



# IBEC Pre-Budget Submission 2010

Submission to the Minister for Finance

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# 1. Summary of recommendations

## **Priorities for Economic Recovery**

IBEC's strategy for economic recovery can be summarised as follows:

- Restore order to the public finances
- Ensure proper functioning of the financial sector and deliver substantive improvements in the availability of credit to businesses and households
- Reinvigorate the labour market by protecting existing enterprises and employment; reducing administered wages and prices; supporting training; and implementing effective active labour market policies
- Retain focus on restoring competitiveness through strategic investment in education; infrastructure; energy; and R&D and innovation

## **Correcting the public finances**

- There should be no relaxation of the target to reduce the General Government Deficit below 3% by 2013
- The bulk of the fiscal adjustment process should be frontloaded to Budget 2010. This will boost consumer expectations of future economic prospects and reduce debt servicing costs
- The fiscal adjustment in Budget 2010 of €5 bn should consist of a €4bn reduction in current expenditure; €0.5 bn in tax base broadening; and €0.5 bn in capital expenditure savings
- The €4 bn current expenditure savings should comprise of €1.4 bn in public sector pay; €1.3 in social welfare costs and €1.3 in delivery of services

## **Taxation**

- There must be no further increase in the income tax burden
- Health and income levies should be incorporated into the existing tax rate structure
- In the absence of a complete overhaul of the PRSI and welfare systems, there should be no further increase in, or removal of, the employee PRSI ceiling
- Tax relief on personal pension contributions should remain at the marginal tax rate
- The tax system should remain supportive of recent Government initiatives to promote employee financial involvement
- Excise on alcohol should be reduced in order to stem the losses to the Exchequer from the growth in cross-border shopping
- A revenue raising carbon tax should not be introduced in the current economic climate

## **Delivering the Smart Economy**

- In order to maintain Ireland as an attractive location for international skills (needed to deliver the Smart Economy), the remittance basis of taxation should not be removed
- Funding and implementation of the Strategy for Science, Technology and Innovation (SSTI) should be maintained
- Savings accrued through the removal of duplication in administration and research in the SSTI, should be re-allocated to technology transfer and programmes that will yield a commercial return within a five year period
- Release resources from the residual National Training Funding investment account to support in-company training
- Companies should be allowed to offset the R&D tax credit relief against either their employer's PRSI liability or corporation tax
- Introduce flexibility in the selection of the base year for the R&D tax credit scheme

## **Stimulating Enterprise and Employment**

- A Government backed trade credit insurance scheme should be introduced urgently
- A further tranche of funding should be provided through an expanded employment subsidy scheme and through the Enterprise Stabilisation Fund
- Introduce a dedicated bursary system for graduate internships
- Apply a reduced employers' PRSI rate or similar stimulus for any new jobs created during 2010

## **2. Priorities for economic recovery**

### **2.1 Global economic Outlook**

The global economy has pulled out of recession in the second half of 2009, thanks to aggressive monetary and fiscal policy intervention. However, the IMF forecast in October that the world economy will contract by 1.1% in 2009 as a whole, before returning to growth of 3.1% in 2010. Recovery remains fragile and the timing of the exit strategies (withdrawal of stimulus) will be crucial. An early withdrawal risks a so-called double dip recession. Leaving the stimulus in place for too long could cause an upsurge in global inflation. The rebalancing of the global economy also remains a substantial challenge. The export-led countries with significant current account surpluses, such as China and Germany, will need to reorient their economies more towards domestic demand. On the other hand, countries such as the US and the UK that have relied too heavily on domestic demand must do exactly the reverse.

The financial crisis may have resulted in permanent damage to world potential output; the IMF forecasts that global output will grow by around 4% during 2010-2014, "appreciably less than the 5% growth seen in the years just before the crisis". Rising unemployment in the wake of the financial crisis presents a challenge in most advanced economies. If the economic recovery fails to gain momentum, unemployment may approach 10%.

### **2.2 Outlook for Domestic Economy**

We believe that GDP will fall by 7.5% in 2009; employment will fall by 7.8%; tax revenue will yield only €32 billion despite the increase in taxes announced in the April Supplementary Budget; and the deficit on the general government balance will be at least 12% of GDP or over €20 billion. The first quarter of 2009 was a period of most rapid contraction and available evidence suggests that the pace of decline will decelerate over the following four quarters.

Serious uncertainties still prevail with regard to the restoration of normal credit conditions; also, the precarious nature of the public finances injects considerable doubt as to the extent of the deflationary impulse the 2010 Budget will impart; as a result, our expectation is that consumer spending will continue to be weak. The manufacturing PMI has shown some less negative tendencies as also the service sector PMI. However, the surveys remain downbeat, making us question the likelihood of a return to growth in early 2010. For these reasons, we think that growth will fall back by a further 1.6% in 2010 only returning to growth of around 1.7% in 2011. Provided the global economy continues to gain pace through 2011 – which is not certain – GDP growth could accelerate over the course of the next two years, perhaps hitting 3.5% to 4% in 2013. It is unlikely that these more positive influences will be reflected in any employment growth before 2012. The fall in the labour force arising out of renewed emigration and a lower participation rate should contain the rate of unemployment to under 14%.

The further loss of at least €2 billion in tax receipts in 2009 lowers the base on which 2010 tax revenues are derived, adding to 2010 funding problems. This makes it all the more urgent that government reduces expenditure levels as it is clear increasing taxation in a depressed economy is unlikely to result in a higher revenue yield. International evidence and our own experience of the 1980s suggest that sharp focus on expenditure reductions, while slowing the economy in the short-term would bring greater and more rapid gains in the medium term. The evolution of tax revenue in 2009 only

adds weight to the urgency with which cuts need to be effected. Our recommendation to government is that significant steps towards achieving the target to reduce the deficit on the General Government Balance to 3% of GDP by 2013 should be made in the 2010 Budget and that the vast bulk of this reduction should be achieved through spending cuts, including pay and social welfare. There is a short window of deflation in which such reductions could be achieved while protecting real living standards.

## 2.3 Priorities for Economic Recovery

### **Restore stability to the public finances**

The supplementary Budget in April began the process of restoring stability to the public finances. It is crucial that the international investment community are convinced that the Irish exchequer finances are being credibly managed to restore that stability. The measures taken so far do seem to have gained credibility though government has had to bare an interest rate premium on its borrowings.

IBEC supported the emergency measures required in 2009 and advocated that further necessary adjustments over the next year or two should concentrate on expenditure cuts. Any tax measures should be both sustainable and be least likely to cause harm to economic growth and employment. To this end the Government has two reports on which to draw: the *Special Group on Public Service Numbers and Expenditure Programmes* and the *Commission on Taxation*.

### **Ensure the proper functioning of the financial sector**

The main concern of the business sector is to restore the proper functioning of the financial system to provide credit worthy companies with the necessary working capital and investment funds to pursue their ongoing activities and expansion and innovation plans; and to restore credit to consumers. A further requirement is that international confidence is restored to Ireland in the aftermath of the loss of reputation resulting from the collapse of the financial and construction sectors.

Ridding the banks of impaired assets to enable them to function in the provision of credit to businesses and consumers is the major concern of business. The operational establishment of NAMA as speedily as possible now seems the best way forward.

