Rialtas na hÉireann
Government of Ireland

Economic Recovery Plan 2021

Accompanying Background Paper: Accelerating Trends and Shifts

Prepared by the Department of the Taoiseach
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Accompanying Background Paper: Accelerating Trends and Shifts

The pandemic has accelerated many trends and shifts that have been emerging for some time. The growing digital economy; decarbonising the economy; labour market composition changes; global developments including Brexit, geo-political change, trade protectionism, international taxation, inflation risks, and demographic change among others comprise a complex landscape.

Some of the most noticeable changes include the shift to online retail and to electronic payments, and to greater levels of remote-working. Associated changes in consumer behaviour and patterns of activity may lead to longer term shifts, including potentially long-term impacts on the traditional functioning of our cities and urban spaces. The acceleration of digitalisation may also offer a positive productivity dividend. The Irish economy is also now dealing with the aftermath of Brexit, and the changes it brings to trade flows with and through the UK (excluding Northern Ireland). In addition, the pandemic has induced a further shift towards de-globalisation. Some of this was policy-induced, with a number of governments introducing protectionist policies and others encouraging the re-shoring of production. Many of these changes are likely to be permanent. In addition, inflation trends globally are being monitored, and supply constraints in terms of housing continue to be a concern in the Irish context.

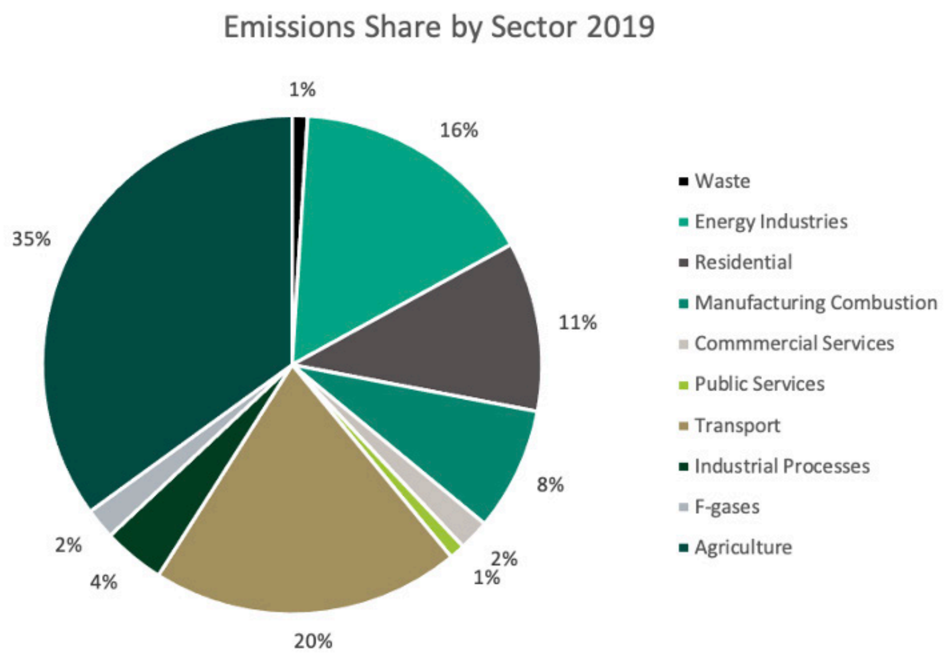
Each of these trends on their own has the potential to reshape businesses and lifestyles in significant ways, and they will increasingly interact with one another creating novel opportunities and challenges. A key objective will be to facilitate and support the movement of firms and workers into expanding areas, as we work towards our overall ambition of exceeding pre-crisis employment levels by reaching 2.5 million people in work by the end of 2024.

Decarbonisation Transition

Over the next decade, Ireland faces unprecedented structural economic change through the transition away from fossil fuels to a low carbon economy. The Government is committed to achieving net zero emissions by 2050 and recognises the long-terms costs of not doing so.

Despite a decrease in greenhouse gas emissions by 4.5% in 2019, the figures indicate that Ireland will exceed its 2019 annual EU emissions allocation by 6.98Mt which makes it highly unlikely that Ireland will meet its overall 2020 targets, even taking the impact of COVID-19 on emissions in 2020 into account. Significant effort will be required across our economy especially among the largest contributing sectors, which are Agriculture (35.3%), Transport (20.3%) and Energy (15.8%).

