Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

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Gobharnóir / Governor

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Dear Minister,

RE: Budget 2026

I am writing to you in advance of the Government finalising Ireland's Medium-Term Fiscal-Structural Plan and the preparation of Budget 2026, in line with the Central Bank's mandate to provide analysis and comment to support national economic policy development.

With the global economic backdrop continuing to shift, heightened uncertainty remains a feature shaping the outlook for the Irish economy. In view of its significant trading and investment relationships with the US and the rest of the EU, Ireland is exposed to the fallout from changing geoeconomic relationships and priorities. But the opportunities also exist for domestic policymakers to focus on issues within their control so as to build long-term resilience in the economy and public finances.

In my view, current economic and fiscal conditions imply that budgetary policy is now in a good position to address the following three priorities:

- improving resilience and broadening the tax base given risks to the sustainability of corporation tax;
- addressing infrastructure gaps in a sustainable manner; and

- planning for the fiscal impact of long-term challenges.

Achieving progress across these three areas will entail trade-offs and require choices and commitments to be made on public expenditure and taxation, along with reforms to improve efficiency in the delivery of public capital expenditure and the crowding-in of private investment. The right choices made in a timely manner can boost long-term potential growth, safeguard the public finances and underpin sustainable growth in living standards for the community as a whole.

Economic outlook

As outlined in our latest *Quarterly Bulletin* (published last week), downside risks overshadow the outlook for economic growth amid widespread uncertainty and the threat of escalating geoeconomic fragmentation. In view of the economy's openness, changes in global economic activity transmit more directly to Ireland than most other countries. In particular, the extent and nature of the linkages to the US mean that trade, tax or other economic policy changes there could have negative implications for the public finances, the labour market, and the economy more generally.

Given the uncertainty over the future direction of US trade policy, our June *Bulletin* presents projections for the economy in a *baseline* and more *adverse* scenario. The *baseline* forecasts assume that US tariffs on the EU increase from 10 per cent currently to the originally announced level of 20 per cent from Q3 2025, once the US Administration's 90-day pause on its reciprocal tariffs ends. Pharmaceuticals and certain ICT products are assumed to remain excluded from tariffs and uncertainty is assumed to decline gradually to 2018 average levels.

This combination of assumptions prompted downward revisions to the growth outlook in our latest projections. Modified Domestic Demand (MDD) is forecast to grow by 2.0 per cent for the full year in 2025 and by 2.1 per cent per annum on average in 2026 and 2027. Despite global headwinds, household consumption is forecast to remain steady and to be the main driver of MDD growth. Continued strength in the labour market is projected to support income growth. Modified investment, while still an important contributor to MDD growth over the horizon, is revised down significantly in light of historically-high uncertainty.

The adverse scenario assumes persistently higher and broader tariffs and elevated policy uncertainty. In this case, annual average MDD growth would fall to 1.2 per cent from 2025 to

2027 compared to 2.1 per cent in the *baseline*, pointing to a significantly weaker path for economic activity.

While the uncertainty related to the geoeconomic backdrop points to more muted economic growth outcomes with further downside risks, the implications for inflation are less clear-cut, with potential upside and downside risks. Over the near-to-medium-term, however, the central outlook for inflation in the euro area as a whole is broadly favourable, with indications suggesting that inflation will settle at around the Governing Council's 2 per cent medium-term target.

Similar to the euro area, the central outlook for inflation in Ireland is also broadly favourable, but that is subject to the fiscal policy stance not adding excessively to demand at a point in time when the economy is operating at capacity. I would emphasise the importance of both monetary and fiscal policy for overall macroeconomic stabilisation. As monetary policy is set for the euro area as a whole and fiscal policy remains a national competence, the latter is particularly important for ensuring sustainable economic growth and inflation in a small open economy such as Ireland.

Budgetary priorities and trade offs

Over recent years, the public finances have benefitted significantly from the growth in economic activity and employment. From 2021 to 2024, annual average growth in national income (GNI*) is estimated to have grown by just under 7 per cent in real terms with employment growth averaging 4.9 per cent. This pace of expansion – well above long-run historic averages – boosted tax receipts, which also benefitted from the exceptional growth in Corporation Tax (CT) observed since 2015. Together, this resulted in Exchequer tax revenue increasing by 42 per cent since the end of 2021, averaging growth of over 14 per cent per annum.

The magnitude of the increase in government revenue has meant that even with the substantial rise in government spending (up by 44 per cent in the last 5 years, an average of 9 per cent a year, on a General Government basis) and some tax reductions, the headline budget balance has run large surpluses in recent years. In addition, a welcome development has been that the Government established the Future Ireland Fund (FIF) and the Infrastructure, Climate and Nature Fund (ICNF) in 2024, with the overall balance in both funds standing at €10 billion at the end of 2024. However, there are signs that this benign combination of factors – namely, a rapidly growing economy and exceptional CT receipts – could be threatened in the coming years.