### **Reinvigorate the Labour Market**

Arguably, one of the biggest costs to the economy of the recession is the loss of jobs and the sharp rise in unemployment. There are two important measures needed to stem the increase in unemployment that we believe will reach 14% in 2010. The first is to take every measure possible to minimise employment losses, the second is to ensure that the sharp rise in cyclical unemployment does not translate into long-term structural unemployment which has characterised the past.

- **Minimise employment loss:** The Temporary Employment Scheme, which came into operation in at the beginning of September, was a welcome support for exporting companies to trade through the recession with the help of a subsidy of €9,100 over a 15-month period for up to 55 employees. We suggest that the scheme be broadened to include other sectors of the economy by supporting employment in firms threatened by import displacement or in firms engaged in sub-supply to the export sector. It is important that businesses in important sub-supply sectors do not lose employment or their skilled workforce, which would dampen the robustness of the recovery.

Government should consider the suspension of employers' PRSI payments to help use this period of deflation to drive down costs, while minimising employment shedding in the course of the recession.

- **Reduce the Minimum wage and make appropriate adjustments to social welfare:** Income levels have reduced across the board and must reduce further if Irish competitiveness is to be fully restored. The fall in incomes in 2009 have distorted existing replacement ratios and an unchanged minimum wage acts against the downward direction of all incomes in restoring competitiveness. If incomes do not reduce the only other outlet for lost competitiveness in a single currency is higher unemployment.
- **Support training:** The opportunities to support enterprise-led training offered by the recession should not be missed. Many companies that are striving to maintain as many employees as possible through moving to short-term working could, with incentives, utilise the opportunity to enhance skill levels within the company, which would place them in a more competitive position to prosper when the global economy recovers.
- **Implement more active labour market policies:** There is a need to increase Jobs Search Supports capacity and retraining in sectors, which have, restructured and downsized. Special measures are required to recognise the needs of the highly educated unemployed to ensure that they remain motivated and trained; otherwise when the global economy lifts ahead of an Irish recovery, there is a danger of losing important skills through emigration. Measures are needed to help newly graduating unemployed to gain work experience.

#### **Ensure medium-term priorities remain focused on competitiveness**

In the urgency to stabilise the exchequer finances, there will be a temptation to implement across-the-board cutbacks which could impinge on Ireland's medium to long-term competitiveness. Building the Smart Economy is already part of Government's agenda. Key areas of this agenda must progress side by side with the necessary retrenchment of other areas of expenditure. Prerequisites for the Smart economy include: creating an innovative island economy, enhancing the environment; securing energy supplies; providing critical infrastructure; and ensuring an efficient and effective public service. Much of the Smart Economy approach requires delivery and despite the current difficulties, there must be evidence that these issues, which are vital to recapturing and maintaining our competitive position in the global economy, are being pursued in the 2010 Budget.

- **Education:** In particular, the continued supply of well-educated people to the workforce requires the necessary educational infrastructure to produce sufficient workers with the appropriate skills.
- **Ambitious public capital investment programme:** Completion of all major essential road and transport infrastructure is needed for intercity travel and convenient modern commuting capacity.
- **Energy:** The energy infrastructure must ensure security of supply and compliance with our EU obligations through increasing the production of renewable energy; from a sustainability point of view and ultimately a cost point of view there must be progress towards installing an East-West interconnector.
- **R&D and Innovation:** The Government should increase the incentive for the commercialisation of good ideas and new products; enhance R&D and innovation by extending the tax credit to service companies; and further improve the environment for IP.

## 3. Strategy for corrective fiscal policy

### 3.1 Introduction

Government has recognised that correcting the public finances is one of the three essential steps in economic recovery. Over the past year or so it has taken a number of steps in its efforts to limit the rise in the budget deficit. Unfortunately the measures taken have been neither of the correct type or of sufficient scale. Budget 2010 has now become a defining moment for Ireland's future economic prospects. It is essential that Government takes the brave decisions required in order to return the public finances to a sound footing. Government needs to frontload the fiscal consolidation process so that Budget 2010 delivers the majority of the adjustments needed and subsequent budgetary adjustments can be less severe. IBEC believes that if sufficient fiscal correction is delivered in Budget 2010 the economy will return to trend growth much quicker than would otherwise be the case and the need for future adjustments could be obviated.

### 3.2 Scale of adjustment required

#### **Targeting the structural deficit**

Given the ongoing volatility in the domestic and international economies there is a risk of an inappropriate reaction to the current scale of the budget deficits. In public discourse it is frequently mentioned that total Government expenditure is running at about €25 bn higher than Government revenues and that adjustments must be made on both the revenue and expenditure side in order to close this gap. It is often not mentioned that a large proportion of the deficit is due to the cyclical effects of the international and domestic recession and once a return to trend growth is achieved the deficit will automatically be reduced. The automatic stabilisers of higher social welfare payments and lower tax payments arising from weak economic activity levels have greatly added to the budget deficit during the past year or so.

It would of course be incorrect for policy makers to try and correct for the cyclical shortfall. Instead they must focus on efforts to address the structural difficulties in the Irish economy. Policy makers face two problems in this regard, however. Firstly; in the midst of the most severe global recession since the second world war and the bursting of a major asset price bubble, it is very difficult to actually identify the scale of the structural deficit; and secondly; EU fiscal policy rules do not distinguish between structural and cyclical deficits and Government remains under pressure to return the deficit to below 3% of GDP by 2013. Nevertheless, Government's priority must remain elimination of the structural deficit as quickly as possible. The scale of this challenge is probably best illustrated by the collapse in the construction sector and the disappearance of the related tax revenues. Property related tax revenue peaked at almost 5% of GDP in 2006 but will be less than 1% of GDP in 2009. The ESRI has estimated the structural deficit at between 6% and 8% of GDP.

The exchequer returns for the first nine months of the year show that the budget deficit has continued to widen further than expected even since the revised forecasts of the April Supplementary Budget. Total tax revenue is now likely to be about €2 bn less than that forecast in April and the general government deficit is expected to reach 12% for 2009. IBEC continues to support Government's own target of returning the general government deficit to less than 3% by 2013. It believes that extending the timeframe for fiscal adjustment would be damaging to economic recovery. It is now clear that in order

to achieve this more aggressive adjustments in the public finances will be required than previously envisaged.

### **International best practice**

International best practice in fiscal consolidations indicates that the damage to an economy's potential growth rate is much less if the balance of the adjustment occurs on the expenditure side rather than in the form of higher taxation. The international evidence also suggests that from an economic perspective it is best to reduce current expenditure rather than capital investment. Efforts to date by the Irish Government to correct the public finances have therefore flown in the face of best practice on both of these issues.

The implications for Budget 2010 are therefore as follows:

- The scale of adjustment must be larger than that indicated in the April 2009 Supplementary Budget
- This additional adjustment must be delivered in the form of greater reductions in current expenditure – adjustments to the taxation burden and capital investment should be much less than previously indicated
- The McCarthy report provides much of the framework through which these additional reductions in current expenditure can be achieved

### **3.3 Priorities for Budget 2010**

IBEC urges Government to take substantial measures to correct the public finances in Budget 2010. The bulk of the fiscal adjustment required in order to correct the structural deficit should be implemented in this Budget. Frontloading the adjustment will enable a swifter return to fiscal stability and will engender confidence in the spending and investment plans of businesses and households. Given that the increase in the precautionary savings rate is a central cause of the collapse of consumer spending, and domestic economic activity, a signal that the 'worst is behind us' would help stimulate consumption .

