns to the 2 per cent medium-term target in a timely manner, we will keep policy rates sufficiently restrictive, with future decisions following a data-dependent and meeting-by-meeting approach.

Fiscal priorities for the short and medium term

The experience of recent years has shown the benefits of having sufficient fiscal capacity to support the economy in the face of severe shocks. The tax-and-transfer system has helped real disposable incomes across the entire household income distribution to fully recover and incomes are expected to exceed pre-pandemic levels this year. This has coincided with an expansionary fiscal stance since 2021. However, given overall economic conditions at present it would not be appropriate to continue with an expansionary fiscal stance over the period 2024-26. Recently published analysis by Central Bank staff illustrates how continuing with so called 'core' expenditure growth similar to the recent past without offsetting discretionary changes in taxation would significantly contribute to overheating risks. Such a scenario would lead to higher inflation in Ireland than would otherwise be the case, potentially moving contrary to the disinflationary process that is expected to continue gradually in the euro area overall. This would damage Ireland's competitiveness and long-term prospects for growth in living standards.

At the same time siginificant structural vulnerabilities are present in the public finances. Most notable of these is the concentration risk surrounding corporation tax receipts, with 10 large multi-national firms accounting for 52 per cent of these receipts in 2023, and 10 per cent of total government revenues last year. This leaves the public finances vulnerable to firm/sector-specific shocks, while also presenting significant uncertainty as to the eventual effect of reforms to the global framework for corporation tax being concluded through the OECD process. Both the Irish Fiscal Advisory Council and the Parliamentary Budget Office have noted other dimensions of concentration in the tax base by income decile and even on the basis of certain products. Should these concentration-related risks crystalise, they have the potential to restrict the capacity for countercyclical fiscal policy to support the economy in the future without a significant rise in government debt. Other challenges arise through the additional demands on the public finances that are emerging as the population ages.

In this context, I welcome the planned creation of the Future Ireland Fund (FIF) and the Infrastructure, Climate and Nature Fund with the use of excess corporation tax receipts. In my view these Funds are important and necessary but they should not be seen as a solution for the challenges (and opportunities) arising from the demographic and climate transitions, nor the critical housing and related infrastructure gap that exists. The ultimate size of the funds is uncertain, given the relatively higher uncertainty around the path for GDP, and relatedly

corporation tax receipts. In addition, based on estimates from the Department of Finance, the extra age-related demands on the public finances expected from 2035 are larger than the estimated future drawdowns from the FIF.

A significant part of achieving an appropriate fiscal strategy is establishing a credible anchor for the conduct of fiscal policy through the cycle. Recent reforms to the EU economic governance framework achieve this only partially in the Irish case. While the setting and oversight of new medium-term fiscal structural plans is welcome, it remains necessary for an appropriate national fiscal rule to complement the provisions of the Stability & Growth Pact. The Government established such a rule in 2021, whereby increases in Exchequer spending would not exceed 5 per cent each year without countervailing new tax measures. Limiting net expenditure growth to the nominal trend growth rate of the economy, which at the time of establishing the rule was estimated at 5 per cent by your Department, has the potential to be an appropriate and credible anchor for fiscal policy.

However, a number of items need to be considered for this to be achieved. First, the rule should be complied with. Estimates by both the Irish Fiscal Advisory Council and Central Bank staff show that net expenditure growth has exceeded 5 per cent in 2022 and 2023, is envisaged to do so again in 2024 and is at risk of continuing to do so out to 2026. Second, the justification for 'temporary' or 'non-core' expenditure items to be excluded from the rule is increasingly difficult to maintain as the extraordinary economic shocks from the pandemic and Russia's invasion of Ukraine pass and certain related expenditures have become de facto permanent. Accordingly, in order for the net spending rule to achieve its aim of promoting an appropriate fiscal stance and more resilient public finances, all expenditure should be included. Third, and in the same vein, the rule should be expanded to cover expenditure on a General Government basis, not just on an Exchequer basis.