Figure 1: Emissions Share by Sector 2019



Source: EPA

An Accelerating Digital Economy

Technology is profoundly changing our society and economy. It is driving the emergence of a new digital and knowledge-based economy which is reshaping what we all do and how we do it. Remote working and online shopping have considerable implications for the future landscape of our urban and rural spaces; and increased automation has implications for employment, labour pools, working environments and conditions, and indeed the volume and type of future FDI flows. OECD analysis has forecast that two in every five jobs in Ireland face a significant risk of automation in the next two decades. Some industries will not offer the same employment as they once did or will require different skillsets, while other activities may be replaced altogether by new industries that don't even exist today.

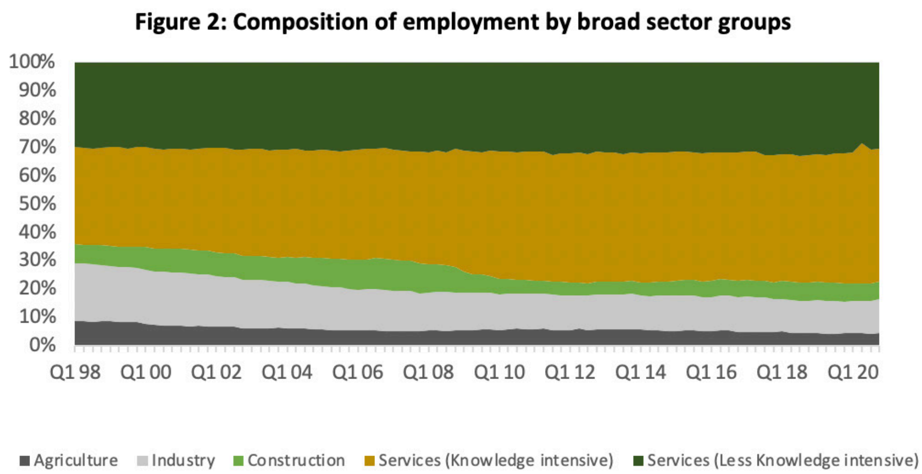
In many cases, higher wages are likely to become increasingly skewed towards occupations with the skills necessary to work with technology, while those in other more labour-intensive occupations may see their incomes stagnate or even decline[1]. However, labour intensive occupations associated with the caring and health sectors are likely to be insulated due to the nature of this work.

1 Hays Global Skills Index - https://www.hays-index.com/

Human Capital and Labour Market Composition Changes

In recent times, the Irish labour market has experienced significant turmoil and has shown a remarkable ability to recover. However, the negative impact of the pandemic has highlighted longer term structural changes facing the workforce, such as digitalisation and sectoral shifts. Over the last 20 years, the employment composition of the Irish economy has moved increasingly towards the services sectors, and in particular to the knowledge intensive services sector, as outlined in Figure 2 below. This trend is likely to continue and may be accelerated by the impact of COVID-19. Ireland's changing demographics, with an increasing share of older people in the population, will also have implications for employment growth, with increasing opportunities emerging in the care and health sectors, for example.

Figure 2: Composition of employment by broad sector groups



Source: CSO Labour Force Survey

Other Important Trends

Global Developments

Ireland's highly open export-orientated economic model has proved extremely robust through various international shocks, not least over the last year. This model is however sensitive to global changes including tensions between the largest trading blocs and wider "de-globalisation" trends. There are a number of significant downside risks over the medium term facing the global economy, some of which have been exacerbated by the pandemic. Adverse external developments could impact the Irish economy through numerous channels, including through exchange rate fluctuations, Foreign Direct Investment (FDI) flows, reduced demand for exports, on-shoring supply chains, increased public and private sector borrowing costs, and deteriorating consumer and market sentiment. Ireland is particularly sensitive to developments in global value chains given its comparatively high dependence on foreign produced inputs in domestic production of goods for exports. In addition, increased tariff and other barriers to trade would adversely affect the exports of Irish firms and multinational corporations (MNCs) operating in Ireland and potentially increase import costs for inputs.

Openness to foreign investment has been a key driver of Ireland's economic development, however, attracting investment is becoming increasingly competitive. Recent incentives to re-shore in the US highlight how quickly the economic calculus facing multinational corporations can change. Compounding the challenge is the profile of FDI in Ireland. Foreign investment is heavily concentrated in Ireland's high value-added sectors such as pharmaceuticals, digital services and ICT. Ongoing uncertainty around the future international tax and IP frameworks governing these sectors, as well as technological change, represents risks.