#### ***Recommendations***

Budget 2010 must achieve the following:

- Maintain progress towards bringing the General Government Balance (GGB) below 3% by 2013. In order to achieve this, the scale of fiscal adjustment will need to be greater than that set out in Budgetary projections of the April 2009 Supplementary Budget. IBEC recommends a total adjustment package of €5 bn – with €4.5 bn coming from expenditure cuts and €0.5 in the form of additional tax revenue
- Measures to address the structural deficit in the public finances should be accelerated so that the majority of that adjustment is frontloaded into the 2010 Budget. If sufficient progress is made in Budget 2010, and the economy begins to recover in 2011, the scale of fiscal adjustments needed over the coming years may be less than currently envisaged
- The public sector pay bill will need to be reduced further on the basis that firstly; given the high percentage of total current expenditure accounted for by public sector pay, significant expenditure reductions can not be achieved without further cuts to the pay bill and secondly; restoration of Ireland's competitiveness requires that public sector pay levels are brought back in line with both private sector comparisons in Ireland and public sector pay levels elsewhere in the EU. In addition to the review of higher remuneration in the public sector a more comprehensive update of the work of the Public Sector Benchmarking Body is

required. This exercise should fully take into account the value of pensions and job security which public servants benefit from, and international comparisons in public sector pay. In the interests of national competitiveness and the quality of services provided to business and the public, it is better that the public sector pay bill is reduced through a unit cost reduction in the services delivered rather than through an excessive decrease in public sector numbers and service quality. IBEC recommends that the public sector pay and pensions bill is reduced by at least a further €2 bn during 2010 and 2011. One of the immediate measures required to achieve this is the cancellation of all pay increments. Pay increments awarded to public servants during 2009 are estimated to have cost about €250 mn p.a.

- To date excessive focus has been placed on increasing taxation rather reducing expenditure and this must be redressed in the upcoming budget. The tax component of the total fiscal adjustments made to date has been over double the current expenditure reductions. The Supplementary Budget targets taxation increases of €2.5 bn for 2010 (on a full year basis) and current expenditure cuts of just €1.5 bn. The planned adjustments for 2011 are taxation increases of €2.1 bn and current expenditure cuts of €1.5 bn. The continued excessive reliance on tax increases to address the budget deficit is entirely inappropriate and this strategy must be reversed
- The overall reduction in current expenditure in Budget 2010 should be substantially greater than the €1.5 bn identified in the Supplementary Budget. IBEC proposes that €4 bn is cut from the current expenditure budget for 2010. This reduction should comprise of €1.3 bn in the social welfare bill; €1.4 bn in the public sector pay and pensions bill; and €1.3 bn in the provision of other current services
- The capital investment budget for 2010 must at the very least be maintained at the level envisaged in the Supplementary Budget. Gross voted capital expenditure of €6.6 bn in 2010 would be 30% less than that envisaged for the year in Budget 2008 and there is no room for further reductions to this budget. It is essential at a time of exceptionally weak activity in the domestic economy, that Government continues to invest in much needed public infrastructure
- The additional tax increases planned for Budget 2010 should not exceed €0.5 bn.

## **4. Restructuring the tax system**

### **4.1 Introduction**

IBEC accepts the need for substantial reform of Ireland's tax system in light of the large structural deficit which has emerged in recent years. Much of the excessive expenditure increases which occurred between 2001 and 2007 were built on the basis of unsustainable tax revenues. The bursting of the property bubble has also demonstrated the risks associated with excessive reliance on transaction based taxes such as capital gains and stamp duty. The report of the Commission of Taxation provides a sound basis from which to reform Ireland's tax system but it is imperative that supporting enterprise and employment remains a central consideration to any such changes. While some of the Commission's proposals obviously require a planning period, IBEC urges Government to ensure swift implementation of the main thrust of the Commission's report.

### **4.2 Tax structure and mix**

The structure of the tax system has a significant impact on economic growth. The Irish tax system was instrumental in supporting economic prosperity over the past two decades. Irish tax policy has gotten much more right than wrong in recent years and the development of a strong enterprise base was largely driven by sound corporate and income tax policies, in particular. In more recent years, aspects of the tax system played a part in the overheating of the domestic economy. Nevertheless, the Irish tax system has proven itself to be much more responsive than those in most other EU countries and it will have a vital role to play in supporting economic recovery.

IBEC believes that the overall structure of the Irish system is largely appropriate, with the exception of an overreliance on asset transaction based taxes, and Government should thread carefully in relation to potential reforms. The policy of charging relatively low taxes on the mobile factors of production – corporations and labour has proved very successful and should not be changed. Despite the scale of the difficulties in the public finances it is vital that Ireland continues to offer a competitive corporation tax offer to mobile investment. The introduction of the new intangible assets taxation regime earlier this year will further enhance Ireland's reputation as an investment location. In order to ensure that the Smart Economy objectives come to fruition, Government must maintain its commitment to the current corporation tax offering.

Prior to the most recent budgets, Ireland had low taxes on labour. Those earning average or below average earnings were the main beneficiaries of this and their effective tax rates were amongst the lowest in the OECD. For workers on above average earnings, the advantage was much smaller and as per 2007 international comparisons, the effective income tax rate for a worker on double average earnings was about the same as the OECD average. Thus prior to recent income tax increases, the tax base on income earned was very narrow but the effective tax rate for high skilled (above average earnings workers) was not particularly low by international standards. The very substantial increase in the effective income tax rates over the course of the last two budgets has greatly altered Ireland's competitive position (see Section 4.4).

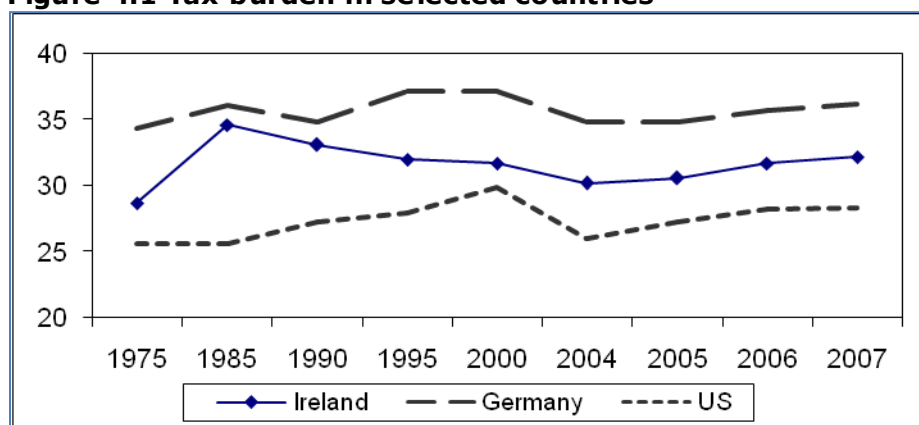
A key feature of Ireland's tax system has been the absence of a non-transaction based property tax. The collapse in stamp duty revenue has accelerated the need to introduce a replacement tax. Research indicates that property tax is the least damaging tax to economic growth. Introduction of a property tax would also constitute a significant move in efforts to achieve a broader tax base. IBEC supports the introduction of a residential based property tax but cautions that implementation and administration may prove

complex. Government should therefore be prudent in assessing the immediate revenue yield from such a tax.

