The Economy is at Capacity: We need a Countercyclical Budget

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Tom McDonnell

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The economy has never been stronger and is set to transition to a more moderate growth trajectory

1. Introduction

The Republic of Ireland's labour market and its economy have never been stronger despite the damaging impact of the pandemic and the recent cost of living pressures. While the employment growth of recent years is not sustainable there is limited evidence of a downturn in the economy. The post-pandemic boom period of pent-up demand and economic recovery has come to an end. Even so, the short-run economic outlook remains positive with moderate and broad-based growth likely over the next year.

This assessment is based on an expected loosening of monetary policy; an expansionary fiscal policy; an increase in real disposable income as wages outstrip inflation in the context of a tight labour market; improving household and business confidence as price pressures recede, and an outlook for modest but positive growth in Ireland's main trading partners.

Modified domestic demand and exports should both grow by close to 2%. Price pressures will ameliorate as inflation falls to close to 2% this year and next, while the economy will remain close to full employment albeit with a slowing in the rate of employment growth. There are of course uncertainties. Major downside risks include but are not limited to weakness in trading partners, political turmoil in the US and radical shifts in trade policy, rising geopolitical tensions, and further shocks to the cost of energy imports.

There is little justification for an expansionary budget in this type of macroeconomic environment. Ideally, a countercyclical approach would be pursued in Budget 2025 with the necessary investments in public spending financed by targeted increases in government revenue and no further once-off supports added on budget day.

2. The World Economy

The Irish economy is small and extremely open. This means that conditions in Ireland's major trading partners and the impact on the export channel matters enormously for Irish economic performance.

The European economy has been fairly resilient given the range of recent shocks although the euro area's GDP grew by a modest 0.4% annually in the first quarter of 2024. Even so, the unemployment rate of 6.4% in May is a record low for the euro area (6% in the EU as a whole) albeit with significant differences between EU countries ranging from 2.7% in Czechia to 11.7% in Spain. Similarly, the long-term unemployment rate is at its lowest level in over 20 years. Employment was up 1% year-on-year in the first quarter although hours worked were up just 0.2%. The June composite PMI of 50.9 points to a continuation of the modest growth trend in the private sector. Consumer confidence remains negative but has been on an upward trend for the last five months and is at its highest level since February 2022.

Price pressures are slowly moderating. Euro area HICP inflation was 2.5% in June and has been stuck close to that level since February. Core inflation is at 2.8% with services (4.1%) driving the upward price pressures. Wage growth was at 5.3% in the year to March and rising disposable incomes should add to consumption levels in 2024 and 2025. Monetary policy will slowly loosen over the course of 2024 and 2025 as price inflation continues to fall towards the medium-term target of 1.9% over the next year. The European Central Bank is projecting modest average annual real growth of 0.9% in the euro area in 2024, with growth strengthening to 1.4% in 2025 and 1.6% in 2026.

The US economy has continued to expand and recent price pressures are now easing. The economy grew 2.5% annually in 2023 and 2.9% in the first quarter of this year. Retail sales were up 2.3% year-on-year in May, while the composite PMI (54.8) suggests solid growth in the short-run notwithstanding relatively weak consumer sentiment. The OECD is projecting growth of 2.6% this year followed by a slow-down to 1.8% in 2025.

The Federal Reserve's tight monetary policy will continue to weigh on demand over the short-term with meaningful loosening unlikely before the final quarter of this year given the strength of the labour market and ongoing price pressure. PCE inflation was 2.6% in May and below 3% for the 8th consecutive month. Core inflation was also 2.6%. Average hourly earnings increased by 3.9% over the year to June. The economy is close to full-employment, albeit with the unemployment rate rising marginally to 4.1% in June. This is the highest rate since November 2021 but is low by historical standards. The employment rate remains below its pre-Covid level suggesting a possible degree of scarring, although, at 60.1%, is above the long-run average. Nominal wage growth was 4.9% in April. The government deficit of 8% is unsustainable in the medium-to-long-term and raises questions about the resilience of growth. Even so, meaningful fiscal consolidation in the short-term is unlikely.

