Opening Statement – Oireachtas Committee on Budgetary Oversight

‘Views on the Overall Budgetary Package as set out in the Summer Economic Statement and Specific Issues to be addressed in the Budget’

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1. Introduction

First of all we would like to thank the Cathaoirleach, and members and staff of the Committee for the invitation to appear before you.

My name is Tom McDonnell. I am co-director of the NERI, and I am joined today by my NERI colleague Ciarán Nugent.

We are grateful for the opportunity to present our views on the economy and overall budgetary package as set out in the Summer Economic Statement.

We will also comment on a number of specific issues that we feel should be addressed in the budget and/or in Ireland’s upcoming medium-term fiscal-structural plan.

Two key factors should always underpin budgetary policy. These are the current state of the public finances and the current cyclical position of the economy. Other factors such as the adequacy of incomes, services and infrastructure are also relevant.

2. Economic context and outlook

Turn first to the economy. It is clear that it is booming relative to historical standards and is close to its current capacity. We will touch on the issue of capacity again later.

Employment and employment rates are at record highs as are participation rates for females. The number in employment increased by 71,500, or 2.7%, in the 12 months to quarter two, while average hours worked increased by 1.7 million or 2%. High inward migration is boosting the labour supply.

While the fast employment growth of the last half decade is unsustainable there is limited evidence of an impending downturn in the economy. We should remain at close to full employment over the short-term, albeit with a slowing in the rate of employment growth to about half its current level. The unemployment rate was 4.3% in August and should continue to hover between 4% and 4.5% over the short-term.

The domestic economy has grown rapidly in recent years, though growth is now reverting to its more normal long-term trajectory. Consumption and modified domestic demand are on track for real growth of circa 2% this year. Real growth of closer to 3% is in prospect for next year. This assessment is based on A) a loosening of monetary policy; B) expansionary fiscal policy; C) increasing real disposable income as wages outstrip inflation in the context of a tight labour market; D) improving household and business confidence as price pressures recede, and E) an assumption of modest but positive growth in Ireland's main trading partners.

Price pressures are receding with the annual HICP measure of inflation at just 1.5% in July and 1.1% in August. The annual CPI measure of inflation rose 1.7% in August. Real wage growth has returned with nominal weekly earnings up 5.6% annually in quarter two and real earnings up by 3.1%[1]. Price inflation is likely to be close to the 2% target over the short-to-medium term.

Notwithstanding this improvement, prices have jumped by close to 20% in recent years and rates of material deprivation have increased. Lower income households need to be prioritised in budget 2025. The strategy of untargeted once-off supports does not adequately protect vulnerable households in the medium-term.

There are many uncertainties to the outlook. Major downside risks include but are not limited to A) weakness in our major trading partners, B) political turmoil in the US with radical shifts in trade policy, C) a slowdown in foreign direct investment, D) rising geopolitical tensions, and E) further shocks to the cost of energy imports.

[1] When measured against the CPI.

3. Fiscal position

The headline fiscal position is clearly very healthy and there will be a significant surplus in 2024 (circa 2.5% to 3% of GNI*) and indeed again in 2025 and 2026. Debt servicing costs continue to fall. However, Ireland's surplus owes its existence to highly concentrated and potentially non-recurrent corporation tax receipts. The potentially transitory portion of these receipts may be in excess of €10 billion per annum.

It is true that there is as yet no sign of these receipts being transitory but the risk remains. For this reason, the NERI has consistently supported the establishment of the two savings vehicles (FIF and ICNF[2]). Indeed, it is unclear why all of the estimated windfall corporation tax receipts are not being placed into the savings vehicles.

If some of the excess receipts *are* to be used, then they should be hypothecated to once-off capital expenditure, for example projects related to the green and digital transitions, or even potentially used as seed capital for a public affordable housing company.

While there is obvious uncertainty about the transitory element of corporation tax receipts there is no uncertainty about the once-off windfall nature of the €14.1 billion from the judgement in the Apple case. Clearly it should not be used for current spending or for tax cuts.

It is also important to note that the headline fiscal balance is flattered by the strong cyclical position of the economy and labour market. The structural position is therefore somewhat weaker than the headline position. Recessions are inevitable so we need to be cognisant of the structural position.

It is also worth recalling the expected impact of future megatrends and their profound negative implications for fiscal policy. The medium-to-long term fiscal position is extremely challenging.

[2] These are the Future Ireland Fund and the Infrastructure, Climate and Nature Fund.

We know that demographic change from longer life expectancy and falling birth rates means greater future public spending on pensions, on social care and on healthcare as well as less receipts from income tax when the working age ratio starts to decline.