### 4.3 An appropriate tax burden

IBEC accepts that some increase in existing tax rates and the introduction of a small number of new taxes are required in order to address Ireland’s fiscal difficulties. Some have argued that much of the reason for the crisis in the public finances is due to Ireland’s low tax burden. It is true that the overall tax burden in Ireland is lower than that in a number of EU 15 countries but it is also higher than that in many developed countries. Countries such as Canada<sup>1</sup> and Australia have been successful in funding world class public services from tax burdens about the same as that in Ireland. In the medium-term Ireland should continue to target a tax burden of about 33% of GDP. While tax as percentage of GDP may increase in the short-term, high taxes must not be maintained over time. The emphasis must remain on obtaining excellent value-for-money from public services. Inappropriately high taxes will merely enable ongoing inefficiency in the public sector.

**Figure 4.1 Tax burden in selected countries**

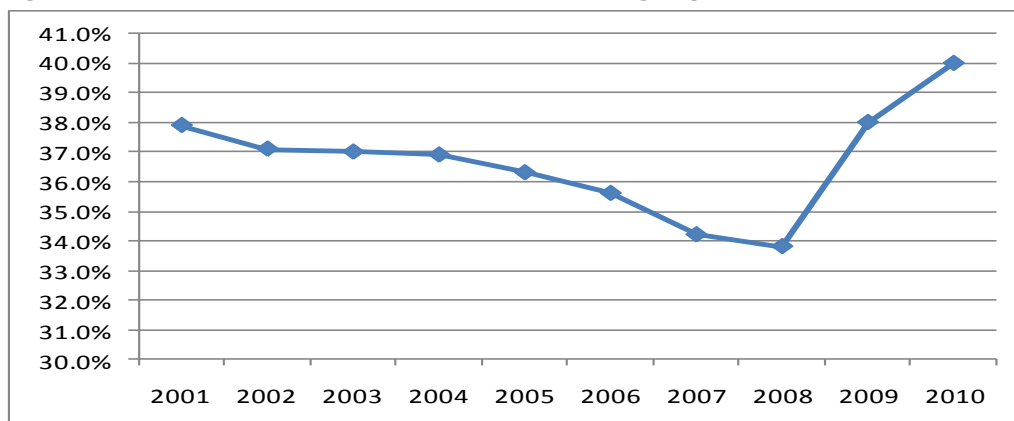


### 4.4 Income tax

Effective income tax rates in Ireland have risen substantially during the past two years or so. For a single person earning an income of €100,000, the effective tax rate has increased from 33.8% in 2008 to 38% in 2009 and would be 40% in 2010 (assuming no further changes in Budget 2010). Those on average or below average income will continue to benefit from relatively low income taxes in an OECD context. Many workers above average earnings are facing an effective income tax rate well above the OECD average and Ireland is rapidly losing its attractiveness as a location for mobile, high skilled, high income labour. Any further increases in income tax rates will greatly diminish Ireland’s ability to both attract and retain the type of skilled labour needed to deliver the Smart Economy.

<sup>1</sup> Canada tax revenue as % of GDP was 33% in 2008; in Australia it was 31%.

**Figure 4.2 Effective income tax rate for single person with income of €100,000**



The recently published KPMG Income Tax and Social Security Rate Survey for 2009, found that Ireland has lost considerable ground to competitor countries in relation to the attractiveness of our income tax system. For high income earners Ireland had the 19<sup>th</sup> highest effective income tax rate out of the 81 countries surveyed in 2009. In 2008 Ireland was 40<sup>th</sup> of the countries surveyed. Significantly, effective income tax rates for high earners in 2009 were found to be higher than in Germany, the UK or Japan. The relative after-tax position of middle-income earners in Ireland has also suffered greatly as a result of the recent tax increases. Those earning €60,000 p.a. went from having the 63<sup>rd</sup> (out of 81) highest effective tax rate in 2008 to the 39<sup>th</sup> highest tax rate in 2009.

In addition to the impact which higher income taxes have on the incentive to work and Ireland's ability to attract and retain skilled labour, they also further exacerbate the country's weak competitive position. The substantial increase in the income tax burden over the past year has greatly weakened firms ability to reduce labour costs. Employers have noted that the willingness of workers to accept wage reductions was much lower after the April Supplementary Budget than it was prior to it. Further increases in the income tax burden would also increase the pressure for wage increases once the recession abates.

IBEC believes that it would be a serious policy error for Government to increase the income tax or social security burden any further in future budgets. Budget 2010 should simplify the current system of income levies and health levies into a more streamlined income tax system of two tax rates. In the short-term this would mean that the standard rate of income tax should be increased to 25% and the marginal rate of income tax to 45%. All of the temporary levies should be abolished and there should be no further increases in PRSI rates or to the employee PRSI ceiling. Once fiscal circumstances permit, both rates of tax should be reduced to a level which provides Ireland with lower effective income tax rates compared to those in our main competitor countries. In relation to employees' PRSI, Government must recognise the equity issues between public and private sector employees. When the PRSI burden is increased it applies to all private sector workers but only a proportion of public sector workers. In the absence of a complete overall of the PRSI and social welfare system, there should be no further increases in the PRSI ceiling.

### **Recommendations**

- No further increases in income tax should be introduced in Budget 2010
- In the absence of a complete overall of the PRSI and social welfare system, there should be no further increases in the PRSI ceiling

## 4.5 Implementing the Commission on Taxation Report

IBEC broadly supports the report of the Commission on Taxation and urges Government to commence implementation of the bulk of its recommendations in Budget 2010. There are a number of recommendations in the report, however, which IBEC believes would be damaging to enterprise and the wider economy and should not be implemented.

### Recommendations to be implemented in Budget 2010

- **R&D tax credit scheme:** the Commission's proposal to allow offset of the credit against either employers' PRSI or corporation tax should be implemented immediately (at no additional cost to the Exchequer). Changes required to the R&D Tax Credit Scheme are addressed in detail in Section 6.2.
- **Stamp duty on shares:** The abolition of stamp duty on quoted shares from the current 1% rate would help reduce the cost of capital for Irish companies and remove the competitive disadvantage which Irish listed companies currently face against those in most EU countries where stamp duty has already been abolished. The change should further enhance Ireland as a location for investment and should encourage more companies to incorporate here.
- **Taxation of international royalty payments:** at present only those companies taxed at 10% can avail of unilateral credit relief on royalty payments. The proposed change to extend the relief to all companies would greatly support the efforts of companies doing business in non-treaty countries. Pooling of international royalty income should also be introduced in order to bring this element of the tax system into line with other areas such as tax on profits of overseas branches and on interest and dividend payments.