The UK economy has struggled in recent years and in May of this year was just 1.8% larger than it was at the onset of the pandemic. This compares to 8.6% in the US. Even so, the economy appears now to be on an upswing and grew 1.4% in the year to May and by a robust 0.4% month-on-month. The Manufacturing and Service PMIs are both modestly positive. Annual inflation appears to be coming under control and was down to the 2% target in May (however core inflation was 3.5% and services inflation 5.7%) with energy inflation and food inflation exerting downward pressure. Average weekly earnings increased by a strong 5.9% in the three months to April 2024. However, the unemployment rate has increased in each of the last four months and was up to 4.4% in April. Interest rates are likely to start falling in the Autumn as lower inflation becomes embedded.

Overall, the baseline growth outlook for Ireland's trading partners is mildly positive for the rest of this year suggesting weak but positive growth in exports. Monetary policy is loosening in most countries and this should stimulate foreign demand for imports. However, there are a number of downside risks ranging from policy shifts in the US to the uncertain trajectory of the Chinese economy. Geopolitical uncertainty and trade fragmentation represent significant medium-term risks to the Irish growth model.

3. Economic Trends in the Republic of Ireland

3.1 The economy continues to perform well

The Irish economy has proven resilient to the wide range of shocks of recent years and continues to perform extremely well (see Table 3.1). GDP declined last year (-5.5%), although this can partially be attributed to a sector specific (industry excl. construction) fall in multinational goods exports related to the unwinding of demand for pandemic era pharma products. Gross Value Added (GVA) in the foreign-owned multinational dominated sectors declined 16.2% in 2023 although GVA in the non-multinational dominated sectors increased by 6.1%. The decline in GDP should be seen in the context of its rapid and unsustainable growth in recent years (35.3% between 2019 and 2022).

Table 3.1 Dashboard of Macroeconomic Indicators, Republic of Ireland

	2020	2021	2022	2023	24'Q1	Latest
Percentage volume change over previous year						
Gross Domestic Product	7.2	16.3	8.6	-5.5	-4.7	-4.7 (Q1'24)
Modified Domestic Demand	-5.7	8.0	8.8	2.6	2.2	2.2 (Q1'24)
Personal Consumption	-9.5	8.9	10.7	4.8	2.1	2.1 (Q1'24)
Retail Sales	-2.3	8.7	-0.6	4.2	3.1	-1.0 (M5'24)
GNI*	-2.8	13.9	4.6	5.0	-	5.0 (2023)
Percentage annual average rate of change						
Employment	-1.2	5.8	6.9	3.4	1.9	1.9 (Q1'24)
Average Hourly Earnings	4.8	4.4	3.6	4.3	4.5	4.5 (Q1'24)
Average Weekly Earnings	5.2	4.7	3.4	3.9	4.7	4.7 (Q1'24)
Compensation of Employees	-0.2	10.5	9.7	10.9	8.3	8.3 (Q1'24)
Inflation (CPI)	-0.3	2.4	7.8	6.3	3.5	2.2 (M6'24)
Inflation (HICP)	-0.5	2.4	8.1	5.2	2.2	1.5 (M6'24)
Percentage of annual GDP or quarterly GDP						
Government Balance (GGB)	-5.0	-1.5	1.7	1.7	-	4.6 (Q4'23)
Gov. Gross Debt (end year)	58.1	54.4	44.4	43.7	-	43.7 (Q4'23)
Percentage of labour force						
Unemployment (Covid Adjusted)	19.4	16.1	4.5	4.3	4.1	4.2 (M6'24)
Long-term Unemployment	1.3	1.8	1.3	1.3	1.0	1.0 (Q1'24)
Percentage						
Participation Rate (15+)	60.2	63.4	64.9	65.5	65.0	65..0 (Q1'24)
Savings Rate	24.1	20.3	12.6	12.6	14.7	14.7 (Q1'24)
Deprivation Rate	14.3	13.7	16.6	17.3	-	17.7 (2022)

Notes: Half-year, ('H'), Quarterly ('Q'), monthly ('M') and other data is compared to same period of the previous year. *Modified domestic demand* (MDD) is non-seasonally adjusted. *Unemployment* is Covid-adjusted for 2020 and 2021.

