Macro Assessment

Capacity constraints and productivity are key

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The Council is required to assess the official forecasts produced by the Department of Finance for *SPU 2024*. The Council recently published its endorsement note (Fiscal Council, 2024), which details many of the key issues that arose during the endorsement process.

This Section outlines the Council's thinking on some of the key macroeconomic issues, as well as highlighting SPU forecasts in these areas.

The Irish economy continues to perform well. The labour market is characterised by record high employment and record low unemployment, while economic activity continues to grow. This is despite a challenging external environment; inflation is moderating due to falling energy prices, but underlying inflation remains high; interest rates are higher now than they have been for over a decade; and global demand appears to be relatively weak.

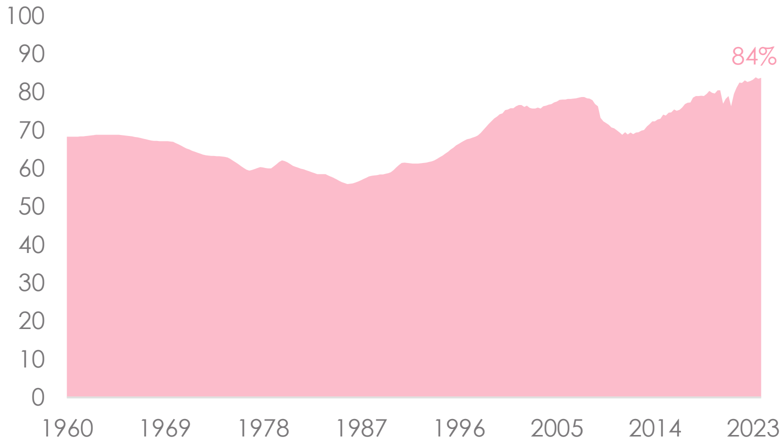
Over the medium term, *SPU 2024* forecasts growth to moderate, with the economy transitioning to a lower medium-term growth rate. Productivity growth in the medium term could be inhibited by infrastructure deficits in the Irish economy.

The labour market is tight

The Irish labour market remains exceptionally tight. This is clear from the record high share of prime age population at work (N°1).

N°1 Employment at record highs

% of population at 'prime' age (25-54 years old) employed



Sources: CSO, AMECO, ESRI, and Fiscal Council workings. Get the data.

Employment growth has been strong in recent years. The strong demand for workers has been satisfied through two channels: rising labour force participation and inward migration.

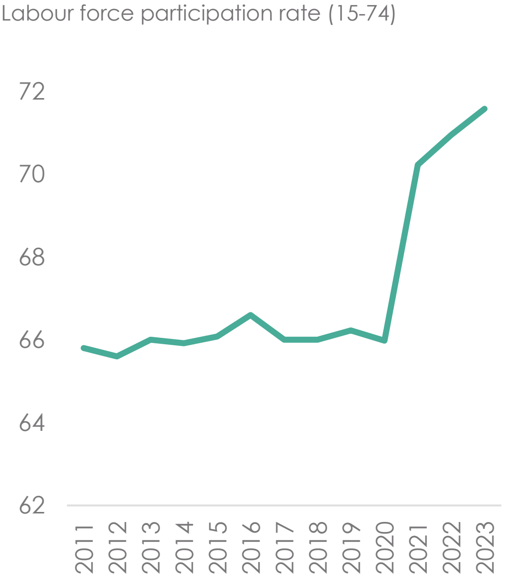
The labour force participation rate has increased substantially since the Covid-19 pandemic, and has remained high in the subsequent years (N°2).[1] However, it seems unlikely that there will be further significant increases in the participation rate over the coming years, due to an ageing population and participation rates already being at high levels.

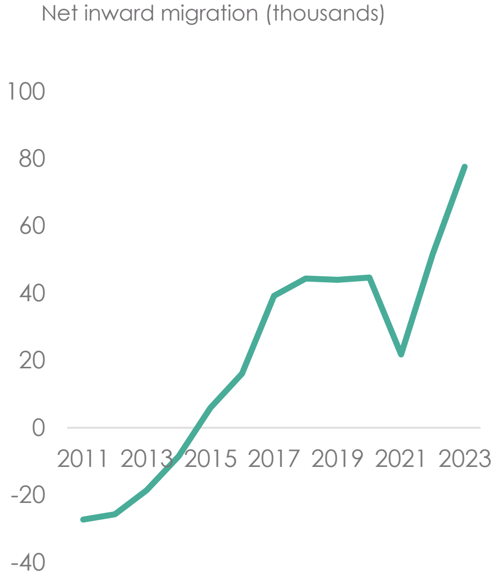
Inward migration has also added significantly to the labour force in recent years (N°2). While some of this inward migration involves refugees, much of the migration appears to be for more standard economic reasons, with workers being attracted by well-paid employment.[2]

[1] This may have been aided by more flexibility in remote-working arrangements.

[2] Box A explores where additional construction workers could come from, given plans to increase housing completions.

Nº2 Labour force growth driven by participation and migration





Sources: CSO and Fiscal Council workings.
Notes: The labour force participation rate is adjusted for the impact of the pandemic unemployment payment in the years 2020-2022. Get the data.

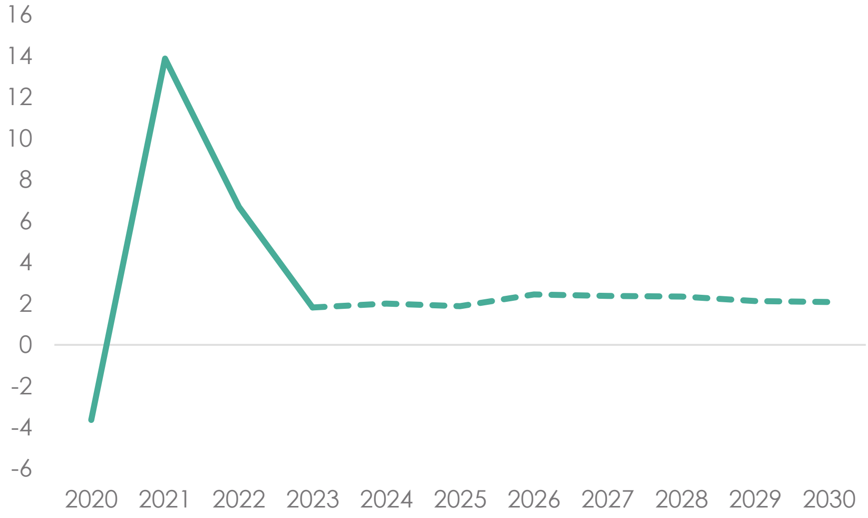
Over the medium term, *SPU 2024* forecasts the labour market to remain tight. Employment is forecast to continue to grow, albeit at a more moderate pace (1% on average over 2026-2030). Forecast labour force growth is mainly driven by continued net inward migration. The unemployment rate is forecast to be largely flat over the medium term, at just below 5%.