### Recommendations requiring further analysis

- **Tax exemption for patent royalties:** IBEC rejects the Commission's conclusions and recommendations in relation to this scheme. We acknowledge that in the past, the scheme has been misused by a small number of businesses, not genuinely engaged in R&D activity. Changes to the scheme in recent years, however, coupled with more stringent application by Revenue, has meant the scheme is now targeted at supporting genuine R&D and innovation. This scheme has a significant impact on the innovation performance of the indigenous enterprise sector, in particular, and any changes to it would fly in the face of the Smart economy objectives
- **Tax relief on pensions:** IBEC believes that the recommendation to reduce the tax relief on personal pension contributions for those taxed at the higher rate would be very damaging to pensions coverage in Ireland. The Commission has made no effort to assess the behavioural impact on those currently contributing to a pension. It may well transpire that the change to a single tax relief rate for personal pension contributions would do little to improve coverage for those on lower incomes and would greatly reduce pensions coverage for those taxed at the marginal rate.
- **Remittance basis of taxation:** Ireland's economic vision (through the Smart Economy and other policies) is to develop a highly innovative traded services and high-tech manufacturing economy. In order to achieve this it is essential that Ireland remains an attractive location for mobile talent and senior executives. The Commission's recommendation to fully remove the remittance basis of taxation would be very damaging in this regard. Higher personal income tax rates have already lessened Ireland's attractiveness – any further changes to remittance basis of taxation would be viewed very negatively internationally and would have negative implications for FDI.
- **Capital Acquisitions Tax (CAT):** the recommendation to increase the effective rate of CAT for inheritances would threaten the viability of many family-owned SMEs. Ireland has a relatively weak SME base and any tax changes which would

present succession planning difficulties for privately owned businesses would be a further blow to the sector.

- **Employee financial involvement:** a series of Government policy initiatives have sought to promote employee financial involvement in recent years. All this work would be undone, however, if the Commission's proposals in this area were implemented. In particular, the extension of PRSI to share based remuneration would greatly increase the cost of such schemes and would be viewed very negatively by multi-national companies which use these schemes in other countries. At a time when so many companies are attempting to restore lost competitiveness, the measures proposed in the Commission's report would further increase payroll costs for companies and undo much of what has been achieved in the past year or so
- **Taxation of foreign dividends:** IBEC believes that the Commission was incorrect not to recommend a participation exemption regime for foreign dividends. Ireland taxes corporate recipients at a 25% rate on dividends received from overseas subsidiaries. This is notwithstanding the fact that the overseas subsidiaries would generally operate businesses which if their activities took place in Ireland, would be taxable at 12.5%. The taxation of foreign dividend income internationally is moving from taxation with credit to exemption, and Ireland is now out of line with other economies in this regard. Given the compliance burden inherent in a credit system (which requires a very detailed recording of country by country, profits and taxes for credit calculation purposes) and the fact that credit systems are very much in the minority, it is recommended that Ireland moves to a participation exception regime on foreign dividends. Such a change would greatly strengthen Ireland's attractiveness as a location for corporate HQs and would advance many of the ambitions of the Smart Economy.

#### **Concerns about implementation of a carbon tax**

IBEC recognises Government plans to introduce a carbon tax at some stage in the future. If such an environmental tax is to be introduced it must be done on a revenue neutral basis, providing incentives for changed behaviour in relation to carbon emissions. IBEC believes that it would be inappropriate to introduce a carbon tax at present due to the unprecedented economic difficulties and competitiveness challenges facing Irish business. The fact that emissions have fallen substantially as a result of the economic crisis also undermines the case for immediate introduction of a carbon tax.

If a carbon tax is introduced at some stage in the future it is vital that the implementation process is managed correctly. Businesses and the energy sector require at least a six month notice period before any new carbon tax would become effective. There are a range of issues to be worked through such as the financing of the collection of a carbon tax; the capacity of Sustainable Energy Ireland to implement voluntary agreements; implications for fuel tourism; and the phasing-in process for rates.

The business community would need to engage with the various Government Departments and agencies on the specifics around the introduction of a carbon tax and it is vital that a sufficient period of time is provided for this. A rushed implementation of a new carbon tax would provide a range of difficulties for administrators and businesses.

## **4.6 Addressing losses from cross-border shopping**

The unprecedented weakness of sterling and the temporary reductions in VAT rates in the UK have substantially increased the price differential in retail prices between this country and Northern Ireland. The increase in cross border shopping during the past 18 months or so has resulted in substantial losses to the Exchequer. Our most recent estimates show that these losses are much greater than previously estimated by the

Department of Finance and the CSO. Estimates of losses to the Exchequer in 2009 can be summarised as follows<sup>2</sup>:

1. Direct loss of VAT and excise = €190 mn
2. Direct income tax and welfare impact of 9,800 jobs lost in retail and food industry = €200 mn
3. Direct loss (VAT and employment) due to incidental spend on cross-border shopping trips = €40 mn

**Total loss to Exchequer = €430 mn**

Research and feedback from the retail industry suggests that a primary motivation for cross-border shopping trips is the price differential in alcohol – with substantial spend on others goods also happening as a result of these trips. The prices of many other grocery items in the Republic have fallen substantially since the start of this year but the high tax content in alcohol, and further adverse currency movements, means that Northern Ireland retains a large price advantage. IBEC therefore recommends that Government should introduce a cut in excise in alcohol in order to reduce the incentive for cross border shopping and prevent the loss of revenue from both alcohol and other goods purchased in Northern Ireland. The reduced rate of excise should be applied for as long as currency and other factors provide the UK with such substantial competitiveness advantages. IBEC believes that a reduction in excise on alcohol would greatly reduce the motivation for cross-border shopping trips and result in substantial benefits for the Exchequer.

***Recommendation***

- There should be an immediate reduction in excise on alcohol in order to reduce the loss to the Exchequer as a result of cross-border shopping

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<sup>2</sup> Further details provided in Annex 1.

## 5. Reforming current expenditure

### 5.1 Introduction

IBEC strongly supports the main thrust of the McCarthy report and agrees that it is essential to immediately reduce current expenditure levels in order to correct the public finances. In this urgency to stabilise the exchequer finances, however, there will be a temptation to implement across-the-board cutbacks which could impinge on Ireland's medium to long-term competitiveness. Building the Smart Economy is already part of Government's agenda. Key areas of this agenda must progress side by side with the necessary retrenchment of other areas of expenditure. Prerequisites for the Smart economy include: creating an innovative island economy, enhancing the environment; securing energy supplies; providing critical infrastructure; and ensuring an efficient and effective public service. Much of the Smart Economy approach requires delivery and despite the current difficulties, there must be evidence that these issues, which are vital to recapturing and maintaining our competitive position in the global economy, are being pursued.

### 5.2 Priorities for expenditure reductions

Reducing current expenditure is a prerequisite to getting the public finances back on a sound footing. The unsustainable growth in current expenditure between 2001 and 2007 is a central cause of the current fiscal crisis. As part of Ireland's efforts to restore competitiveness and to readjust all wages, prices and costs across the economy, significant reductions in current expenditure are required. The McCarthy report has set out a framework through which this can be achieved and IBEC strongly supports the overall emphasis of the report. In order to alleviate the dilution of service quality to end users, particularly in the areas of health and education, it is vital that pay reductions are considered as part of the overall current expenditure reduction process. Excessive reductions in public service employee numbers could ultimately prove counter-productive from an economic perspective. Some reductions in staffing levels are inevitable but as a principle of reform IBEC strongly favours a reduction in the unit cost of services delivered rather than cuts in the volume and quality of services.