Sources: CSO: *National Income and Expenditure, Quarterly National Accounts, Retail Sales Index, Labour Force Survey, Earnings and Labour Cost, Consumer Price Index, Government Finance Statistics, Monthly Unemployment, Household Saving, Survey on Income and Living Conditions.*

The GNI* indicator gives us a more meaningful measure of economic activity in Ireland and it grew by a robust 5% in 2023. This was the third consecutive year of above potential growth and shows the strength of the post-Covid recovery. The domestically-oriented Modified Domestic Demand (MDD) grew by a solid 2.6% while personal consumption grew 4.8% and retail sales (volume) by 4.2%.

The economy's growth momentum is moderating with MDD increasing 2.2% annually in the first quarter and personal consumption increasing 2.1%. Exports have fallen annually in each of the last four quarters. However, the short-run horizon will be characterised by a loosening of monetary policy, expansionary fiscal policy, an increase in real disposable income, and modest but positive growth in the main trading partners. The outlook is therefore for moderate growth to persist for the rest of this year and into 2025.

3.2 Price pressures are receding

Annual price inflation (CPI and HICP) in Ireland was consistently running somewhat below the ECB's target of just under 2% in the pre-Covid period. The Covid lockdowns suppressed demand for many goods and services which caused the CPI to fall into deflation in April 2020. Price deflation peaked at -1.5% in October 2020.

The economy's reopening in 2021 created a mismatch between supply and demand. In particular, supply chain blockages and delays caused by Covid disruption, a very high level of pent-up consumer demand and the reduction in the savings rate, all combined to jumpstart price inflation. Inflation accelerated from 0% in March 2021 to 5.1% in October of that year. The invasion of Ukraine in early 2022 triggered a further acceleration in prices with a particular spike in the cost of energy products and other commodities. Price inflation (CPI) peaked at 9.2% in October of that year.

The European Central Bank (ECB) responded to the high price inflation by tightening monetary policy in July 2022 and the disinflation process finally started to gain traction in late 2022. Price growth in Ireland fell from 9.2% in October 2022 to 5.1% in the year to October 2023 and then to 2.2% by June 2024. The alternative HICP measure of inflation has already fallen below 2% with a flash estimate of 1.5% in the 12 months to June 2024 (the HICP was 2% in May).

While the normalisation process is still proceeding the ECB has now begun the process of loosening monetary policy with at least one more interest rate cut expected to occur in 2024.

Table 3.2 Annual price inflation, CPI, % change

	2019	2020	2021	2022	2023	2024
January	0.7	1.3	-0.2	5.0	7.8	4.1
February	0.5	1.1	-0.4	5.6	8.5	3.4
March	1.1	0.7	0.0	6.7	7.7	2.9
April	1.7	-0.1	1.1	7.0	7.2	2.6
May	1.0	-0.5	1.7	7.8	6.6	2.6
June	1.1	-0.4	1.6	9.1	6.1	2.2
July	0.5	-0.4	2.2	9.1	5.8	
August	0.7	-1.0	2.8	8.7	6.3	
September	0.9	-1.2	3.7	8.2	6.4	
October	0.7	-1.5	5.1	9.2	5.1	
November	1.1	-1.1	5.3	8.9	3.9	
December	1.3	-1.0	5.5	8.2	4.6	

Source: CSO: *Consumer Price Index*

The largest upward contributors to the CPI in June were Restaurants & Hotels (0.87pp) and Transport (0.61pp). Mortgage interest is exerting upward pressure though this should reverse over the course of the next year. Core inflation which excludes volatile energy and unprocessed foods was 3.1% in June. Core inflation tends to be 'stickier' than headline inflation and is often more predictive of future inflation. Even so, and in the absence of further shocks, we anticipate that CPI inflation will average close to 2.3% in 2024 and 2% in 2025. HICP inflation will average marginally below 2% in 2024.

Inflation is now on a clear downward trend but cost pressures remain

The rise in the cost of living and the failure of incomes (particularly from social transfers and wages) to match the price increases experienced in 2022 and 2023 is manifest in the jump in the deprivation rate (see Table 3.1). The cost of living as measured by the CPI increased just over 20% in the four years to May 2024 (Table 3.3).

