Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

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Dear Minister,

BUILDING ECONOMIC RESILIENCE: THE NEXT FIVE YEARS

Congratulations on your appointment as Minister for Finance. The tenure of the new Government coincides with a period of both challenge and opportunity for the Irish economy, against an uncertain global backdrop. I want to offer my perspectives on the outlook, and the associated implications for economic policy. I would summarise the latter as underlining the ongoing need to build economic resilience through the economic and societal transitions that Ireland and Europe are undergoing.

The economic outlook

As outlined in our latest Quarterly Bulletin (published on 17 December), the baseline outlook for the economy and the public finances over the medium term is relatively favourable. We expect the domestic economy to grow in-line with its medium-term potential out to 2027, having been operating above that level in 2023 and 2024. We see unemployment as remaining low and headline inflation as being contained, while real household disposable incomes continue to rise. However, downside risks to this outlook have increased and there is a higher level of uncertainty, particularly as to how geoeconomic fragmentation will continue to develop and the extent to which it will affect Ireland. At the same time, near-term cyclical risks are increasingly coinciding with longer-term structural changes, many of which will require policy actions to guard against the build-up of vulnerabilities for the economy and the public finances over time.

The challenges

Most immediately, the Irish economy's most pronounced economic challenges are (1) the infrastructure deficits affecting housing, transport, energy and water and (2) the risks to the Exchequer from the over-reliance on a relatively narrow tax base, especially in the context of a rapidly-shifting external environment. However, equally importantly, ongoing demographic trends mean that – absent policy actions – the long-term potential growth of the Irish economy is likely to decelerate significantly, with implications for living standards into the future.

With the economy having been operating above its medium-term potential in recent years, supply-side constraints underlie near-term risks of overheating as well as limiting the resilience of the economy in the face of well-known longer-term transitions (climate, demographic, and technological change) and a relatively new transition (towards a more fragmented global economy).

High costs and delays in the **delivery of infrastructure** manifest themselves in asset price inflation and rent inflation. In turn, these price rises can eventually feed through to higher wage demands and a higher cost of living and doing business more generally, thus damaging competitiveness. They can also lead to consumption and investment opportunities being foregone or delayed, as the economy cannot supply the volume of goods and services society demands. The ability to deliver infrastructure is particularly important in a small open economy such as Ireland in order to maintain incentives for foreign investment. And this is especially the case as geoeconomic fragmentation turns from distant risk into current reality.

As you know, Corporation Tax (CT) now accounts for 25 per cent of **Exchequer** tax revenue. Almost 90 per cent of CT revenue in Ireland is paid by foreign-owned firms (and US MNEs are the largest CT payers). The proportion of CT deemed 'excess' has increased and is estimated at over €16bn in 2024, only a third of which is being put aside for the future. CT is particularly vulnerable to geoeconomic fragmentation, whether as a result of trade tensions or changes in third-country policies. A substantial loss of CT would push the budget into a deficit position.

These near-to-medium term risks coincide with the challenges that arise from a more structural and long-term perspective.

As outlined in recently published research by Central Bank staff, the potential growth rate of the Irish economy is set to halve to around 1.4 per cent by the middle of the century as the working-age population declines. The analysis also shows, however, that an enhanced level of investment in **physical and human capital** to support productivity growth (including by ensuring that we continue to build skills for the future) and enabling people to stay longer in the workforce can in part offset this decline. This points to the opportunities available for economic policy to take action now, supporting continued sustainable growth in Irish living standards over the longer-run.

A positive development in Ireland in recent years has been the increase in labour force participation rates for older workers, enabled in part by improvements in life expectancy. I expect to see such participation increase over time. (Increasing the retirement age – guided broadly by the parameters of the Pension Commission recommendations – would boost future labour supply and lift the long-run potential growth rate of the Irish economy to around 1.7 per cent. A similar increase in the growth rate could be achieved by boosting the economy's capital stock, such as by raising the share of investment in the overall economy (GNI*) to 25 per cent by 2050 (compared to 20 per cent in 2024).)