As set out in Section 3 of this submission IBEC proposes that current expenditure should be reduced by €4 bn in 2010. This should comprise of a €1.4 bn reduction in public sector pay; €1.3 reduction in the social welfare bill and €1.3 cut in the delivery of other current services.

#### **Social welfare**

Since the outset of the economic crisis there has been extensive debate on the issue of social welfare costs and rates. Total social welfare costs to the exchequer have increased from 33% of tax revenue in 2007 to 67% of tax revenue in 2009. It is therefore impractical to attempt to correct the public finances without seeking to reduce the social welfare budget.

Falling prices mean that people on unchanged incomes are experiencing an increase in their living standards. As a result of the 3% average increase in social welfare rates in Budget 2009 and the forecast 2% decline in consumer prices (using the HICP i.e. excluding the benefits of lower mortgage costs) in 2009, social welfare recipients have experienced a 5% improvement in living standards this year. During Ireland's greatest ever economic crisis it is unaffordable and unsustainable to award such an increase in living standards to one section of society. A clawback of the increase awarded in Budget

2009 would save the Exchequer about €700 mn and would still provide welfare recipients with an increase in living standards over those experienced in 2008.

A further important issue in relation to welfare rates is that of relativity with those still at work. While living standards for those in receipt of welfare have increased during 2009, those at work have experienced a fall in living standards of about 10% due to a combination of tax increases and wage reductions. This has resulted in a major shift in the income distribution and for many workers in the lower income declines the incentive to work has been substantially reduced. Failure to redress the relative position of those on unemployment benefit and those at work will severely restrict the economy's ability to generate new employment, even when economic growth returns.

### **Replacement rates**

Since the early years of this decade the replacement rates<sup>3</sup> available to those on long-term unemployment benefits in Ireland have increased substantially. OECD data show that in 2007 Ireland had the second highest replacement rate for one-income two children families in the OECD at 67% of average earnings and had the highest replacement rate at 100% of average earnings. At 67% of average earnings replacement rates were similar to those of the Nordic countries and about twice as high as that in the US. At 100% of average earnings, the replacement rate of 82% was well above that in Norway (73%), Finland (77%) and Sweden (66%).

**Table 5.1 Replacement rates in the OECD, 2007. (Data relate to one-earner families with 2 children)**

|                | 67% of Average wage | 100% of Average wage |
|----------------|---------------------|----------------------|
| <b>Ireland</b> | <b>95%</b>          | <b>82%</b>           |
| Norway         | 100%                | 73%                  |
| Finland        | 92%                 | 77%                  |
| Sweden         | 89%                 | 66%                  |
| Germany        | 82%                 | 64%                  |
| France         | 77%                 | 54%                  |
| UK             | 78%                 | 66%                  |
| Spain          | 48%                 | 34%                  |
| US             | 46%                 | 37%                  |

Source: OECD.

The replacement rates for the short-term unemployment do not rank as highly in OECD terms as many countries provide relatively higher benefit levels for the first six months or so of unemployment. A series of OECD and other reports have been critical of the lack of withdrawal of welfare benefits in Ireland. In particular, the OECD has pointed out that Ireland is the only country in the OECD where single parent welfare benefits are provided until children are aged 18. Welfare systems in the vast majority of developed economies are structured in a manner which provides a high level of short-term support to those who become unemployed. In many cases these higher level of benefits are subject to participation in education or training. After the initial period of unemployment, benefits are reduced in order to provide a strong economic incentive for the unemployed to return to work. The structure of Ireland's welfare system means that there is no financial incentive for many long-term unemployed to seek employment.

### **Recommendations**

- Budget 2010 should introduce immediate reform of the social welfare system in order to deliver much needed savings for the Exchequer

<sup>3</sup> Unemployment benefits as a percentage of average after-tax earnings in the economy.

- A more substantial restructuring of the system is also required in order to provide strong incentives to work and a more comprehensive safety net for those who experience short-term unemployment

### 5.3 Supporting productive investment

#### **Science, Technology and Innovation Programme**

Ireland needs to strive to become an innovation leader in Europe. To achieve this, an increase in R&D expenditure is needed throughout the innovation system. The Government must ensure that supports for R&D match those offered to industry and higher education institutions by leading innovators such as Finland.

In the early 1990s, Finland experienced a similar economic crisis to the one facing Ireland today. The key to Finland's recovery was an increase in public investment in all aspects of R&D. R&D grants to industry actually increased in spite of the contraction in public finances. In facing its current economic difficulties, Finland is adopting the same approach that proved successful fifteen years ago. Ireland must learn from the Finnish model. Government investment can imbed innovative, high-value activity in Ireland which will provide high quality jobs.

Investment in research and development in third level institutions, through Higher Education Authority and Science Foundation Ireland programmes, is critical. While Ireland has converged with the OECD average in terms of higher education research and development investment (0.46% of GNP), it still lags behind leading countries such as Sweden (0.76% of GDP) and Finland (0.64% of GDP).

Ireland is already beginning to see the returns from research and this is not a time to falter on such investment. Despite the exceptionally challenging conditions in 2008, business sector research has started to increase (to 1.09% of GNP), having remained static since the beginning of the decade. Over 40 IDA projects had a significant R&D dimension – attracted here by the increasing levels of human and knowledge capital resulting from public R&D investment. The perception by these companies of Irish policies is of vital concern to us. They have seen Ireland as a location which provides the assurance of high levels of policy consistency – on corporate taxation since the late 1950s, on increased access to education since the late 1960s and more recently in investment in research, development and innovation. Any serious deviation from this, particularly any pause in our commitment to investment in science, technology and innovation, will have major damaging effects on our international competitiveness and will seriously impair national recovery.

Not only must we acknowledge the time required to bring successful innovations to fruition, due recognition must be paid to the inter-linkages between the stakeholders that pervade the innovation ecosystem. The national policy objective must be to ensure that the innovation needs of business are reflected in government policy and that Ireland is able to convert public investment in research into commercialised products and services. Commercialisation is the priority. This will allow the country to develop real competitive strength while also creating a dynamic enterprise culture which will drive real value creation in the economy.

Therefore, IBEC disagrees with the McCarthy report's assertion of 'the lack of verifiable economic benefits' from research investment and its recommendation to reduce total STI expenditure. However, we note its comments on the proliferation in the number of bodies involved in the formulation and delivery of Strategy for Science, Technology and Innovation (SSTI) and believe that this should be addressed

#### **Recommendations**

- Funding and implementation of the SSTI should be maintained.

- There should be a radical rationalisation of SSTI funding streams but no decrease in projected overall expenditure. Savings accrued through the removal of duplication in administration and research, should be re-allocated to technology transfer and programmes that will yield a commercial return within a five year period.