2021 will be a critical year for International Tax as agreement is sought at the OECD on addressing global tax challenges, in particular that of digitalisation. In October 2020, the **OECD BEPS Inclusive Framework** published a series of progress reports on work to address the tax challenges of digitalisation. Ireland will continue to engage constructively with the work in the BEPS Inclusive Framework, and remains optimistic that an agreement can be reached in 2021. These discussions must be considered in the context of the broader challenges we will be facing as we emerge from the pandemic. Changes to corporation tax regimes have impacts not just for our public finances but potentially more importantly for our industrial policy.

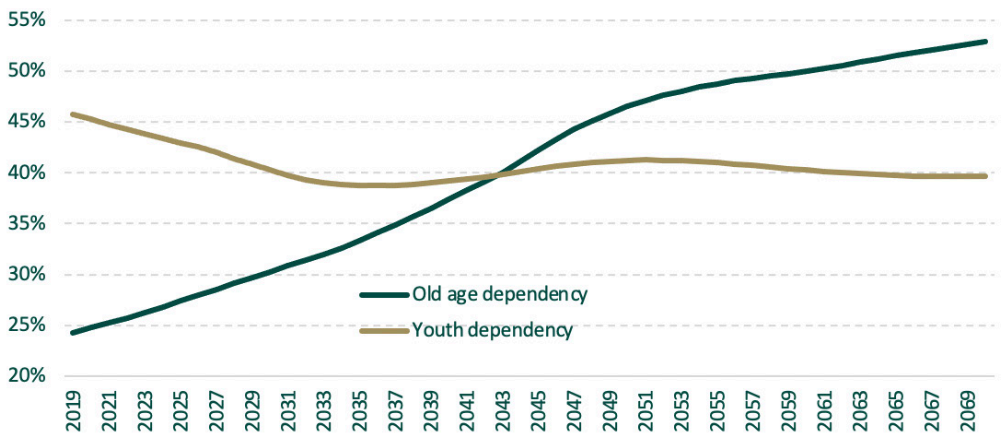
Ireland's corporation tax regime will remain competitive, fair and sustainable with the 12.5% rate at its core. The Government will focus on increasingly attracting a broader spectrum of multinational corporations across geographies and sectors and on simultaneously boosting the indigenous sector. This is part of a broader approach to increased diversification of our exports, not least in the context of Brexit.

While the **full, and longer-term impacts of Brexit** for the economy will remain unclear for some time and to a large extent have become entangled with pandemic impacts, the overall level of output for the Irish Economy is expected to be lower than if Brexit had not occurred. Over the short term there may continue to be supply chain disruptions. Longer term, notwithstanding the significant opportunities for Foreign Direct Investment and export diversification as a result of Brexit, a reduction in output is expected. Brexit will also likely see the emergence of a considerable competitor on the margins of the EU, the consequences of which are not yet clear.

Demographic Structural Changes

Ireland is fast catching up with Europe when it comes to demographic challenges. According to Eurostat's long term demographic projections (EUROPOP 2019), Ireland's population could grow to more than 6 million people by 2050 and 6.5 million by 2070. However, despite a growing population, the old age dependency ratio is projected to increase steadily, rising by an average of 3 percentage points every five years, (as illustrated in Figure 3 below). By 2050 this ratio will have nearly doubled from its 2019 level. Rapid ageing of the population structure marks Ireland out as one of the fastest-ageing populations in the EU.