Table 3.3 Price inflation, May 2024, by time period, CPI, % change

	1 month	3 months	1 year	2 years	3 years	4 years
May (100.9)	0.5	1.2	2.6	9.4	18.0	20.1

Note: December 2023=100
Source: CSO: *Consumer Price Index*

3.3 The labour market has never been stronger and real wages are growing again

The labour market continues to perform very strongly, albeit the rate of employment growth is starting to normalise from its previous unsustainable levels (6.9% in 2022 and 3.5% in 2023). Net employment is up 16.9% over the last five years (over 391,000) and 1.9% year-on-year in the first quarter (+51,500). Employment growth has also been disproportionately in higher paid sectors (see Table 3.4). There are now over 2.7 million working for pay or profit. The monthly employment index in May was up 15.2% since 2019 and was up 2.2% year-on-year (0.2% month-on-month).

Labour market composition remains highly gendered with females comprising just 6.9% of employment in *Construction* but 78% of employment in *Health & Social Work* (see Table 3.5) which also happens to be the sector with the highest total level of employment. While the economy appears close to full employment with an unemployment rate of 4.2% in June, it remains the case that Ireland is performing badly in terms of employment outcomes for marginalised groups including lone parents, Travellers and people experiencing disabilities. Ireland has the highest employment gap in the EU for people with disabilities.

Actual hours worked in the economy fell back marginally to 85.4 million from the first quarter record of 85.6 million in 2023 but it is still well up compared to pre-Covid levels (78.3 million in Q1 2019) and 2022 (82.8 million). The largest sectors by hours worked are *Industry* (11.4 million), *Health and Social Work* (10.3 million), and *Wholesale and Retail and Vehicle Repair* (9.6 million).

Table 3.4 Persons aged 15-89 in employment, by sector, thousands, 1st quarter

	2019	2023	2024	Growth 5 year	Growth 1 year
	000's	000's	000s	%	%
Agriculture, forestry, fishing	104.7	102.0	108.5	3.6	6.4
Construction	145.1	162.8	171.7	18.3	5.5
Industry	288.7	334.7	323.5	12.1	-3.3
Wholesale & retail, vehicle repair	305.4	334.3	329.0	7.7	-1.6
Transportation and storage	106.1	112.8	111.1	4.7	-1.5
Accommodation & food services	176.5	173.0	174.5	-1.1	0.9
Information & communication	118.8	172.3	175.4	47.6	1.8
Financial, insurance & real estate	111.0	135.0	136.4	22.9	1.0
Professional, scientific & technical	139.6	170.4	196.6	40.8	15.4
Admin & support services	110.9	114.1	111.1	0.2	-2.6
Public administration & defence	111.1	142.8	144.4	30.0	1.1
Education	180.6	214.1	231.0	27.9	7.9
Human health & social work	289.4	356.1	355.4	22.8	-0.2
Other or not stated	124.8	128.4	135.6	8.7	5.6
All sectors	2,312.8	2,652.7	2,704.2	16.9	1.9
Male	1,243.8	1,410.3	1,431.9	15.1	1.5
Female	1,069.0	1,242.4	1,272.3	19.0	2.4

Source: CSO: *Labour Force Survey*

Table 3.5 Labour market composition including gender breakdown, Q1 2024

	('000s)	% Total	% of which Female
Agriculture, forestry, fishing	108.5	4.0	12.9
Industry	323.5	12.0	32.1
Construction	171.7	6.3	6.9
Wholesale, retail, motor repair	329.0	12.2	49.0
Transportation & storage	111.1	4.1	16.7
Accommodation & food services	174.5	6.5	51.8
Information & communication	175.4	6.5	32.9
Financial, insurance & real estate	136.4	5.0	51.6
Professional, scientific, technical	196.6	7.3	45.0
Administration & support	111.1	4.1	44.8
Public administration & defence	144.4	5.3	57.3
Education	231.0	8.5	73.3
Human health & social work	355.4	13.1	78.0
Other & unknown	127.0	4.7	57.8
Unknown	8.6	0.3	*
Total	2,704.2	100.0	47.2