Growth is expected to moderate in the coming years

Economic activity continues to grow, despite headwinds from inflation, high interest rates and a mixed picture from the external environment. Early estimates suggest that real GNI* grew by around 2–3% last year, slower than previous years. *SPU 2024* forecasts growth of 2% this year, with similar growth rates for the rest of the forecast horizon (N°3).

N°3 Growth to moderate in the coming years

Real GNI* growth

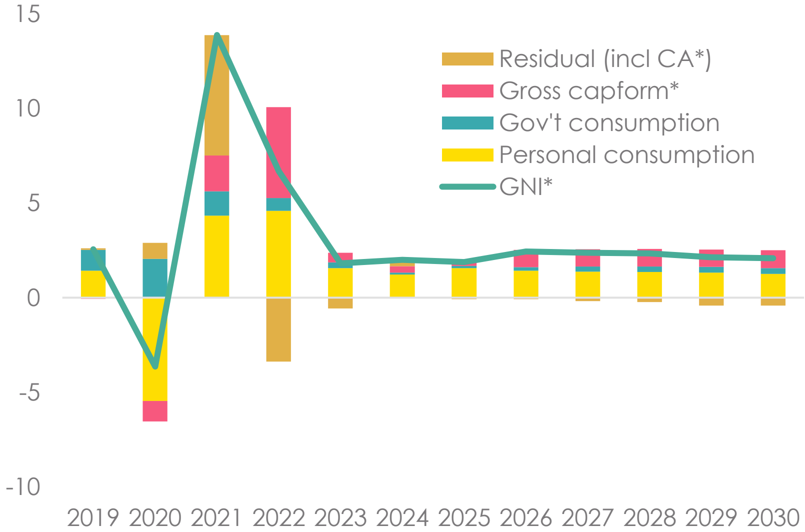


Sources: CSO, Department of Finance (*SPU 2024* forecasts). Get the data.

SPU forecasts of growth of real GNI* are driven by domestic components, particularly personal consumption (N°4). Net trade is forecast to make no significant contribution to growth in 2024 and 2025. This may reflect a more mature phase in the Irish economy as competitiveness declines somewhat.

N°4 Growth to be driven by consumption

Contributions to GNI* growth



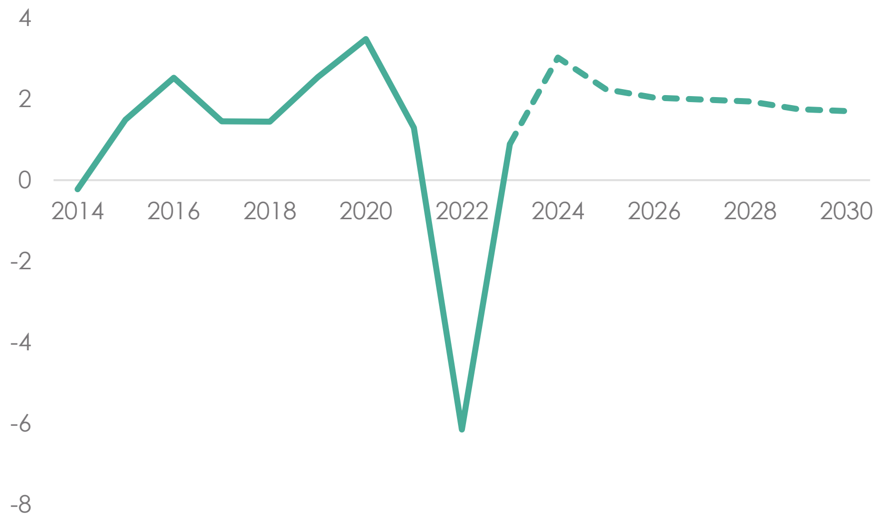
Source: *SPU 2024*. Get the data.

Real wage growth forecast to outpace productivity

Real wages are now recovering, having been reduced by the sharp increase in inflation in 2022. Modest real pay growth was recorded in 2023. A significant increase is forecast for this year in *SPU 2024*. This would still leave real wages below their 2021 level (N°5).

N°5 Real wages to recover

Real hourly wages, percentage growth



Sources: CSO, Department of Finance.
Notes: Nominal hourly wages are deflated by HICP. Get the data.

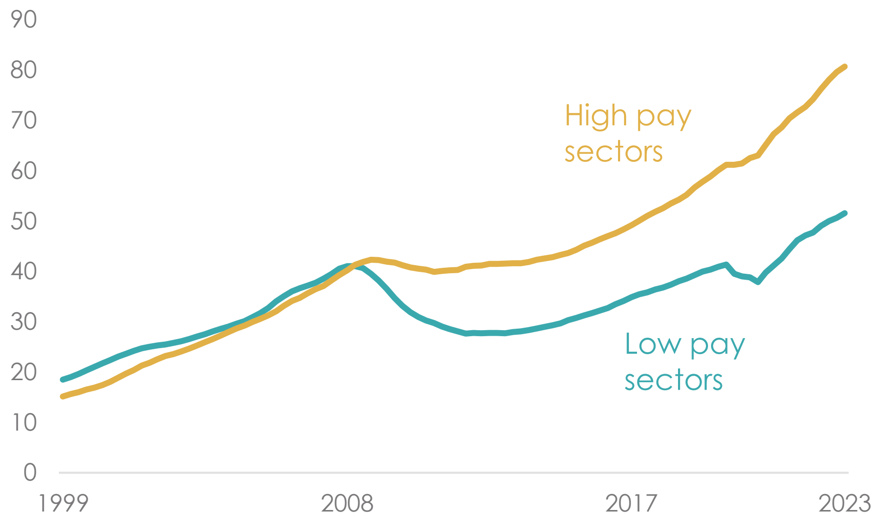
The growth in real wages comes despite modest productivity growth being forecast (N°11). Ordinarily, one would expect real wages to broadly grow in line with productivity growth. This potential inconsistency in SPU forecasts is explored further in our Endorsement Note (Fiscal Council, 2024).

As Timoney (2022) has previously highlighted, the high-paying sectors in Ireland have become increasingly important since the pandemic. Looking at overall compensation of employees, high-wage sectors are responsible for an increasing share of total pay (N°6). This is mainly driven by stronger increases in actual hours worked in high paying sectors.[3] This has significant fiscal implications. Timoney (2022) shows how strong income tax receipts in recent years have been largely driven by growth in high-paid sectors. High-paying employments ordinarily have higher average and marginal tax rates.

[3] Employment has grown more strongly in high-paying sectors, but hours worked per worker has also fallen more sharply in lower-paid sectors, which also contributes to the increasing divide in actual hours worked in the low and high-paying sectors.

N°6 High-paying sectors account for more of the pay bill

€ billion, compensation of employees, 4 quarter sum.



