Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

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Gobharnóir / Governor

Mr Paschal Donohoe T.D.
Minister for Finance
Department of Finance
Government Buildings
Merrion Street Upper
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30th July 2021

Dear Minister,

Re: Budget 2022

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

The context for Budget 2022 is more favourable than was the case for Budget 2021. The better economic outlook is supported by more positive business and consumer sentiment, a stronger international backdrop and supportive fiscal and monetary policy. However, the ongoing public health challenges do mean that uncertainty remains high. In framing Budget 2022, I would encourage you to consider:

- an increased emphasis on facilitating – and managing the challenges of – the necessary structural change brought-on or brought-forward by the pandemic;
- establishing a credible path toward a lower public debt ratio, so as to rebuild economic resilience and improve the capacity to respond to future shocks.

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In achieving these objectives, it will be important to account for known structural risks to revenues and expenditure as well as creating sufficient space for public investment (while ensuring that the fiscal policy stance does not contribute to capacity constraints). Similarly, there is a need to focus on planning for the impact of the longer-term structural challenges facing the economy, including an ageing population and the need to finance the digital and carbon transitions.

Economic outlook

As we indicated in our July Quarterly Bulletin, the Central Bank expects that the domestic economy will continue to strengthen over the coming months, having seen a rebound in activity as restrictions eased in April and May. Overall, domestic economic activity is expected to be above pre-pandemic levels next year, although a more gradual recovery in sectors most negatively affected by the pandemic is also likely. Supply bottlenecks, increased demand and base effects lead to higher inflation forecasts in the near term. Our current central expectation is that these price pressures will ease and not lead to excessive medium-term inflation.

While COVID-19 related risks could reduce near-term growth prospects, a more rapid use of savings accumulated by households since early 2020 could boost consumer spending, economic activity and inflation more so than expected. Overall, the risks to the growth outlook to 2023 appear to be relatively balanced.

The labour market is expected to take longer to recover, with unemployment forecast to remain higher than pre-pandemic levels through to 2023. A somewhat slower labour market response relative to the pick-up in economic growth is expected during most recoveries. However, our current outlook also reflects some change in the nature of labour demand and labour supply. Employers and workers across different sectors will take time to adjust to changing consumer and investor behaviour and preferences, as well as alternative work, supply chain and migration patterns, and increased digitalisation. There is also the ongoing adjustment to the new trading arrangements between the EU and the UK.

Policy challenges

This highlights one of the key challenges for public policy in 2022.

The domestic fiscal response to the pandemic has so far been proportionate and warranted. It has minimised the shock to demand and reduced the potential for long-term scarring to the supply-side factors that underpin the productive capacity of the economy. Extending the

pandemic-related supports, as announced in the Economic Recovery Plan, should continue to limit the extent of the shock for workers and (otherwise) viable businesses in the most vulnerable sectors.

However, different challenges emerge as trading conditions normalise, current government supports are removed and the viability of individual businesses become clearer. The focus of policy should shift from limiting the effects of the near-term shock to minimising supply constraints arising from labour market mismatches over the medium-term. This includes through targeted and effective labour market activation measures (such as re-skilling, training, apprenticeships, minimising welfare traps, etc.) and facilitating moves out of longer-term unemployment and inactivity into employment in sectors with high labour demand. Orderly and timely liquidation processes that can allow capital and entrepreneurial talent to be reallocated are also necessary.

In summary, public supports should increasingly facilitate post-pandemic structural adjustments in the way we live, work and travel, rather than targeting a return to pre-pandemic norms that are no longer viable. (Such action probably warrants careful consideration in view of the likely need for public policy to support wider economic resilience given the trend towards greater digitalisation.)

Building resilience in and through the public finances

As the near-term impact of the pandemic eases, a credible plan is required to reduce the public debt ratio over time to a more sustainable level, ensuring long-term resilience and the capacity to respond to future shocks. I note the Summer Economic Statement (SES) has set out the Government's medium-term budgetary strategy, with revised projections for the public finances up to 2025.

The SES projections envisage a planned deficit of €7.4 billion or just under 3 per cent of GNI* by 2025, €6.6 billion higher than the figure set three months earlier in the Stability Programme Update. Higher permanent current expenditure accounts for close to two-thirds of the upward revision to the deficit by 2025, with additional capital spending making up the remainder. As a result, the overall debt-to-GNI* ratio in 2025 is forecast to be broadly unchanged from its level at the end of 2020, at 106 per cent of national income (GNI*). As acknowledged in the SES, Ireland's public debt-income ratio is already among the highest in the developed world.