Source: CSO: *Labour Force Survey*

Table 3.6 Participation, employment and unemployment, %, 1st quarter

	1998	2019	2023	2024
Labour Force (Thousands)	1,699.0	2,428.2	2,764.0	2,819.4
Unemployed (Thousands)	148.7	115.4	111.3	115.2
Employed (Thousands)	1,550.3	2,312.8	2,652.7	2,704.2
Participation Rate 15-24				
All	60.7	44.2	51.4	51.5
Male	65.6	45.5	51.9	51.6
Female	55.6	42.8	50.8	51.4
Participation Rate 25-74				
All	64.0	71.1	74.3	74.4
Male	79.3	78.1	80.8	80.3
Female	49.0	64.4	68.0	68.7
Employment Rate 15-24				
All	53.3	39.3	46.9	47.0
Male	57.2	39.6	47.2	47.1
Female	49.3	39.0	46.7	46.9
Employment Rate 25-74				
All	65.4	76.2	80.0	80.2
Male	80.4	82.8	85.8	85.7
Female	50.4	69.8	74.4	75.0
Unemployment Rate 15-24				
All	12.1	11.0	8.6	8.8
Male	12.7	12.9	9.0	8.7
Female	11.3	8.9	8.1	8.8
Unemployment Rate 25-74				
All	7.8	4.0	3.4	3.5
Male	7.2	4.1	3.7	3.4
Female	8.8	3.8	3.1	3.6

Note: Male employment rate (25-74) fell to a low of 70.5% in 2011 and 2012.

Source: CSO: *Labour Force Survey*

The participation rate (25 to 74-year olds) of 74.4% is a record for the first quarter. The female participation rate of 68.7% is also at a record high. The male participation rate for the quarter peaked at 81.2% in 2007 before bottoming out at 76.5% in 2013. It has recovered since to 80.3%. The male employment rate for the quarter (25-74) peaked at 85.8% in 2023 (Table 3.6). The long-run transformation (increase) in female participation and employment is the most striking change in the labour force in the last 25 years.

The seasonally adjusted unemployment rate was 4.2% in June, or 117,100 persons. Unemployment fell by 4,100 year-on-year despite growth in inward migration and in the total labour force. However, unemployment in the 25-74 years age range has increased year-on-year. The job vacancy rate has fallen from 1.4% in Q1 2023 to 1.1% in Q1 2024 suggesting a potential deterioration in job prospects. Nevertheless, the long-term unemployment rate of 1% is at a record low level.

The economy will remain close to full-employment for the rest of this year

Real wage growth resumed in the first quarter of 2024 (see Table 3.7). This follows two years of declining real wages. Economy-wide nominal weekly wage growth of 4.7% was 1.2 percentage points higher that price inflation (CPI). Average hourly wages increased 4.5%. Wage growth was stronger in the private sector with notable weekly gains in *Construction* (8.5%), *Information & Communication* (8.1%) and *Arts, Entertainment & Recreation* (8.9%). Average weekly earnings were €969.12 in the first quarter with average hourly earnings at €29.82. Hourly labour costs were highest in *Information & Communication* (€60.42) and lowest *in Accommodation & Food Services* (€18.85).

The Indeed wage tracker indicates posted wage growth of 4.2% in June (the CPI was +2.2%). Strong real wage growth is likely to persist for the remainder of 2024 and 2025 as the lagged impact of high nominal wage growth in a tight labour market characterised by significant recent price increases combines with slower future price increases.

Table 3.7 Earnings by sector, € or % annual change, Q1

	Weekly	%	Hourly	%
Industry	1159	5.5	30.65	5.7
Construction	962	8.5	26.17	6.9
Wholesale, retail, motor repair	698	5.2	23.36	4.8
Transportation & storage	866	1.8	23.90	1.4
Accommodation & food services	443	4.1	16.97	7.5
Information & communication	1787	8.1	47.46	7.4
Financial, insurance, real estate	1486	-0.7	42.59	-0.6
Professional, scientific, technical	1142	4.6	32.88	3.5
Admin & support	771	5.0	24.27	4.7
Public admin & defence	1123	4.2	30.95	2.9
Education	1002	2.6	40.89	2.8
Human health & social work	904	5.9	27.93	4.6
Arts, entertain, recreation	649	8.9	22.68	4.6
Private Sector	916	4.9	28.21	4.6
Public sector	1148	4.0	35.16	4.3
All	969	4.7	29.82	4.5

Source: CSO: Earnings and Labour Cost Quarterly

3.4 Sentiment remains mixed

Sentiment indicators are mixed (see Table 3.8). The *Consumer Confidence Index* improved to 70.5 in June. While it remains below the historical average it represents a 5-month high. The *Construction PMI* decreased to 47.5 reflecting a fall in commercial activity. However, housing activity expanded. The *Manufacturing PMI* was also in negative territory as new orders and production sank. Even so, the services index which is the most important for the domestic economy was a solid 54.2 suggesting a moderate level of growth in the short-run. All of the PMIs are below their long-run averages thereby tempering expectations somewhat.