Sources: CSO and Fiscal Council workings.
Notes: The economy is divided into high and low-paying sectors, based on compensation of employees per hour worked. Get the data.

While the economy is set to grow at a slower rate in the coming years, overall conditions remain favourable for the Government's finances. Employment is forecast to continue growing over the medium term. Given the tight labour market conditions, this is expected to lead to strong wage increases. These developments would provide additional boost to income tax and PRSI revenue. Moreover, the persistence of low unemployment implies that government spending on unemployment supports will continue to be limited.

Inflationary pressures are abating

The rate of inflation has been slowing since the second half of 2023, with Harmonised Index of Consumer Prices (HICP) inflation in May 2024 falling to 1.9%.[4] Much of this fall in inflation has been driven by energy price falls. However, underlying measures of inflation have also fallen, though some remain elevated (N°7). Core HICP – HICP excluding food and energy – fell to 2.3% year-on-year in April, down from a peak of 5.8% in July 2022.[5]

Domestically generated inflation – inflation of goods and services with low import content – also peaked in July 2022 at 6.8% and has since moderated but remains elevated at 4.4%. A further measure of underlying inflation is the Irish Persistent and Common Component of

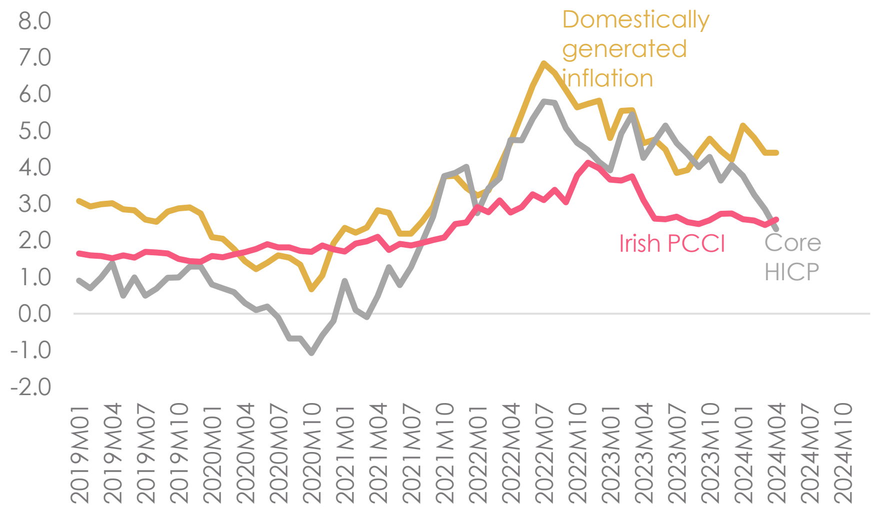
[4] This is based on the flash estimate of HICP for May. The latest available official estimate for HICP is for April, showing an inflation rate of 1.6%.

[5] The fall in core inflation is driven by falls in goods prices. Services prices continue to grow quickly.

Inflation (PCCI). Based on work by Banbura and Bobeica (2020), this measure aims to capture price pressures which are common across the consumption basket and are persistent over the medium term. This measure peaked at 4.1% in November 2022 but has since fallen back to 2.6% in April.

N°7 Underlying inflation has fallen, but remains high

% change year on year



Sources: CSO; Eurostat; and Fiscal Council workings.
Notes: Core HICP excludes energy and food. Domestically generated inflation captures the inflation of goods and services with low import content. Domestically generated inflation is based on work by Fröhling et al. (2022). See Fiscal Council (2022a) for further details. Irish PCCI is the persistent and common component of inflation (PCCI) for Ireland which is developed by the Council based on work by Banbura and Bobeica (2020). PCCI is a measure of underlying inflation that aims to capture price pressures which are common across the consumption basket and are persistent over the medium-term. Get the data.

Following Fagandini et al. (2024), input-output tables can be used to identify the components of core HICP – HICP excluding food and energy – that are sensitive to energy price increases and components that are sensitive to wage increases.[6] Using these identified

[6] Using input-output tables allows for both the direct and indirect impact of energy and wage price changes to be considered. Components are identified as energy-sensitive if their energy cost share is greater than average. For non-energy industrial goods (NEIG) components, this is an energy cost share greater than 6.1% and, for services, an energy cost share greater than 4.4%. In Ireland, in 2024, energy-sensitive components of core HICP make up 36% of the overall HICP basket. Components are identified as wage-sensitive if the direct wage cost share is greater than 38%. No component of NEIG is identified as wage-sensitive, meaning the wage-sensitive core HICP only consists of services. In Ireland, in 2024, wage-sensitive components of core HICP make up 14% of the overall HICP basket. Energy-sensitive components and wage-sensitive components are not mutually exclusive, but there is relatively little overlap between the two. A tenth of energy-sensitive core HICP is also wage-sensitive.

components, Figure N°8 shows the inflation rates for energy-sensitive and wage-sensitive core HICP in Ireland since 2018.[7]

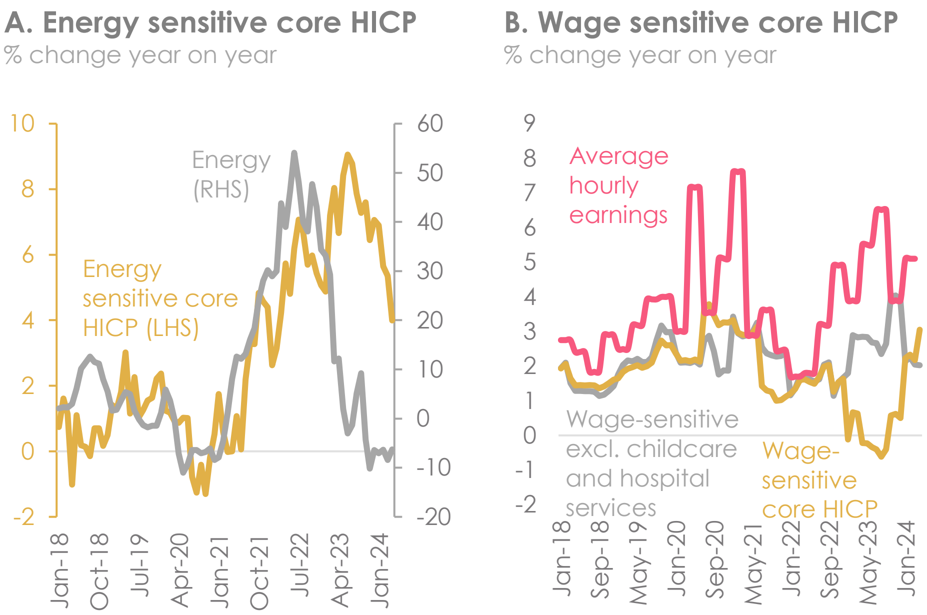
Energy inflation peaked in June 2022, while energy-sensitive core HICP peaked 12 months later (N°8A). Since then, energy prices have fallen, while energy-sensitive core HICP remains elevated, at 4% in April 2024. Energy price deflation began in June 2023; since then, energy-sensitive core HICP inflation has moderated, with prices increasing by only 0.7%. Given the previous lag time in the passthrough, energy-sensitive core HICP inflation could be relatively low in the second half of the year.