### **Education and training**

Education and training at all levels of progression have an essential role to play in putting our economy back on a growth path. They provide the key to enabling us to be both competitive and prosperous. Economic return from investment in this area tends to accrue mainly in the medium to long term, but it is vital that we treat it as a priority area for investment, even during this time of acute fiscal stress. If we falter, we will lose the valuable momentum achieved during the past decade.

This does not imply that Exchequer spending on education can be exempted from the consequences of the need for major fiscal adjustment, but it does mean that it should be treated as a priority area for policy attention and continued investment. Sustained attention must be given to improving the effectiveness of our system and to ensuring excellent outcomes. Ireland will have great difficulty in succeeding in the face of intensifying global competition without a world class education and training system.

### **Pre-school**

IBEC welcomed the Government's decision to introduce a pre-school Early Childhood and Education Scheme (ECCE) announced in the Supplementary Budget (April 2009). This was a significant step and an acknowledgement of the importance of linking early childhood payments directly to pre-school education. International research supports the view that investment in pre-school education is a key contributor to combating child poverty and educational disadvantage, and protecting children at risk. It is a significant factor in how children learn, their readiness for formal schooling, and their future success in school, at work, and as citizens.

Therefore it is critically important that the ECCE is based on the highest quality professional and pedagogical practices. The Office of the Minister for Children and Youth Affairs is currently seeking suggestions on what should go into a Workforce Development Plan for the Early Childhood Care and Education Sector. This is to be welcomed and hopefully the final plan will be informed by how other countries have developed their pre-school care and education policies.

The ECCE represents an important example of where the Government must not lose sight of the need for strategic investment in areas where early intervention can result in substantial socio-economic benefits. Therefore it is critical that investment in the scheme is afforded the highest priority.

### **Recommendations**

- The Early Childhood and Education Scheme (ECCE) must be based on an accredited professional and pedagogical practices informed by international best practice. Therefore investment in the scheme must be afforded the highest priority

### **Primary and secondary level**

As the National Competitiveness Council has recently stated<sup>4</sup>, spending on educational institutions is a necessary prerequisite for the provision of high-quality education but spending alone is not sufficient to achieve high levels of outcomes. Excellent teachers, curricula, policies, strategies are even more important for achieving strong outcomes.

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<sup>4</sup> Statement on Education and Training (February 2009): National Competitiveness Council

For example, excessive focus on class sizes can deflect scarce resources from (i) ensuring teachers are able to avail of frequent professional development (ii) modernising career structures and promotions and (iii) providing students and teachers with suitable physical (e.g. school buildings, science labs and sports facilities) and technological (adequate computers and broadband access) infrastructure.

To ensure that Ireland keeps pace with the overwhelming digital revolution and to truly support every child's development potential, an urgent strategic ICT in the classroom initiative is required to support our schools and teachers in fulfilling their key social and economic responsibility.

Business has specific concerns about the education system's failure to develop mathematical competence in students. Mathematical concepts, models and techniques are central to working in technology, finance, pharmaceutical and medical devices - sectors in which the Government has invested heavily. Therefore IBEC welcomes the Government's recent commitment to the curriculum reform programme, Project Maths. This programme must continue to receive adequate resources in terms of support materials and teacher training.

### **Recommendations**

- Specific budget lines for the continuous professional development of teachers (CPD) and implementation of curriculum reform should be included in expenditure voted for Education
- A CPD framework for secondary teachers, adapting good practice from business and the best performing education systems, should be developed by the Teaching Council and the Department of Education and Science
- Outstanding teachers should be recognised through the promotion system
- A detailed three year ICT in schools implementation plan and a procurement strategy based on a centralised model should be developed from the recommendations of the Joint ICT Advisory Group to the Minister of Education & Science
- Significant training and personal development support for maths teachers in the introduction of Project Maths should be delivered to ensure its successful implementation and expeditious rollout nationally
- Given the sectoral FDI profile, government and business must work together to stimulate interest in chemistry or physics from primary level

### **Third and fourth level**

IBEC welcomes the fact that the long-awaited strategic review of the Irish higher education system is currently under way. As part of this review, an 'investment needs' analysis should be conducted to determine the funding required to enable Irish institutions to become world class. Greater specialisation and amalgamation of courses among Irish higher level institutes is also required to develop critical mass.

The Confederation also welcomed the Government's announcement that it is considering an alternative basis for the funding of the third level sector. However, reform of the existing model should not be seen as part of a short-term solution to the crisis in public finances. While this context is obviously impossible to ignore, it is critical that any future funding strategy will enhance the contribution of the higher education system to society and the economy.

IBEC supports the concept of top-up fees and income contingent loans. This is in line with the OECD's recommendation to the Irish government in 2004. The loans reduce the liquidity constraints faced by individuals and improve progressiveness of the overall system - lower public subsidy for graduates with higher private returns. Any re-

introduction of fees should be accompanied by the development of a comprehensive student support mechanism.

### **Recommendations**

- Establishment of accessible Centres of Excellence within higher education should be a key priority of the strategic review of higher education. Greater specialisation and amalgamation of courses is required to develop critical mass.
- An 'investment needs' analysis should be conducted, as part of the review, to determine the funding required to enable these Centres to become world class.
- Additional income from tuition fees should not be offset against reductions in state funding and should represent a real funding increase for third level education.
- Third level funding should be based on the principle of cost sharing between the State and students. It should be based on a universal loan system, with income contingent repayments
- A targeted and means-tested grant systems should be available to those with greater financial need
- The funding model should not discriminate against part-time students and graduates who wish to pursue further studies

### **Life-long learning, further education and in-company training**

Lifelong learning and continuous development for those in employment is essential for boosting productivity, assisting job retention and enhancing competitiveness. This has been acknowledged by the EU, successive governments, agencies and policy documents including the Report of the Enterprise Strategy Group and the National Skills Strategy. Most recently, the 'Building Ireland's Smart Economy report, made a commitment on behalf of the State to 'provide training to people in employment'.

State support for in-company training is financed through the National Training Fund (NTF), which is financed through a levy on employers of 0.7% of reckonable employee earnings. The NTF was established under the National Training Fund Act, 2000 to raise the skills of those in employment and provide training for those who hope to take up employment.

Up to the end of 2008, approximately half of the fund was made available for the purpose of in-employment training. However since the beginning of 2009, there has been a significant shift to for-employment training and NTF expenditure on in-employment training has fallen from €191.7m in 2008 to a forecasted €122m in 2009. This has resulted in a dramatic reduction in the Skillnets and FÁS Services to Business allocation which will seriously damage the long-term sustainability of many critical in-company programmes. This also comes at a time when a significant proportion of the fund remains unspent.

It is more difficult to create a new job than retain an existing job. Therefore IBEC believes that it is extremely short-sighted to divert large scale funds from in-company skills development to social employment schemes, particularly at a time when the projected fund surplus for 2009 is €205m. Notwithstanding this, the Confederation shares the view that State funded in-employment programmes should only provide skills for which there is an identified demand and would support any reforms that would ensure value-for-money in the delivery of these programmes.

### **Recommendations**

- Release resources from the residual National Training Funding investment account to support in-company training
- Ensure that State funded in-employment programmes meet the identified skills requirements of employers and employees.