Table 3.8 Sentiment Indicators

PMI	April	May	June	14-year range	Long-run average
Services	53.3	55.0	54.2	13.9 - 66.6	55.0
Manufacturing	47.6	49.8	47.4	36.0 - 64.1	54.0
Construction	53.2	49.8	47.5	4.5 - 68.8	54.0
				29-year range	
Consumer Confidence	67.8	65.7	70.5	39.6 - 130.9	84.5

Note: A PMI in excess of 50 represents activity expansion compared to the previous month (growth), whereas a PMI below 50 represents contraction. The consumer sentiment index was 77.0 before the invasion of Ukraine in February 2022. Range is 12 years (2013 to 2024) for construction PMI.

Sources: AIB: Manufacturing and Services PMIs; BNP Paribas: Construction PMI; KBC/ILCU: Consumer Sentiment

4. Context for Budget 2025

4.1 The public finances appear strong – but only in the short-run

The headline fiscal position remains strong. There was a general government surplus of €8.6 billion in 2022 and €8.3 billion in 2023 (2.9% of GNI*) notwithstanding ongoing 'once-off' cost of living measures. The net debt ratio (% of GNI*) is falling though remains above the OECD average. The 10-year bond yield was close to 2.9% in mid-July and effective interest rates are unlikely to meaningfully raise the debt path over the medium-term. Ongoing surpluses and moderate growth will reduce the net debt ratio over the next few years. Tax receipts to end-June were up 9.3% year-on-year while gross revenue was up 6.8%. Against this, voted expenditure was up €5.2 billion (12.4%) to end-June.

The first and most significant caveat is the high concentration of corporation tax receipts and the potentially unsustainable or 'windfall' nature of the surge in corporation tax in recent years. The Department of Finance's Stability Programme Update notes that up to half of the corporation tax yield in 2022 cannot be explained by economic fundamentals, while the Fiscal Council in their Fiscal Assessment Report note that around 43% of all corporation tax receipts come from just three corporate groups. Such concentration represents a dangerous fragility within the tax base. It makes Ireland's fiscal outlook highly dependent on the commercial fortunes and tax decisions of a tiny number of companies making decisions outside of Ireland. Corporation tax receipts are inherently volatile and pro-cyclical.

Secondly, Ireland's strong headline fiscal position should be seen in the context of a very strong labour market and high employment rate. In other words, the structural position is less healthy than the headline position.

Thirdly, focusing only on the short-term position ignores the profound fiscal impacts of looming economic and social megatrends. The most fiscally significant of these shifts will be demographic change from longer life expectancies and falling birth rates. An ageing population means greater spending on pensions while the rapid growth in the over 75s will put increased pressure on social care and healthcare. Demographic change will also mean less tax receipts from employment as the population's working age ratio declines. On a no-change basis ageing demographics imply an additional fiscal cost of 6% of GNI* by 2050. The Fiscal Council estimate even higher costs. Even if these are overestimates it is clear there are difficult tax and spending decisions ahead with immense significance for the future of the welfare state.

Climate transition costs will also be significant and range from green infrastructure and upgrades, to just transition supports, to the loss of green tax revenue as emissions decline. Supply side transition costs on the spending side have been estimated by the Fiscal Council at 0.6 to 1.1% of GNI* by 2030 with the transition away from fossil fuels costing 0.9% of GNI* in lost annual revenues by 2030 and 1.6% by 2040. On the other hand, failing to meet EU emissions targets will lead to substantial EU fines.