Figure N°8B shows wage-sensitive core HICP inflation in Ireland since 2018. In March 2024, wage-sensitive core HICP inflation was 3.1%. This index has been heavily influenced by changes in government policy over this period, with childcare and hospital prices being cut by government decisions. Excluding these components, wage-sensitive HICP inflation peaked in November 2023 at 4%, but has since declined to 2%. In comparison, nominal hourly wages grew by 5.1% in Q1 of 2024, a relatively fast pace. In addition, real wages are forecast to grow relatively quickly in 2024, which might result in a pickup in wage-sensitive inflation over the next 18 months.[8]

[7] Energy-sensitive core HICP makes up 48% of core HICP, while wage-sensitive core HICP makes up 19% of core HICP.

[8] This is excluding hospital and childcare services prices. Further government policies that will reduce the price of childcare services are due to kick in in the latter part of 2024.

N°8 Inflationary pressures are abating



Sources: CSO; Eurostat, and Fiscal Council workings.
Notes: Energy-sensitive core HICP is the components of core HICP identified by Fagandini et al. (2024) that have above average energy cost share. Likewise, Wage-sensitive core HICP is the components of core HICP identified to have above average wage cost share. Average hourly earnings are available on a quarterly basis and exclude irregular earnings. The peaks in average hourly earnings in 2020 and 2022 are affected by compositional issues related to the Covid-19 pandemic. Get the data.

Overall, inflationary pressures are abating and *SPU 2024* forecasts a significant fall in inflation in 2024, but risks remain.

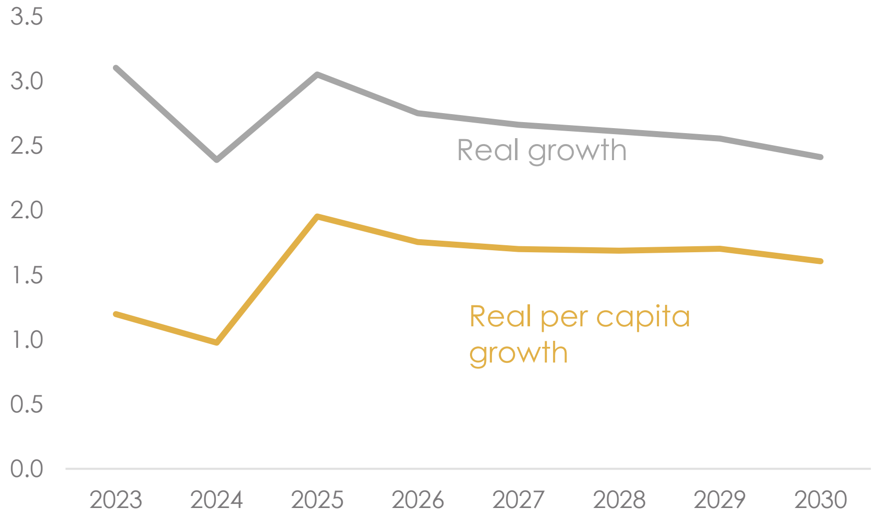
Consumption moderating

Personal consumption growth is expected to weaken to 2.4% in 2024, from 3.1% in 2023 (N°9). This fall in growth in 2024 follows on from a slow-down in growth in the second half of 2023. Despite the introduction of an auto-enrolment pensions scheme, which is planned for 2025, consumption growth is forecast to rebound in 2025 as inflationary pressures continue to ease.

This rebound in consumption growth outpaces disposable income growth, resulting in lower savings. The household savings ratio is expected to continue falling out to 2025 (N°10).

Nº9 Consumption growth expected to moderate over the medium term

% growth, year on year

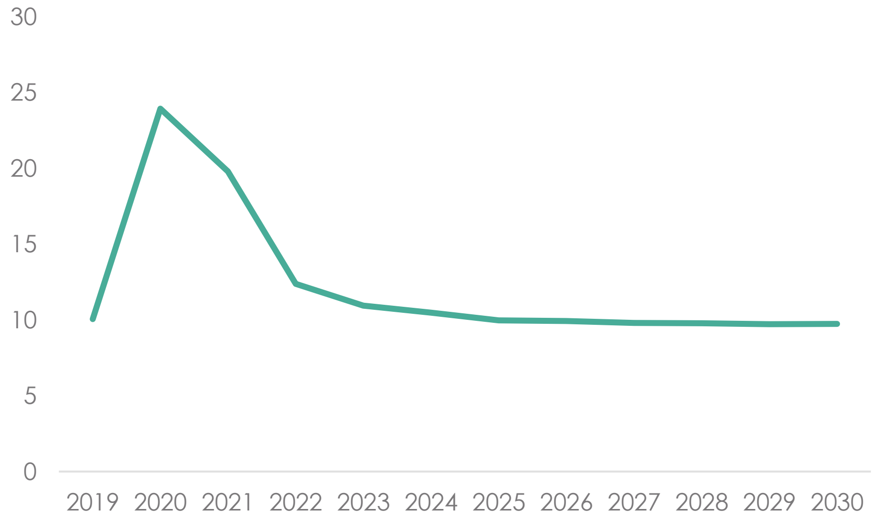


Sources: Department of Finance and Fiscal Council workings. Get the data.

Over the medium term, consumption growth is expected to be moderate (Nº9). Real per capita growth is expected to be 1.7% on average over 2026-2030. Overall, the savings rate is largely flat in the medium term, settling at close to pre-pandemic levels (10%).

Nº10 Savings ratio forecast to stabilise at pre-pandemic levels

% personal disposable income



Sources: Department of Finance and Fiscal Council workings. Get the data.

How will the Irish economy transition over the medium term?

The nature of the economy's transition to medium term will also have significant fiscal implications. Stronger productivity growth would lead to stronger wage growth. This in turn would be reflected in income tax and PRSI receipts.

