Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

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Gobharnóir / Governor

Mr Michael McGrath T.D.
Minister for Finance
Department of Finance
Government Buildings
Upper Merrion Street
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22nd June 2023

Dear Minister,

Re: Budget 2024

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 economy has proven resilient through the overlapping shocks of the Covid-19 pandemic and the economic effects of Russia's war of aggression on Ukraine and its people. This resilience was in part due to supportive monetary and fiscal policy working with common purpose. Now, with the Irish economy operating at capacity and essentially at full employment, domestic policy has a key role in addressing the challenges and opportunities such a situation brings.

Overall, the public finances are in a good position to:

- Contribute to near-term macroeconomic stability by not unduly adding to already strong demand conditions and fuelling inflationary pressures; and,

- Enhance medium-to-longer term resilience in both the public finances and the economy as whole.

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Both the near and longer term objectives point to distinct choices and priorities for the overall stance of fiscal policy in 2024, and the need for careful management of the public finances in the years ahead. With monetary policy taking the necessary action to restore price stability in the euro area, it would be counter-productive for domestic fiscal policy to stimulate demand. If overheating pressures become pronounced, this could result in a period of higher and more prolonged inflation in Ireland than currently expected, ultimately damaging the competitiveness of the Irish economy and potentially undermining its ability to deliver sustainable growth in living standards.

Economic outlook

As outlined in our latest *Quarterly Bulletin* (published yesterday), there are signs of binding capacity constraints in the economy and labour market that are contributing to more robust domestically-driven price inflation. The unemployment rate has reached multi-decade lows. Employment growth has continued, but not enough to accompany any significant reduction in the high number of vacancies relative to available labour supply. While wage growth has been contained, it is expected to pick up in 2023 reflecting the tight labour market and a degree of real wage catch-up. With headline inflation easing, and a still substantial economy-wide level of savings, the underlying support for demand conditions remains considerable. This underpins the expectation that while externally-driven inflation, linked to the developments in global commodity markets for energy and food, will ease substantially, the domestic factors contributing to underlying measures of inflation remain relatively high out to 2025.

The performance of the domestic economy comes against the backdrop of somewhat similar dynamics in other advanced economies, of slowing growth, low unemployment and high inflation. This combination of factors, alongside the higher interest rate environment, provides some headwinds to the Irish outlook, and in particular for investment. Uncertainty around the outlook remains, particularly in light of any possible intensification of geopolitical risks.

The outlook for inflation continues to be too high for too long across the euro area. The longer inflation persists, the greater the damage, and to everyone in society. The ECB's policy rates will need to be brought to levels sufficiently restrictive to achieve a timely return of inflation to our two per cent medium-term target and kept at those levels for as long as is necessary.

At our meeting last week, the Governing Council decided to raise the key policy rates by 25 basis points, bringing to 400 basis points the total increase so far during the current tightening cycle. We also confirmed that future decisions will continue to depend on our assessment of the inflation outlook in light of the incoming economic and financial data, the dynamics of underlying inflation and the strength of monetary policy transmission. Transmission has been advancing as interest rates on loans to firms and households rise and lending volumes are declining but, as monetary policy affects the economy and inflation with long and varied lags, its full effects are still likely ahead of us.

Fiscal policy and near-term macroeconomic stability

The public finances have improved rapidly since 2020, despite higher expenditure on temporary cost of living measures and necessary humanitarian support. At headline level, the surplus in the General Government Balance (GGB) is expected to widen out to 2025 based on current central forecasts for the economy, and assuming the net 5 per cent increase in spending rule is met and temporary measures are fully unwound.

These positive headline developments are dominated by exceptionally strong growth in one source of revenue – corporation tax – over half of which cannot be considered linked to underlying economic activity in the State. It is appropriate to consider the budget balance excluding these windfall corporation tax receipts and doing so in the 2023 Stability Programme Update was a welcome development. On this underlying measure, the projected budgetary position is significantly less favourable over the coming years, with a deficit still expected this year and small surpluses in 2024 and 2025. The concentration of corporation tax receipts leaves the revenue base of what is now the State's second largest tax head highly exposed to the decisions and profitability of a very small number of companies, almost entirely in the pharmaceutical and technology sectors. In addition to firm or sector-specific trading shocks that could lead to a reduction in corporation tax receipts, there also remains the possibility that changes in international tax arrangements could eventually lead to a reduction in the taxable profit that multinationals currently book in Ireland. It remains important that excess receipts are not used to fund permanent increases in spending commitments.

With the economy being at full employment and at risk of overheating, now is not the time for the overall stance of fiscal policy to further stimulate demand. Headline inflation in Ireland has passed its peak, as the spike in energy prices following the Russian invasion of Ukraine

has faded. However, broad inflationary pressures remain pronounced. Core inflation, which excludes energy and food and is a better reflection of underlying price pressures in the domestic economy, is expected to rise through 2023, and decline more gradually than headline inflation thereafter.

Euro area monetary policy is being calibrated to slow demand in the bloc as a whole, and ensure medium-term inflation expectations remain anchored at 2 per cent. For a small, open economy in a monetary union, fiscal policy is a key lever for overall macroeconomic management, including to ensure domestic demand-supply conditions remain broadly balanced. In particular, fiscal policy has a role to play in ensuring that excessively high inflation does not become embedded in the Irish economy. If domestic policy is oriented such that it stimulates excess demand in Ireland, it will be working at cross-purposes to monetary policy. And should domestically-driven inflation exceed that of the euro area over the medium term, the relative cost of living and doing business here could become a more severe constraint on achieving sustainable growth.