Figure 3: Projected youth and Old age dependency ratio, per cent



Source: Eurostat

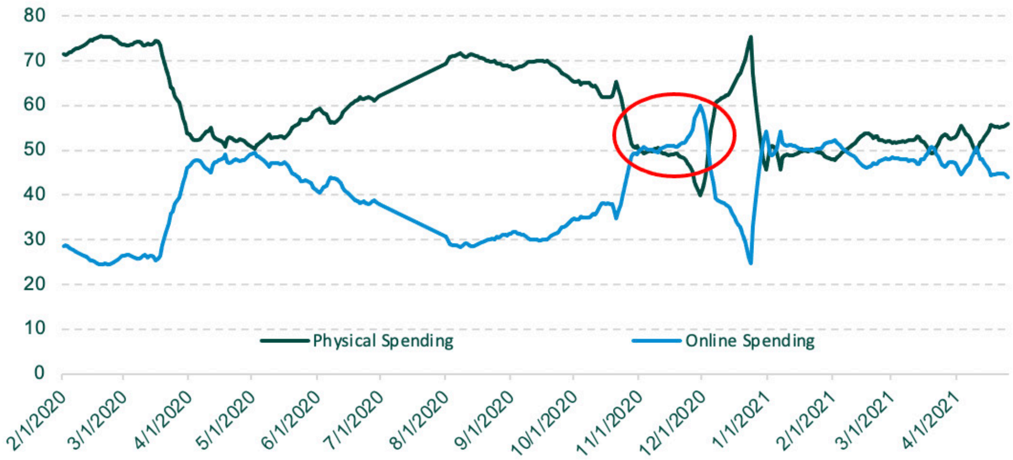
The increase in the share of older people in the population will have significant implications for the economy in the long term. Total age-related expenditure is projected to increase by 10.1 percentage points of GNI* over the forecast period reaching 31.5 per cent of GNI* by 2070.

An ageing population will have significant long-term consequences for public spending across pensions and health. Moreover, the EU fiscal rules take account of future ageing costs, with a stricter medium-term budgetary objective (MTO) required for Member States facing a significant increase in ageing costs that fail to take appropriate action.

Consumer Behavioural Changes

The restrictions necessary for controlling transmission of COVID-19 have disrupted how we all work, consume and socialise. The disruptions have manifested in many ways, most clearly with shifts to remote working and online shopping as well as a collapse in travelling. According to consumer data from financial technology company Revolut, for the first time ever in Ireland, the share of expenditure using debit cards going to online transactions exceeded physical purchases in November last year, as set out in Figure 4 below. This shift to online activity is also reflected in data from Central Bank of Ireland and may become a more permanent feature with implications for employment, business models, and domestic value-added as most online purchases are sourced from abroad. These changes are particularly pertinent in sectors such as retail, with implications for our cities and urban areas from reduced footfall, as well as the banking sector, with banks increasingly moving their services online, in response to changing consumer behaviours.

Figure 4: Proportion of debit card spending spent online and physically



Source: Revolut, Department of Finance calculations.

Productivity Growth

Ireland has seen remarkable income growth over recent decades, however the pace of growth has slowed since 2000 in keeping with well-developed advanced economies. Ireland has also experienced a slowdown in overall labour-productivity growth, with relatively high levels meaning the scope for catch up growth is limited, though accelerating technology provides potential further future boost. However, significant productivity differences persist between foreign owned and indigenous sectors, as outlined in Figure 5 below. Annual average growth in labour productivity over the period 2000 to 2018 for the foreign owned sector was 9.3% compared to 1.5% for the domestic sector.

How COVID-19 will have affected Ireland's productivity growth remains uncertain. The disruption caused by the virus could harm productivity growth if resources (i.e. capital and labour) are slow to reallocate towards fast growing industries. As well as this, innovation could be impaired by lower spending on research and development owing to the prolonged period of elevated uncertainty. However, there may also be a 'digital dividend' spurred by the crisis, via the increased adoption of new technologies. This feature of the pandemic may accelerate the digital transformation of the economy and contribute positively to productivity growth.

Figure 5: Labour productivity – domestic and foreign firms, per cent

Source: CSO

Inflation

Inflation in large regions such as the euro area is determined by the interaction of demand and supply. While other factors such as temporary disruptions to supply-chains or indirect tax changes will also impact, these are more of a one-off shift in the price level than inflation per se. The pandemic has proven to be both a demand-side shock (spending by households and firms has fallen) and a supply-side shock (firms have been closed, workers have left employment). April's Stability Programme Update noted that at a global level, the pandemic in the first instance exerted a dis-inflationary impulse, with the fall in aggregate demand exceeding the contraction in aggregate supply. In-line with this global trend, Irish consumer price inflation averaged -0.5 per cent for 2020. However, while consumer price inflation remained relatively subdued in the opening months of this year, the annual rate of change is expected to pick up as the year progresses. This expectation is framed by a number of temporary and one-off factors, including higher oil prices and a pick-up in demand as the economy re-opens. In terms of the latter, the pace at which supply responds will have a key bearing on (non-traded) domestic services prices (hospitality, entertainment, etc.), with the possibility of some margin building also a factor. Also in the short-term, Brexit impacts on trade costs may also pass through to consumer prices.