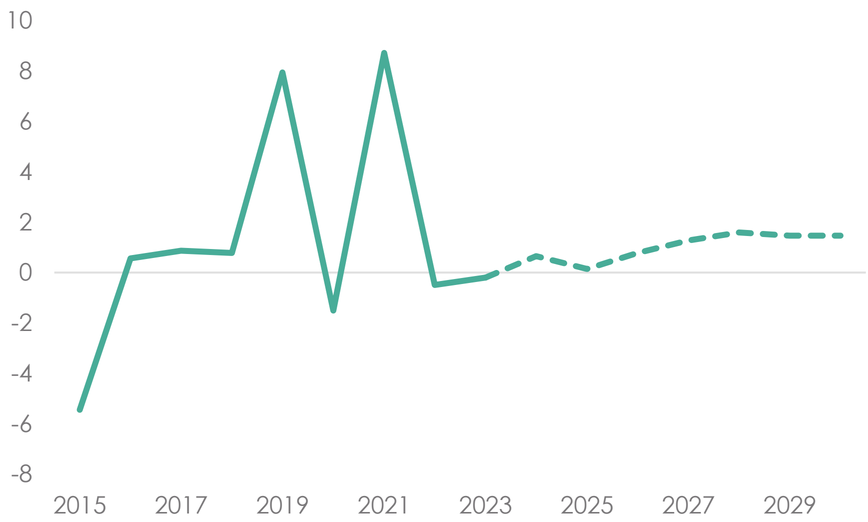
As outlined above, the Irish economy has performed extraordinarily well over recent years. *SPU 2024* forecasts the economy to smoothly transition to its medium-term growth rate of around 2–2.5% (N°3).

Productivity growth will be a key determinant of how the Irish economy transitions to its medium-term growth path. This is because increases in employment or hours worked are limited in the medium to long term, leaving productivity as the key growth driver.

Many standard measures of productivity in Ireland are distorted due to the impact of foreign multinationals. A more reliable measure of productivity is real GNI* per hour worked. *SPU 2024* forecasts imply almost no productivity growth for 2024 and 2025, before rising to 1.5% by the end of the forecast horizon (N°11).

N°11 Productivity growth forecast to recover over the medium term

Real GNI* per hour worked, percentage growth



Sources: CSO, Department of Finance, and Fiscal Council workings. Get the data.

Infrastructure and the capital stock will likely influence this transition and productivity growth more generally. If Ireland's capital stock and infrastructure remain stretched, the economy may struggle to have a high productivity transition to its medium-term trajectory. Below we explore how Ireland's overall capital stock compares to other high-income EU countries and potential issues in the supply of construction workers to deliver additional infrastructure (Box A).

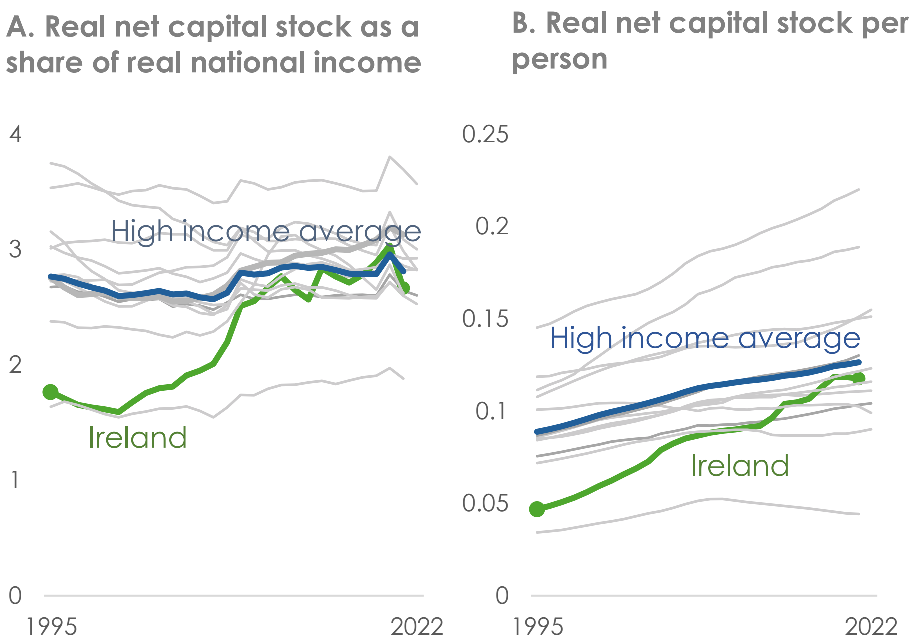
Ireland's infrastructure deficits persist

The recent growth in economic activity and population has not been matched by infrastructure investment. As a result, Ireland's capital stock has become more stretched. The Fiscal Council (2023b) showed some evidence of low levels of infrastructure in housing, health and transport.

Using an economy-wide measure, we can compare Ireland's infrastructure to that in other high-income EU countries (N°12). Whether national income or population is used as a scale factor, a similar picture emerges. Compared to other high-income EU countries, Ireland has risen from well below average in the 1990s to around average at present.

It is worth noting that the Eurostat data end in 2021 for Ireland. Given the strength of national income and population growth in the meantime, it is likely that the capital stock has not kept up with population or economic growth. So, Ireland's position could be slightly worse than is shown in N°12A and N°12B.

N°12 Ireland's capital stock has risen to mid-table EU levels



Sources: Eurostat, CSO, and Fiscal Council workings.
Notes: GDP is used for national income for all countries apart from Ireland, where GNI* is used. Capital in the manufacturing and ICT sectors is excluded for all countries due to distortions in the Irish data. The countries used are Belgium, Denmark, Germany, Ireland, Greece, France, Italy, Luxembourg, Netherlands, Austria, Finland, Sweden and Norway. In panel B, the real net capital stock (2015 prices, € millions) is divided by total population. Get the data.

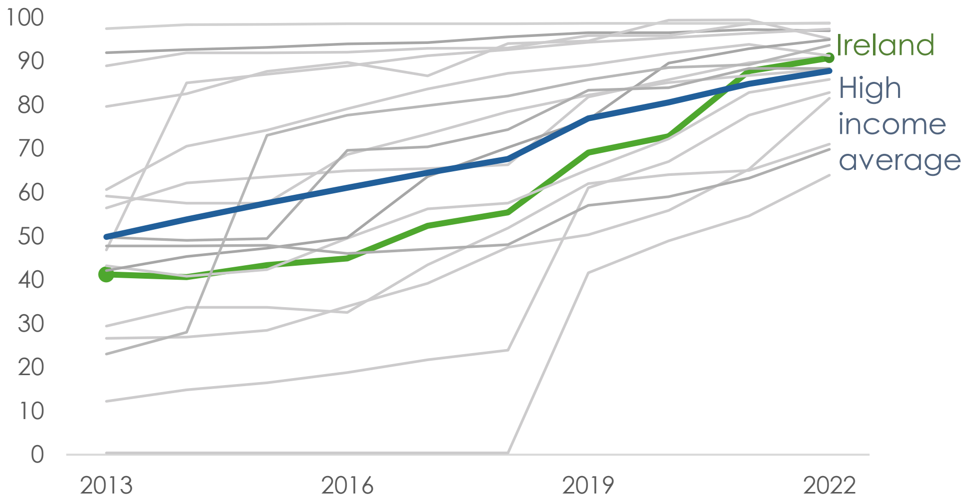
As well as catching up with areas where the capital stock is stretched (such as housing, health and transport), there will be significant investment needs for the transition to a zero-carbon economy. The overall capital stock is driven not just by government capital spending, but also by private sector firms and households. Facilitating and incentivising the private sector to invest and add to the productive capacity of the economy should be a key consideration in addressing these infrastructure deficits. This can include providing policy certainty to the private sector. However, some of the most acute shortages in Ireland's infrastructure are in areas that are predominantly publicly funded (transport and health).