Analysis by Central Bank staff shows that a scenario with higher levels of expenditure and a permanent loss in corporation tax receipts funded by additional debt would see the debt-to-GNI* ratio increase further from its current high levels out to the middle of this decade.

The SES contains a new commitment to borrow only for capital investment from 2023. It will be important for this to be delivered on to ensure that improvements in the fiscal position are realised. Even with this commitment, and taking into account the current favourable growth outlook and low interest rate environment, the larger annual deficits out to 2025 – with higher debt – increase the risks facing the public finances and the economy compared to a plan that targeted a quicker pace of deficit reduction and lower debt.

In these circumstances, the implications of the planned expenditure increases and tax changes on capacity constraints in the wider economy and labour market need to be considered carefully. In an economy already experiencing strong economic growth (as is currently projected), there is a risk that higher government spending and tax changes – as well as resulting in higher debt – could generate excessive inflationary pressures, leading to the emergence of damaging imbalances in the economy.

There are also a number of risks surrounding the SES 2021 projections.

First, as monetary policy normalises – which it will in time – higher debt may lead to increased investor scrutiny and the associated risk of a rise in sovereign bond yields and needing to refinance higher levels of debt at higher interest rates in the future.

Second, as we at the Central Bank have highlighted before, Ireland is highly exposed to external developments and often experiences 'higher highs' and 'lower lows' as measured by key economic indicators compared to other countries. Higher debt limits the scope for a counter-cyclical fiscal response to mitigate the negative effects of future crises. These considerations underline the need for sufficient buffers to withstand and respond to shocks as they arise.

Third, there is a risk of structural imbalances between revenue and expenditure emerging in the coming years. Three factors are particularly relevant here:

- the higher permanent current expenditure incorporated in the latest SES;
- the known medium-to-longer term expenditure pressures related to an ageing population;

- the prospective changes in global corporation tax arrangements through the OECD process (which could permanently reduce Irish corporation tax revenues that are already heavily reliant on a relatively small number of large firms in certain sectors).

In the upcoming Budget, I would encourage consideration of actions to signal clearly a sustainable path to a more resilient medium-term position for the public finances. Identified sources of funding for permanent current expenditure increases will help to demonstrate their long-term sustainability. When considering such funding actions, measures aligned with achieving sustainable and balanced long-run growth in a revenue neutral way may be particularly appropriate. These could include broadening the tax base, reducing certain tax reliefs or changing certain tax rates. I welcome the establishment of the Commission on Taxation and Welfare, which is considering these matters in depth and expected to report in 2022. Effective use of medium-term expenditure ceilings, allowing flexibility within a clear budgetary constraint and ensuring that spending remains consistent with overall budgetary policy, is increasingly important.

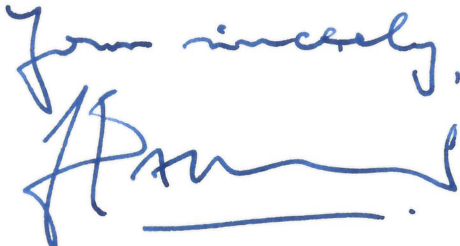
I also suggest that any revenue windfalls – whether from unexpected corporation tax receipts or the proceeds from the sale of bank shares, for example – should be used to reduce debt levels rather than fund extra expenditure.

Sustainable funding of current expenditure creates space for public investment, an important consideration in the context of the forthcoming update to the National Development Plan and the Climate Action Plan. If managed correctly, this can complement private investment in contributing to long-run balanced and sustainable growth, raising productivity and addressing known infrastructure deficits.

The pandemic will leave a legacy of structural change, adding to pre-existing challenges from globalisation, climate change and the transition to net zero by 2050, demographic ageing and digitalisation. These challenges and the changes they trigger will require adjustments by households, businesses and policymakers. As the immediate crisis management phase of the pandemic ends, attention should focus on planning for the impact of these challenges. This will help to ensure that the economy is well-placed to leverage the opportunities created by structural shifts while minimising the costs of transition and disruption.

Conclusion

The domestic fiscal policy response to mitigate the impact of COVID-19 has been warranted and proportionate. The response was in part possible due to the actions taken over previous years to restore sustainability to the public finances. Addressing post-pandemic structural change and re-building resilience in the public finances now come to the fore as domestic economic policy looks to 2022 and beyond. In doing so, public policy will play its necessary role in building wider Irish economic resilience in light of the longer-term transitions of ageing, digitalisation and climate action.



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