Economic growth is necessary to provide a tax base to fund the delivery of essential public services and infrastructure over the long-term. The number of people of working age for each retiree is set to halve from around four currently to two by 2050. This will create new demands for additional public expenditure relative to the present position. Estimates from your Department show that total **age-related public spending** is projected to rise by 6 percentage points of GNI* by 2050 (which would be the largest increase in age-related expenditure over this period across the EU). Moreover, in addition to meeting these new demands, the cost of maintaining existing levels of public services in future years will absorb significant resources. In 2025, the cost of maintaining public services – before the impact of any new policy decisions – is estimated at €3.4bn or 4 per cent of the current expenditure base.

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 emissions relative to 2018 by 2030. With current projections (from the Environmental Protection Agency) signalling a significant undershoot in meeting this target, estimates point to an additional annual investment need of around 1.7 per cent of GNI* to 2030, or €54.5bn in total by 2050 to achieve it, at least 20 per cent of which would likely comprise public investment. Over the period to 2030, this would constitute an increase of 8 per cent in public capital expenditure over and above what is currently envisaged in Budget 2025.

The opportunities

These challenges are significant, but the economy is in a good position to address them. The near-term outlook speaks for itself. The establishment of the Infrastructure, Climate and Nature Fund and the Future Ireland Fund is an important development and will help to allay the emerging fiscal cost of the ageing and climate transitions (and I welcome the Government's commitment to the two Funds). The Commission on Tax and Welfare's report provides a menu of options for broadening the tax base (and so future-proof the public finances). And Ireland's membership of the EU gives it access to both a significant internal market as well as a large network of Free Trade Agreements across the globe. Moreover, the overall fiscal position should enable the significant investment needed to address the infrastructure deficits that are essential to removing the constraints to more sustainable growth in living standards, while guarding against the risks of overheating.

Implications for economic policy

Given the domestic and global backdrop, Irish economic policy has the opportunity over the next five years to make a substantial contribution to maintaining sustainable growth in living standards across our community for the decades ahead. In order to do so, I believe the following areas of policy focus should be considered:

- Prioritise capital expenditure and tax base broadening to create the economic and fiscal space for the necessary increase in investment needed in the coming years;

- Enhance and introduce structural reforms to reduce the costs of infrastructure delivery and boost productivity in the construction sector;

- Further enable the expansion of the labour force including through increased labour force participation and productivity, supporting life-long learning and adaptation to technological change;

- Continue to support efforts to mitigate geoeconomic fragmentation while protecting supply chain security.

With euro area monetary policy becoming less restrictive and the Irish economy expected to grow in-line with its medium-term potential, the role of domestic policy in maintaining macroeconomic stability comes to the fore. The Government should commit to rigorous expenditure control alongside an appropriate anchor (fiscal rule) for budgetary policy to ensure the overall fiscal stance is appropriate, guards against procyclicality and boom-bust dynamics and safeguards long-run fiscal sustainability. This should support the creation of the necessary economic and fiscal space for the investment in infrastructure and the other structural reforms – in particular with regard to planning regulations – essential to Ireland's resilience and future prosperity.

From a broader perspective, sustainably mobilising private savings across the EU for investment in Europe's productive capital stock would also enhance the resilience of households, businesses and the economy as a whole. In this respect both domestic and EU policy efforts should be enhanced to translate savings into investment and create a more vibrant funding environment for infrastructure and innovation. Progress on the Savings & Investment Union and supporting the European Commission's Competitiveness Compass matters for Ireland's future living standards. In particular, adopting an approach to industrial policy and related matters in EU and global fora that maximises the benefits of multilateralism, while at the same time addressing relevant aspects of supply chain security, is important for a small open economy such as Ireland.

Conclusion

Ireland and Europe are undergoing significant economic transitions in climate, in demography and in technology. Moreover the growing fragmentation of the global economy is a challenge to Ireland's openness, one of the defining features of its economy and a key platform for the country's living standards. Building economic resilience – through investment in physical and human capital in particular – is the most effective way of helping to manage these transitions.

The new Government takes office at a challenging time for the European and global economies against the backdrop of a positive near-term outlook for the Irish economy itself. There are substantial opportunities for the Government over the next 5 years to invest in the future. The Central Bank will continue to provide advice and comment to support national economic development while ensuring that a resilient financial system continues to work for the community as a whole.

I look forward to discussing these issues with you.

Yours sincerely,

Gabriel Makhlouf