Post-pandemic, remote working has become much more commonplace globally. This is particularly the case for high-value services sectors. With that in mind, high-speed broadband for households has become much more important, not just for personal use, but also for working remotely.

The percentage of households with access to high-speed broadband in high-income European countries is shown in N°13.[9] Ireland, like most other countries has seen high-speed broadband coverage increase substantially over the last decade. Despite this increase, Ireland ranks around the middle of the high-income European countries for such coverage. Given that Ireland has a large number of leading technology firms, one might expect Ireland to be a leader in high-speed broadband coverage in Europe.

N°13 Ireland's high-speed broadband coverage has improved

Percentage of households with broadband of 100 megabits per second or faster



Source: Eurostat.
Notes: The countries used are Belgium, Denmark, Germany, Ireland, Greece, Spain, France, Italy, Luxembourg, Netherlands, Austria, Portugal, Finland, Sweden, Iceland, Norway, Switzerland and the United Kingdom. Get the data.

Significant investment will be required

Housing completions in 2023 were higher than expected, leading to an upward revision in the forecast. After a modest increase this year, housing completions are projected to rise more notably over the medium term (N°14). Evidence of some reallocation of activity from commercial to residential real estate supports these projections. Box A explores the challenges of increasing the number of construction workers to ramp up the number of house completions and deliver other infrastructure projects.

There has been a strong increase in commencement of housing projects. However, this likely reflects timing effects rather than a sustained increase in housing activity. Residential projects that started

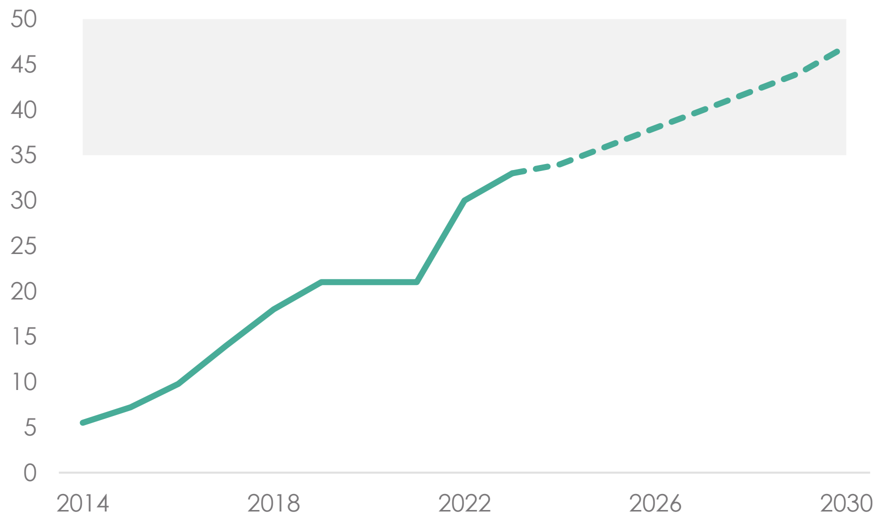
[9] For the purposes of this exercise and due to data availability and comparability, high-speed broadband is defined as 100 megabits per second or faster.

before 24th April 2024 could avail of a waiver for development contributions and a water connection charges refund scheme.[10] As a result, projects that might ordinarily have commenced later in the year may have been pulled forward to the early part of this year.

Even with these higher forecasts of completions Ireland's stock of housing is set to remain low relative to its population for some time. This shortage of housing is one of the key infrastructural challenges Ireland is facing. Addressing the multiple areas with infrastructure shortfalls is key to supporting productivity growth in the coming years.

N°14 Completions to increase

Thousands of dwellings



Sources: *SPU 2024* and Fiscal Council workings.
Notes: The shaded area provides a range of estimates of the annual requirement for housing completions. Get the data.

Modified investment is forecast to grow strongly over 2026-2030 (averaging over 5%). As a result, investment is forecast to grow as a share of output. This is mostly driven by increased housing completions and investment in machinery and equipment.

Investment in machinery and equipment is forecast to be weak this year. This is largely due to base effects, with some large projects completed last year. Thereafter, machinery and equipment investment is forecast to outpace output growth. This would be

[10] The waiving of development contributions has since been extended to projects that commence before the end of 2024. The refunding of water connection charges has been extended until 30 September 2024. To qualify for the waiver and the refund scheme, all units must also be completed by 31 December 2026 (Department of Housing, Local Government and Heritage, 2024).

consistent with the large investment required for the transition towards a zero-carbon economy.

As noted earlier, there are likely to be substantial investment needs in the coming years. These are driven by infrastructure shortfalls in certain areas, such as housing, health, and transport. In addition, substantial investment is required for the transition to a zero-carbon economy. Resolving these infrastructural deficits may be key to ensuring that productivity growth can be maintained in the medium term. Doing this, while the economy is operating at or above capacity, could be challenging.

Box A: Where will additional construction workers come from?

Ireland needs construction workers to address the housing crisis, to address infrastructural deficits and to meet climate transition targets. Addressing infrastructural deficits is key to ensuring sustained productivity growth and maintaining competitiveness internationally.

At a time when housing needs are acute, there is also a need to retrofit the existing housing stock to meet climate targets. This will place significant demands on the construction sector which will require increased numbers of construction workers. This box explores where these workers might come from.

There are both domestic sources of additional labour supply and international sources. On the domestic front, further labour supply could come from:

1) Unemployed or inactive workers: Figure N°150.A show the unemployment rate for workers in the construction sector. Unemployment in construction is at very low levels, under 1.5%, much lower than in the broader economy. As a result, this is unlikely to be a source of many workers over the medium term.