For 2021, the SPU forecasts headline HICP inflation of 1.1 per cent and 'core' (excluding inter alia volatile energy prices) inflation of 0.7 per cent. A further increase is projected in 2022 as the economy continues to recover from the pandemic, with services inflation driving both headline and core inflation. While the inflation outlook over the medium-term is more uncertain, nonetheless, inflationary pressures are expected to continue to increase in line with a more sustained economic recovery.

An increase in inflation in Ireland or in the euro area is not necessarily a negative development. A re-anchoring of inflation expectations at around 2 per cent, consistent with price stability would be a positive development. If, however, the supply capacity of the economy was permanently affected by the pandemic (permanent exit of firms and workers), inflation pressures could potentially become more pertinent. With vaccination now being rolled out, and the end of the most severe phase of the pandemic in sight, demand in Ireland and across the euro area can be expected to increase. The release of pent-up demand financed by the unwinding of household savings has the potential to fuel inflationary pressures from the second half of this year as the vaccine roll-out progresses and the economy is re-opened. This rapid release of pent-up demand could eliminate spare capacity in the economy: in other words, the increase in demand might arise more rapidly than the ability of firms and workers to respond. In that regard, the ability or capacity of firms to respond to rapidly increasing demand could be constrained by factors such as the need for on-going, albeit less restrictive, social distancing measures. Additionally, firms could find it difficult to re-hire workers in the sectors hardest hit by the pandemic. Broadly speaking this is especially true in sectors where transactions between producers and consumers require face-to-face contact and have been more adversely affected.

Additional inflationary pressure points in the domestic economy could also include potential labour market shortages in the construction sector over the coming months which could feed into wage inflation, and capacity constraints in the construction and housing sector more generally.

While not a baseline scenario, if euro-area inflation were to move significantly beyond 2 per cent for a prolonged period of time, pressure could arise within some parts of the European monetary system to taper its purchases earlier than expected. Domestic policy should therefore be cognisant of the risk of a sustained rise in inflation which in turn could trigger higher (market / policy) interest rates.

Housing

Capacity and supply issues remain a significant challenge in the Irish housing market, and have been exacerbated by the pandemic.

Once the recovery takes hold, there is a likelihood of a release of pent up demand, boosted in part by the unwinding of household savings, which may result in house price inflation. This is in the context of reduced supply over the course of the pandemic, due to restrictions on construction sector activity, as well as increased uncertainty and reduced confidence. The main longer-term impact on the housing market of COVID-19, therefore, is expected to be an increasing imbalance between the supply and demand for properties, exacerbated by the long lag between increased demand and supply catching up and the fact that stock shortages were a pre-pandemic reality.

Work undertaken by the ESRI to identify future, long-term structural demand for housing was published in December 2020. The report provides estimates of structural housing demand at a local authority level out to 2040, based on regional demographic projections and projections for rates of household formation. The report examines a 'business as usual' baseline population projection scenario based on current trends and medium-term projections for the Irish economy, as well as alternative scenarios that incorporate both higher and lower international migration assumptions and a spatial distribution of the baseline projection in accordance with the objectives of Project Ireland 2040 (National Planning Framework scenario).

The baseline scenario sees the total population expected to increase to over 5.665 million people by the end of 2040. In a high international migration scenario, the total population would reach almost 6 million by 2040, versus a low international migration scenario of around 5.554 million people by 2040.

At a regional level, in the baseline scenario, the Eastern and Midlands region is expected to experience the fastest population growth, with Dublin expected to continue have the highest population share, and the Northern and Western region having the slowest rate of growth, showing signs of an ageing population.

The ESRI analysis, when combined with existing demand, indicates **annual average demand for housing arising from a total of just over 33,000 new households across the four tenures of privately owned and rented, and social and affordable housing each year over ten years to 2030**. This will require annual levels of total housing output to increase in the years ahead and to exceed that figure for several years thereafter.

Achieving this ambitious output links strongly with our skills architecture, ensuring the capacity is there to meet the significant supply challenge.

These wide-ranging issues represent considerable changes and present longer-term challenges and indeed opportunities, which the Economic Recovery Plan and related forthcoming strategies seek to manage and optimise.

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