De-globalisation and disruptive technologies such as artificial intelligence may also have important fiscal impacts. De-globalisation and a shift in industrial policies towards subsidies and on-shoring may have implications for foreign direct investment and ultimately income tax and corporation tax revenues while technological disruption will require the state to invest more in digital skills and life-long learning.

The 2022 Commission on Taxation and Welfare (COTW) made 116 recommendations with the majority relating to the tax system. Their key message was that Ireland faces major fiscal sustainability challenges from the 2030s onwards and that, over time, the overall level of taxation as a share of national income will have to meaningfully increase.

In this context the creation of the two new investment funds is very welcome – the Future Island Fund (FIF), a de facto sovereign wealth fund, and the countercyclical Infrastructure, Climate and Nature Fund (ICNF). However, these funds do not 'solve' the looming fiscal squeeze. In the long-run, government revenue as a share of output will have to increase.

4.2 We need a counter-cyclical budget

The economy appears to be operating above potential. There have been rapid levels of employment growth, we have high employment rates and low levels of unemployment, and there has been strong output growth and high inflation. This suggests the economy does not need additional stimulus from an expansionary budget. Instead, a countercyclical budget appears prudent.

However, there are clear constraints on future economic growth. These include capacity constraints caused by a range of infrastructure deficiencies including in energy, water, housing, broadband, and public transport just to name a few areas. The future health of the economy will also require ongoing investment in education and skills and in public R&D at higher per capita levels than at present. Finally, lower income households have seen an erosion of living standards in recent years due to the cost of living crisis and deprivation rates have increased. Welfare rates will need to increase by faster than inflation to begin to reverse this deterioration in living standards. In the medium-term, the welfare system needs to be reformed in order to adequately protect households on fixed incomes (benchmarking) while simultaneously eliminating distortions and perverse incentives within the system.

As such, the current context suggests the need for a relatively cautious budget (net basis) that simultaneously invests sufficiently in the long-run components of sustainable productivity-based growth and protects lower income households. This mix implies the need for taxes to increase in Budget 2025.

As it happens, the Government have stated their intention to increase spending by 6.9% in Budget 2025 along with tax cuts worth €1.4 billion. Once account is taken of pre-existing decisions there will be €1.8 billion in new spending measures and €1.4 billion in net tax cuts. The wisdom of such a large-scale package at this point in the economic cycle might be questioned and it will certainly add to inflation. Cutting taxes now means larger tax increases in the future and pushes the burden on to younger workers. The government should avoid further pro-cyclical expansion on Budget day via additional 'once-off' measures. Additional once-off supports make little sense given the permanent nature of the price increases in recent years. Cost of living supports outside of major temporary shocks like pandemics should be part of on-going current spending.

A mature and evidence-based debate is needed about expenditure needs and revenue sufficiency with multi-annual and transparent fiscal planning needs a priority.

Even so, and given that €1.4 billion in tax cuts has been signalled in the Summer Economic Statement, it is worth briefly considering the relative merits of the options available to government within this envelope, and in particular the types of measure to avoid. The COTW's tax recommendations are instructive. They made the case that the use of tax expenditures should be very significantly reduced over the medium-term[1] and they also argued that future tax increases should disproportionately fall on capital taxes and on green excises. As such, the €1.4 billion tax cutting package should avoid cuts to capital taxes, cuts to green taxes, or increases in the use of tax expenditures.

Instead, and given recent price pressures, there is a reasonable case for partial indexation of the income tax system in order to compensate wage earners. Such a measure would absorb most of the €1.4 billion and may be the most prudent way to approach the tax cuts. However, such an approach would be regressive and disproportionately benefit middle and higher earners.