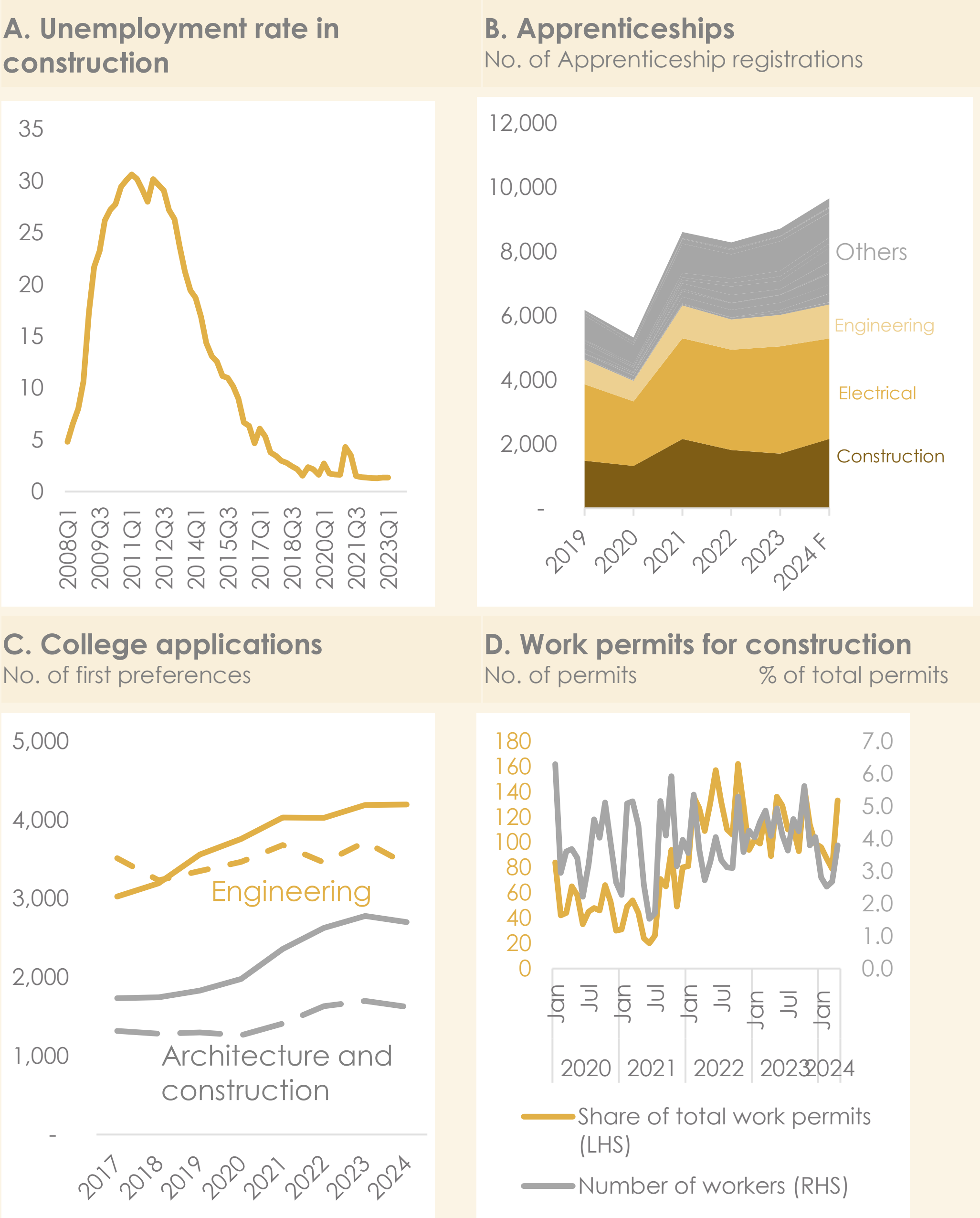
   While there has been a large increase in the inflow of refugees since 2022, at present, it seems that this is unlikely to add to the potential labour force for the construction sector given the skills and training required. For instance, 5.7% of Ukrainian refugees who are employed in Ireland, are employed in the construction sector. This is a marginally lower share of construction employees than for the economy as a whole (6.2% in 2023).

2) A switch from commercial real estate activity to residential and civil activity: Since the onset of the Covid-19 pandemic and the resultant changing work patterns, there has been a big fall-off in the demand for office space. This has resulted in a slowdown in construction in the commercial real estate sector. As activity in this sector moderates, there is the potential for workers who had been employed building commercial real estate to switch to building residential properties or other civil engineer projects. This reallocation of workers might help to address the additional labour needs.

3) Apprenticeship and college courses: Given the skills required in construction, it seems unlikely that people already in the labour force would switch sectors to the construction sector, without partaking in an apprenticeship or other training course.

   The government has a target of 10,000 apprenticeship registrations per annum by 2025. A large proportion of these would be in areas outside of construction. In 2023, there were 8,712 registrations, with almost 70% of these in construction, electrical and civil engineering (N°15.B). The growing numbers on apprenticeship programmes should add to the domestic labour supply over the medium term provided that the apprentices do not emigrate once they complete their training.[11]

N°15 Additional construction labour supply looks limited



Sources: CSO; Central Applications Office (CAO); Department of Enterprise, Trade and Employment; National Apprenticeship Office; and Fiscal Council workings.
Notes: In panel C, solid lines represent first preferences for level 8 courses, dashed lines represent first preferences for level 6 and 7 courses. Get the data.

Outside of apprenticeships, another way to learn the skills necessary to work in the constructions sector is through college courses. Figure N°150.C shows the number of first preferences listed on CAO applications for third-level courses for engineering

[11] A recent paper by officials at the Department of Public Expenditure discusses the trends in apprenticeships in more detail (Department of Public Expenditure, 2024).

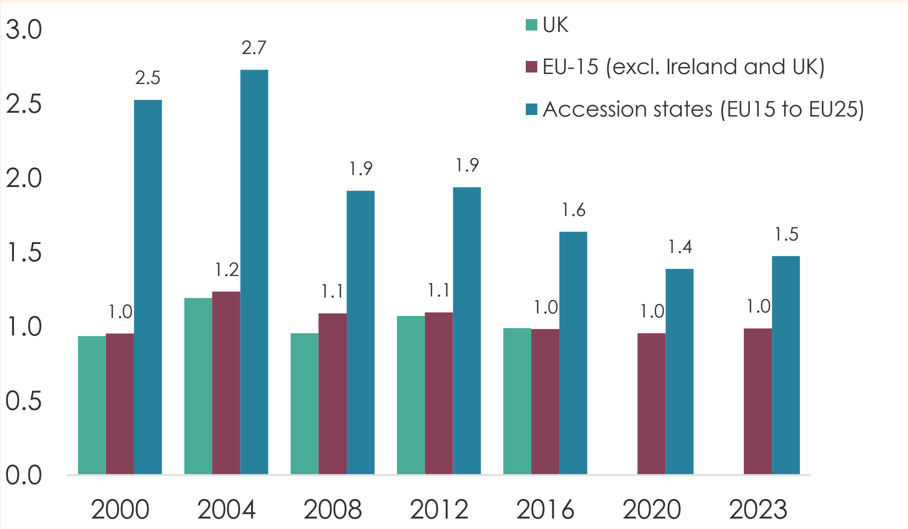
and architecture and construction. There were around 6,000 level 8 first preferences for these courses. However, first preference does not equal places in college courses.