In particular, risks to the fiscal position from a loss of CT and other MNE-dependent taxes have increased materially given recent international developments. Concerns over the long-term sustainability of revenue from this source have not dissipated and the risk of a reversal remains. Recent Central Bank analysis examined the implications for the public finances of a loss of 'excess' CT (i.e., that which is disconnected from domestic economic activity), accompanied by weaker economic activity and a reduction in MNE investment in Ireland. Such a scenario could see the budget deficit rising to over 4 per cent of national income by 2030, in the absence of corrective action.

Risks to the public finances are, of course, not limited to the particular concerns in terms of CT. Focusing on the manufacturing and ICT sectors – in which there is a particularly large presence of US MNEs – data produced by Revenue highlights the risks to the broader tax base. In total, foreign-owned MNEs in these sectors generated at least €22.8bn – or 20 per cent – of all tax and PRSI received by the State in 2023. Analysis by Central Bank staff also points to vulnerability arising from the relative narrowness of the income tax and VAT bases in Ireland. The income tax base in highly concentrated with 8.5 per cent of the highest-income taxpayers in Ireland accounting for 56 per cent of aggregate personal income tax revenue (income tax and USC). And the VAT base also appears relatively narrow by EU comparison owing to both changes in the composition of household expenditure over time as well as the widespread application of reduced and zero rates to a variety of goods and services.

The current environment clearly presents a balancing act for budgetary policy. The economic and fiscal outlook is clouded by uncertainty and there are considerable downside risks. At the same time, a key current public policy priority is the need for higher public investment to close infrastructure gaps, improve productivity and boost the economy's long-term potential growth.

Two specific areas that require significant increases in public investment in the years ahead are housing and decarbonisation. Our analysis shows that further increases in capital spending must be managed carefully. If the economy and labour market remain close to capacity as at present, new revenue-raising measures would help to reduce the risk of higher public spending damaging competitiveness and crowding-out activity in other parts of the economy. If economic growth slows materially and some excess capacity emerges, then higher investment could be absorbed with a lower risk of crowding-out.

The medium and longer-term

Beyond these short-run demand management considerations, and as I mentioned in my letter of 5 February, the medium-term resilience of the public finances points to a need to broaden the tax base to increase government revenue as a share of national income so as to address known emerging funding needs and to mitigate the reliance on CT receipts. Analysis by Central Bank staff indicates that government expenditure will need to rise by 6½ percentage points of national income (GNI*), or €265bn, between 2025 and 2050 to fund higher age-related spending and the additional public investment required to meet housing and net zero targets. It is important that transfers to the FIF/ICNF continue as planned but also that the Funds are not seen as a panacea. For example, the FIF will be insufficient – on its own – to fund the higher level of public expenditure that will be required to meet the needs of an older population and to fund climate and housing investment. Taking prompt and concrete action to broaden the tax base would help to ensure that additional known expenditure needs can be met sustainably even if CT was to decline significantly.

A fiscal anchor

A major criticism of Irish budgetary policy in the run-up to the 2008 economic and financial crisis was that it was excessively short-term in focus and lacked a long-term strategic anchor. Since then, reforms at EU level and domestically have aimed to address this weakness in budgetary policy-making but with limited success. EU rules, including the most recent reforms, are based on sound principles – including a much greater focus on medium-term budgetary planning – but their application and effectiveness in an Irish context is undermined by their reliance on GDP.

To avoid a repeat of past mistakes and to shift budgetary policy away from an excessive short-term approach, the Government should commit to a credible fiscal anchor for budgetary policy to ensure the overall fiscal stance is suitable, guards against procyclicality and boom-bust dynamics and safeguards long-run fiscal sustainability. It is important that policy supports rigorous expenditure control – not least of current expenditure - and enables the enforcement of sustainable increases in net government expenditure over time.

Conclusion

Domestic economic policy has an opportunity to achieve the complementary aims of maintaining sustainable economic growth and building longer-term resilience in light of the major transitions the economy is undergoing. Fiscal policy requires careful calibration to ensure sufficient economic and fiscal space is available to achieve the necessary (sustainable) rise in public capital expenditure to address infrastructure gaps in housing, water, energy and transport over the near-to-medium term. At the same time, the need to reduce the risks to the public finances from an excessively narrow tax base has become more immediate, given the reliance on CT receipts from a small number of MNEs, which may be more vulnerable in light of geoeconomic fragmentation. As I have indicated before, the Commission on Tax and Welfare's report provides a menu of options to future-proof the public finances.

Public capital investment alone will not be sufficient to address the housing and wider infrastructure gaps that have emerged. Fiscal and broader public policy should more actively consider reforms to crowd-in private investment and to promote productivity growth. Domestically, given the necessary large increases in public investment already being undertaken and planned, reforms that reduce delays – and, therefore, the ultimate costs – in the planning and building of infrastructure are needed to help ensure that the benefits of public investment for longer-term growth are fully realised. Measures to incentivise scale and investment in new machinery, equipment and technologies in the construction sector would enhance productivity growth and enable more sustainable delivery of housing and infrastructure.

Budget 2026 and the finalisation of the Medium-Term Fiscal Structural Plan are opportunities for the Government to lay out proposals for building longer-term economic resilience and in so doing mitigate the impact of the current heightened uncertainty and create a platform for sustainable growth in living standards.

I am happy to discuss these issues further with you.

Yours sincerely,

Gabriel Makhlouf