Estimates by your Department point to a possible decline in long-term economic growth potential to below 3 per cent per year in the next decade, mainly due to a shrinking workforce and lower productivity. This projection implies that even maintaining net government spending growth as high as 5 per cent in the next decade could result in trend inflation in Ireland exceeding 2 per cent in the medium-to-long term. To prevent this unwelcome scenario, efforts should be focused now on increasing efficient investment in physical and human capital to boost the economy's real potential growth rate.

In particular, sustainably addressing infrastructure constraints in housing, water, energy and transport should be priorities over the medium-term. Public capital investment alongside structural reforms and initiatives to enhance its efficiency and enable complementary private capital investment needs to play a significant role. Analysis by Central Bank staff has shown how delays in planning and delivery of public infrastructure materially reduce the benefit of such expenditure. This includes a persistently lower level of private investment than would otherwise take place, that is either crowded-out or not enabled to happen.

One of the more significant areas where concerted investment efforts are needed is the decarbonisation of the economy, if Ireland is to meet the target of a 51 per cent reduction in greenhouse gas emmisions relative to 2018 by 2030. With current projections from the Environmental Protection Agency signalling a significant undershoot in meeting this target, estimates (by Central Bank staff) point to an additional annual investment need of around 2 per cent of GNI*, or €54.5 bn in total by 2050 to achieve it, just under 30 per cent of which could be public investment. Over the period to 2027, this would constitute an increase of 15.7 per cent in public capital expenditure over and above what is currently envisaged in the *Stability Programme Update 2024*.

At the same time, the forthcoming review of the National Planning Framework will likely reflect an increase in the estimated housing need in what is clearly a market that is already undersupplied. The recent report of the Housing Commission highlights a number of challenges to the delivery of housing, with needs according to the Commission that may well exceed 50,000 units per annum. On the assumption that at least some part of any additional housing need would be financed either directly or indirectly by the State, such an increase in public capital expenditure has to be planned for. Importantly, efforts here may well be better focussed on the delivery of necessary public infrastructure in terms of energy, water and transport to support housing development. The market in and of itself will not produce such infrastructure, and more efficiency in terms of planning could amplify the benefits of such capital spending. Relatedly, it is also useful to consider the most effective means of funding the provision of such infrastructure and how best, from an economy-wide perspective, the value accruing to zoned land-owners from the provision of public infrastructure can be captured, as recommended by the Housing Commission.

With the economy already operating at or around its medium-term potential, it would be appropriate for fiscal and wider public policy to actively create the necessary economic

capacity to facilitate the rise in investment to meet climate targets, housing and other infrastructural needs over the rest of the decade. This is necessary to avoid running the risk of overheating and excessive inflationary pressures. As a consequence, within the boundaries of the 5 per cent rule for growth in net public expenditure, growth in public capital expenditure should be prioritised, with an additional focus on structural reforms and other means to crowd-in complementary private investment. Moreover, examining ways of catalysing private savings into investment would be beneficial, again within the parameters of an overall appropriate fiscal stance.

Conclusion

By their nature Budgets are about the Government's fiscal policy, the choices being made on the public finances and the specific decisions on the allocation of resources. They are also important milestones for economic policy-making in general and an opportunity for the Government to lay out its proposals for longer-term structural reform in particular.

Policy choices should strive to reconcile short-term priorities with long-term objectives. Addressing structural vulnerabilities, maintaining an appropriate fiscal stance and sustainably delivering on the necessary rise in public capital investment in the coming years has to be achieved alongside choices on current spending to maintain or enhance existing levels of public services. Given increasing demands on, and relative priorities for the public finances, measures to broaden the tax base (such as recommended by the Commission on Taxation) and increase government revenue as a share of national income are increasingly unavoidable. In the short run, this could help to guard against inflationary pressures while public capital spending is increased. Longer-term, with material uncertainty over the sustainability of current revenue from corporation tax and concentration risks in other revenue sources, new revenue-raising measures would help to create a more sustainable tax revenue base and more resilient public finances with which future fiscal challenges can be addressed. To help guide fiscal policy in a sustainable direction, the Government should commit to a credible anchor for medium-term expenditure growth net of tax changes.

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