On the international side: International labour supply channel:

1) Wage differentials: In the early 2000s Ireland's construction sector benefited from a large inward supply of migrants from other EU countries, particularly after the 2004 accession of an additional 10 countries to the EU. Part of the pull factor for this inward migration was the wage differential between these EU countries and Ireland. This differential has reduced substantially, by almost half since 2004 (N°16).
2) Work permits: The other potential source of emigration is from non-EU countries. In recent years, this has been a very limited source of construction workers. Since 2020, on average only 85 work permits per month have been issued (0.D). This is a very low proportion of total work permits, with the share of work permits issued in construction averaging 3.8% per month. This is a relatively low share as construction employment made up on 6.1% on average over the same period.
3) Returning workers from abroad. Previous work by Conefrey & McIndoe-Calder (2018) showed that many of Ireland's construction workers emigrated after the property bubble burst. Given this, there is a large stock of Irish construction workers abroad that may return. However, given the lapse in time since then, it is likely these workers are now settled, and it is unlikely that a large proportion of them will return in the near future.

N°16 Ireland is not as attractive as it once was for construction workers

Construction wage differentials. Hourly wages, Ireland relative to region specified, PPS adjusted



Sources: Eurostat; Department of Enterprise, Trade and Employment; and Fiscal Council workings. Get the data.

Conclusion

According to the recent Report on the Analysis of Skills for Residential Construction & Retrofitting 2023–2030 (Department of Further and Higher Education, 2023), Ireland needs over 50,000 new construction workers to meet its retrofitting and housing targets between 2023 and 2030. However, this is before any increase to the housing targets—which will require additional workers—and it does not include the need for construction workers for other badly needed infrastructure projects.[12] There is clearly an acute need for more construction workers.

However, taken together, there is not a large stock of unused domestic labour supply. While apprenticeship numbers and CAO applications in construction-related activities are growing, these numbers are still relatively small.

Internationally, the attractiveness of Ireland as destination for intra-EU migration has fallen substantially over the past two decades, meaning that this is unlikely to be a major channel. In addition, the number of work permits issued to non-EU workers in construction is very low. However, this may be one policy lever that could be used to increase the labour supply of construction workers.

Potential output growth slowing

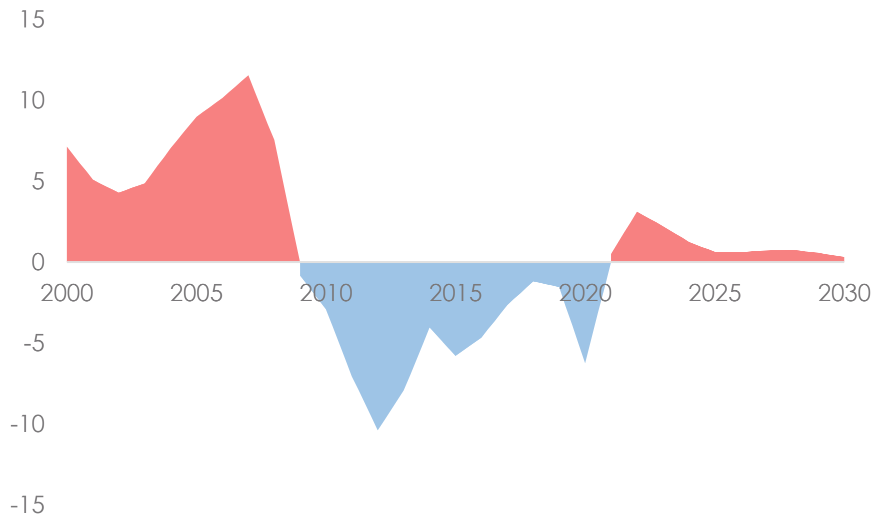
The Department of Finance uses a range of models to estimate potential output and the output gap. The midpoint of these estimates shows a positive output gap of over 3% in 2022, which then declines gradually in 2023 and 2024 (N°17). A positive output gap of less than 1% is forecast for 2025-2030. This would be consistent with an economy operating at or just above its potential capacity.

The Department estimates potential output growth to be an average of 2.2% over 2025-2030. As employment growth slows, labour makes less of a contribution. This means that capital deepening and productivity growth are the main drivers of potential output growth.

[12] The report assumes that housing completions average 34,500 each year from 2025 to 2030. Actual housing need is likely to be higher than this.

Nº17 Modest positive output gap forecast

Output gap, percentage of potential output



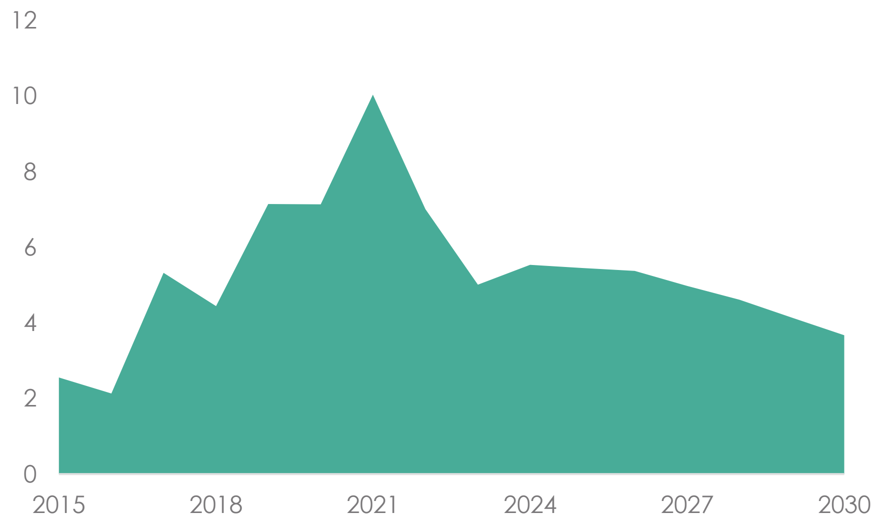
Sources: *SPU 2024*, midpoint of estimates shown.
Notes: Positive/negative output gaps indicate output is above/below its potential level.
Get the data.

Modified current account

The modified current account surplus is projected to fall over the forecast horizon (N°18). This is partially driven by the fall in the household savings rate. The forecast government surpluses contribute to the current account remaining at high levels over the medium term.

Nº18 Current account surplus falling in the medium term

Modified current account balance (as a share of GNI*)



Sources: *SPU 2024* and CSO. Get the data.

Risks are broadly balanced

The supporting information section, S3, assesses the macroeconomic risks outlined in *SPU 2024* as well as additional risks identified by the Council. Overall, the Council sees macroeconomic risks as broadly balanced. Both fiscal and monetary policy are likely to be looser than ideal. This would add to price pressures and risks of the economy overheating. Higher migration or a faster fall in inflation would pose upside risks for the economy.