Climate transition costs will also be significant as will the loss of green tax revenues as emissions decline. Responding to technological disruption will require increased investment in skills while de-globalisation has implications for foreign direct investment and attendant tax flows.

4. Counter-cyclicality and the Summer Economic Statement

Budgetary policy should be countercyclical. If the economy is in a downswing then it makes absolute sense for government to stimulate the economy. But the opposite is true when the economy is close to capacity with labour shortages in key sectors.

There appears little justification for an expansionary budget in the current macroeconomic climate. A countercyclical approach should be pursued in Budget 2025 and the scale of the €8.3 billion package outlined in the Summer Economic Statement must therefore be seen as questionable. The scale of the package will add to inflation.

And yet, there is certainly a strong case in Budget 2025 for increased investments in public spending beyond the 4-to-5% or so implied by the economy’s medium-term output growth potential. An important reason is the recent inflation surge which added to the cost of providing existing real levels of public services and income supports.

In addition, Ireland’s per capita public spending is low relative to peer high-income EU countries. Our evident deficits in energy, water and public transport infrastructure, in housing, in childcare, and in our spending on public R&D, all add to the case for increasing public spending beyond 5%. Such interventions will eventually increase the economy’s productive and carrying capacities.

But a budgetary spending package in excess of 5% or so should be financed by targeted and sustainable increases in government revenue.

Ireland's bleak history of pro-cyclical budgets and their consequences should warn us against making similar mistakes this time. We have an economy of winners and losers. Net household wealth is at record levels on the one hand while material deprivation is rising on the other.

Once-off cost-of-living supports have no obvious rationale in the current economic climate. Such policies only make sense if we expect prices to decline. Instead of once-off, untargeted, and/or ad-hoc supports, we need to move to an evidence-based approach to welfare payments based on income adequacy. The Commission on Taxation and Welfare made a number of recommendations in this area and the NERI supports their approach.

We need a mature conversation about fiscal policy and fiscal sustainability. Budget 2025 cannot and should not do everything. It should prioritise those that have not been fully insulated from the cost of living crisis and take steps to restore living standards for those most in need.

5. Tax reform

This brings us to tax reform. We strongly agree with the analysis of the Commission on Taxation and Welfare that government revenue must increase materially as a percentage of national income. Tax cuts are obviously deeply problematic in this context and we strongly caution against them. Indeed taxes, in aggregate, should be increased both for cyclical reasons and for longer term structural reasons.

Tax cuts now mean larger tax increases in the future. The eventual burden of future tax increases is therefore being pushed on to younger workers and on to future workers.

Of course, a specific tax cut might have some policy merit on an individual basis. If so, such a tax cut should be offset by a tax increase somewhere else. For example, cuts to taxes on workers could be offset by increasing taxes on capital stocks and capital transfers. Such a measure would likely be broadly progressive and good for growth. Ultimately, our decisions about tax should be based on social equity, economic efficiency and sustainability.

Unfortunately, it seems some questionable decisions may be coming in Budget 2025. Consider, as one simple example, the calls to cut inheritance tax by increasing the threshold to an enormous €400,000. This would be an extremely regressive move that will merely benefit those few lucky enough to receive a large unearned inheritance to the tune of over €21,000. A minimum wage worker on 35 hours would have to work 48 weeks to reach that amount, while someone working for their income for 10 years to reach €400,000 would pay close to €68,000 in tax.

Inheritance tax is one of the most growth friendly and progressive of all taxes - it should be increased not reduced. Cutting it simply worsens intergenerational inequities.

Overall, and as per the Commission's recommendations, the tax to output ratio will need to increase in the years to come.[3] This should be reflected in the medium-term fiscal structural plan and hopefully it will be acknowledged or debated in political party manifestos. The balance of taxation should be recalibrated to ensure fairer taxation of capital including inheritance, gifts, land and property and capital gains, alongside the gradual winding down of the regressive, distortive and non-transparent system of tax expenditures.

6. Conclusion

Budget 2025 needs to be a budget that builds towards sustainable consistent well-being gains over the next generation for everyone in society. We want to avoid the booms and busts that have caused such pain in the past and we need to ensure that our revenue base is sufficient to meet our public spending needs.

If we want better services, adequate income supports, and structural improvements in areas such as childcare, public transport and housing then we will have to pay for them.

Thank you.

[3] The Irish Fiscal Advisory council estimates the cumulative annual revenue yield from the Commission's proposals at close to €15 billion or 5% of GNI* with the largest individual amount coming from taxes on property and land.