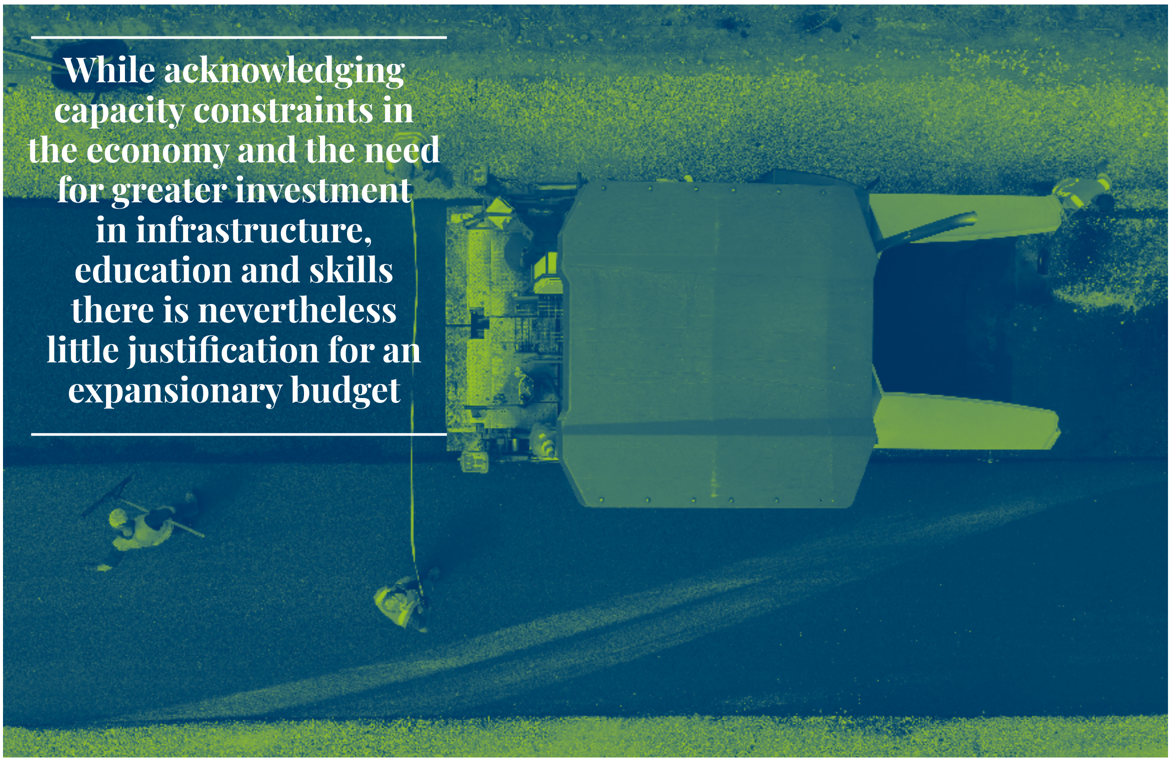
1 There have been recent calls to reduce the VAT rate on hospitality to 9% and calls to increase the threshold for Capital Acquisitions Tax (CAT). The Commission on Taxation and Welfare found that there was little merit in either proposal and warned against such tax measures. McDonnell and Collins (Forthcoming) make the economic and distributional case for reforms to CAT. They find that it would be optimal for a greater proportion of total revenue to come from CAT in the long-run.

Conclusion

The post-pandemic boom period of pent-up demand and economic recovery has come to an end. The short-run economic outlook remains positive with moderate and broad-based growth likely over the next year. This assessment is based on a loosening of monetary policy; an expansionary fiscal policy; an increase in real disposable income as wages outstrip inflation in the context of a tight labour market, and an outlook for modest but positive growth in Ireland's main trading partners. Price pressures will ameliorate as inflation falls to close to 2% this year and next while the economy will remain close to full employment albeit with a slowing in the rate of employment growth.

While acknowledging capacity constraints in the economy and the need for greater investment in infrastructure, education and skills there is nevertheless little justification for an expansionary budget in this macroeconomic environment. Ideally, a countercyclical approach would be pursued in Budget 2025 with the necessary investments financed by targeted increases in government revenue and no further once-off supports added on budget day.

The EU's new fiscal rules will have limited impact on Ireland in the short term due to the masking effect of the windfall corporation tax receipts although the move towards five-year budgeting might assist with longer term budgeting. As we move past Budget 2025 into a new five-year cycle we will need to have a mature debate about long-run expenditure needs and revenue sufficiency and design.



NEVIN ECONOMIC RESEARCH INSTITUTE

31/32 Parnell Square, Dublin 1, Ireland
Phone: +353 1 8897722

45-47 Donegall Street, Belfast BT1 2FG, Northern Ireland
Phone: +44 (0)28 9024 6214

info@NERInstitute.net

www.NERInstitute.net

@NERI_research