In addition, and as outlined in our recent *Financial Stability Review*, persistently high inflation – and any resulting increases in higher interest rates or risk premia over an extended period – presents risks to domestic financial stability. This potential for a higher risk environment would feed through to assessments of macroprudential policy and the resilience of the system in the face of such risks (notwithstanding the fact that macroprudential policy is not in a position to address the underlying drivers of inflation, or target inflation),

In order to avoid overheating dynamics taking hold, the overall stance of fiscal policy should at least be neutral in the short term, with a readiness to move to a tighter stance than currently envisaged by the middle of the decade. It is useful to consider this in the context of the Government's 5 per cent net spending rule. Scenario analysis by Central Bank staff highlights the potential for total spending increases that are not matched by corresponding discretionary increases in tax revenue (i.e. outside the net 5 per cent rule) to add significantly to overheating dynamics in the coming years. Indeed, even under current plans where (net) spending is forecast to grow at 5 per cent, there is a risk of overheating pressures emerging given the current conditions in the labour market. In the scenarios analysed by the Bank, the results point to the potential rise of imbalances in the economy. An acceleration in domestic demand would crowd out the traded sector over the medium-term, as more upward pressure on prices and wages

emerges. This highlights the need to be very careful in setting the fiscal policy stance at the current juncture, in order to promote sustainable increases in living standards.

For the near-term, the net 5 per cent increase in spending allowed under the Government's spending rule should be considered to cover all expenditure. If the risks of overheating become more pronounced this year and next, it may be appropriate to adopt a tighter fiscal stance by the middle of the decade. Choices on specific priorities for tax rates and base, reliefs, and all current and capital spending should be considered within this overall bound.

Enhancing medium-to-longer term resilience

In addition to the appropriate fiscal stance to avoid stimulating demand in the near-term, there are significant medium-to-longer term structural challenges and opportunities facing the public finances that warrant attention.

The excess corporation tax receipts provide an opportunity to bolster the resilience of the public finances in light of known financing needs into the future. Additional costs related to the ageing of the population clearly need funding. Projections from Eurostat show that the number of people of working age for each person aged 65 and over in Ireland will drop from around four currently to three in 2030 and two by 2060. This transition to an older population structure will have significant implications for both tax revenue and government expenditure. Age-related expenditure is estimated to have to rise to just under 30 per cent of GNI* by 2050 (from 21.4 per cent of GNI* in 2019) to simply maintain current levels of services, according to estimates from your Department. At the same time, the Department of Social Protection has indicated that the decision not to follow the recommendation of the Pension Commission to raise the State pension age will require higher PRSI receipts to fund future pension payments to the same level which they are currently. Saving the entirety of the excess corporation tax receipts expected in the coming years to address those future financing needs is highly appropriate. It would reduce the drag on future economic activity that would otherwise be the case if a much higher level of tax was required to fund the State's commitments in the absence of a fund. I welcome your proposal to establish a sovereign wealth fund for these purposes. However, in light of analysis by your Department and IFAC it is likely that even with the existence of such a fund, additional resources will be required to maintain age-related services at their current level into the future.

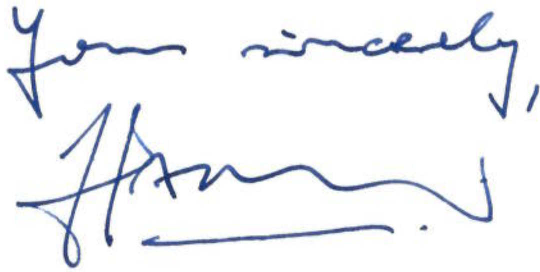
In addition to the transition to an older population, there are other structural changes emerging that are less well-quantified but will likely also result in additional fiscal outlays. Among these are the implications of climate change and the transition to net carbon neutrality, and the adaptation of work and business to a more digitalised economy. Addressing the digital transition also overlaps with the ageing of the population, as the approach to training and skills development will likely have to evolve in order to support people to take full advantage of technological change over a longer working life. Putting this together with the known additional age-related costs that would not be fully covered by a sovereign wealth fund – and the concentration risk in corporation tax receipts – presents challenges to the long-term sustainability of the public finances. In the circumstances, it would be appropriate to consider options for broadening the tax base that would result in an increase in government revenue as a share of national income, in line with the recommendations of the Commission on Taxation.

Public capital investment has an important role to play in helping to alleviate current supply-side bottlenecks in the economy, in particular in housing and other infrastructure. Increases in public and private investment will also be needed to ensure Ireland meets its climate change targets and to assist firms and households with the transition to a low-carbon economy. Relative to the original envisaged delivery in the National Development Plan 2021-2030, the real value of public investment is now expected to be significantly lower in the coming years (as a result of the drop in activity arising from the pandemic and the higher cost of delivery given the rise in raw material and other prices). At the same time, capital spending is still expected to rise by just under 10 per cent on average between 2023 and 2025. Given the importance of public capital spending to enhance economic resilience, and the necessity to avoid overheating dynamics in the near-to-medium term, prioritising capital expenditure within the context of the 5 per cent net Spending Rule should be considered. Indeed, it may be appropriate to consider revenue-raising measures to create the necessary space for the increase in public capital spending needed over the coming years.

Conclusion

The economy and the public finances have weathered significant challenges in recent years. For a combination of reasons, we find ourselves in a strong position to support both near-term macroeconomic stability and enhance medium-to-longer term resilience in light of future challenges. In doing so, choices should be made to protect against overheating dynamics,

ensure excessively high inflation does not become embedded to the detriment of households and businesses, and promote sustainable growth in living standards. Both near-term and longer-term objectives point to the potential benefits of considering measures to increase government revenue as a share of national income by the middle of the decade. This could help contain inflationary pressures, allow the State to support those most vulnerable, address infrastructure gaps and enable a more positive adjustment of the economy as a whole to the emerging realities of climate change, ageing and digitalisation.



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