## 6. Supporting enterprise and employment

### 6.1 Introduction

IBEC remains frustrated by a lack of action by Government to preserve and create much needed employment in the current economic circumstances. The jobs crisis is threatening to decimate Ireland's social and economic fabric. While countries all over Europe have implemented a range of measures to protect jobs during the ravages of the most severe post world war recession, the Irish Government has displayed a paucity of ambition. A stimulus package for enterprise and employment must be delivered in Budget 2010. IBEC believes that through re-directing existing Government expenditure to the jobs agenda employment can be sustained and new jobs created.

### 6.2 Supporting R&D and innovation

#### **Enhancing the R&D tax credit scheme**

Securing an increase in R&D expenditure by both the public and private sectors is at the core of Government enterprise policy. The R&D Tax Credit Scheme, which was introduced in 2004, has been instrumental in supporting private sector R&D investment and has become a key element of Ireland's suite of enterprise supports for FDI. Similar schemes operate in most other competitor countries and in particular in those countries which regularly compete with Ireland for high-end knowledge based mobile investment opportunities.

Despite a number of improvements to the scheme in recent years, it continues to have two significant shortcomings which need to be addressed. IBEC has previously brought to the attention of the Department of Finance and others, the difficulties caused by the lack of flexibility in the manner in which the R&D tax credit can be offset against various tax heads. The fact that it can currently only be offset against corporation tax and is therefore a 'below the line' deduction from an accounting perspective for multinational companies, greatly limits the effectiveness of the scheme. Multinational operations in Ireland bidding for mobile R&D projects in competition with plants in other countries are not able to count the benefit of the R&D tax credit in their project bids.

In recognition of this problem, the Institute of Chartered Accountants in Ireland (ICAI) issued a research paper in early Summer 2009, which examined the accounting treatment of the R&D tax credit. The paper concluded that under International Financial Reporting Standards (IFRS) the R&D tax credit could be classified as a pre-tax government grant for R&D and therefore could be regarded as 'above the line' for project bidding purposes. The correct treatment of the credit was concluded to be less clear under Irish General Accepted Accounting Principles (GAAP). The paper did not attempt to specify what the correct treatment of the credit would be under US GAAP.

IBEC's understanding of the overall implication of the ICAI paper is that it does not provide the basis for any change in the accounting treatment of the R&D tax credit by multinational companies operating in Ireland. The problem therefore still remains that multinational operations in Ireland are unable to get the full benefit of the R&D tax credit scheme and numerous mobile R&D investments are being lost to competitor countries due to a lack of flexibility in the current scheme. IBEC recommends that Government urgently changes the scheme in order to allow companies to offset the value of credit against employers' PRSI liability. This change could be introduced at no additional cost to the exchequer and it would greatly enhance the effectiveness of the scheme.

The other shortcoming facing the R&D tax credit scheme is the rigidity that remains in relation to the base year to be used for the purposes of calculating the incremental R&D spend on which the credit can be claimed. A fixed base year of 2003 has been in place since the scheme was introduced. For the majority of companies, the fact that the base year has remained at 2003 has provided increased incentive for investment as time elapses. For a number of companies, however, which recorded exceptionally high levels of R&D investment in 2003, the scheme offers limited benefit. The base year of 2003 has been arbitrarily selected and companies with higher than normal R&D expenditure in that year are being unfairly disadvantaged in the scheme. Flexibility in the selection of the base year in the form of either an average spend level over a three year period (e.g. 2002 to 2004) or the option of choosing a single year from over a three year period, would ensure that all companies would have meaningful incentive to continuously increase R&D investment. The onset of deflation in Ireland should also be taken into account in the context of reviewing the incentive for R&D investment provided by the current incremental model. A sustained bout of deflation would greatly reduce the effectiveness of the incremental approach to the R&D tax credit scheme.

### **Recommendations**

- Companies should be allowed to offset the R&D tax credit relief against either their employers' PRSI liability or corporation tax
- Introduce flexibility in the selection of the base year for the R&D tax credit scheme

## **6.3 Measures to protect employment**

### **Protecting enterprise and employment**

Government was exceptionally tardy in implementing a programme to protect employment and help stem the increase in unemployment. Despite the delay in its implementation, the Employment Subsidy Scheme was nevertheless a welcome development. More now needs to be done to preserve as much employment as possible in firms that are ultimately viable.

The general approach of the Employment Subsidy Scheme is a sound one and the scheme provides the framework for further support measures. A second tranche of funding is urgently required through a similar scheme which would be extended to those exporting companies which do not generally receive state agency support. The number of Irish exporting companies is far greater than the typical client list of the enterprise support agencies. Those companies in the sub-supply sector (to exporting companies) and businesses threatened by import substitution, largely as a result of the weakness of sterling, should also be supported.

Increased funding is also urgently required under the Enterprise Stabilisation Fund. While the worst of the global recession may now be behind us and there are signs that international market conditions are improving for some Irish exporters, the ongoing weakness of sterling presents a major challenge for a range of Irish businesses. The rationale for Government intervention aimed at supporting otherwise viable employment therefore remains strong. The Stabilisation Fund should immediately be re-opened for 2009 in order to help businesses survive the current exchange rate challenges. Indigenous sectors in particular, such as food and drink; forestry and wood products; and traditional engineering and manufacture are in urgent need of stimulus and investment.

### **Trade credit insurance**

There are significant problems with the availability of short-term credit insurance cover in the private market as a result of the economic / credit crisis. This was acknowledged by the introduction by the European Commission of the Temporary Framework for Member States to tackle the effects of the credit squeeze on the real economy in December 2008 which amongst other things led to the approval of a number of government backed National Export-Credit Insurance schemes

Amongst the problems faced by exporters are:

- Policy holders are paying an increased premium for an inferior product - coverage reductions of up to 40-50% on individual risks are common
- Lack of cover is impacting on sales decisions by companies and hence overall exports
- Foreign competitors are taking business because they have cover as a result of state backed schemes in their countries
- Lack of cover has the potential to impact on working capital facilities depending on arrangements with banks

National short term export credit insurance schemes have received state aid approval from the European Commission in the following countries - Hungary, Luxembourg, Denmark, Finland, Germany and most recently Netherlands (October 2<sup>nd</sup>) and France (October 5<sup>th</sup>). The UK has introduced a domestic scheme (effectively placing Irish exports that go there at a competitive disadvantage) and is also examining the feasibility of a short term export credit scheme.

Since early this year the Government has deliberated on the matter, commissioning reports from Forfás and more recently KPMG. The EU Commission's December paper on temporary state aid measures has simplified approval mechanisms for Government support for export credit insurance. There is therefore no significant obstacle to the Irish Government providing a guarantee scheme for export credit insurance and the Government must introduce a scheme to provide short-term export-credit insurance cover to Irish companies, faced with the unavailability of private insurance cover, for financially sound transactions.

### **State Aid**

The Commission has raised the individual enterprise limit for de minimis aid grants from €200,000 over three years (equivalent to €66,666 per annum) to €500,000 over 2009 and 2010 (equivalent to €250,000 per annum). The temporary framework itself is underpinned by Article 87 of the Treaty of Rome and in particular Section 3(b) which indicates that the provision of state aid to remedy a serious disturbance in the economy of a member state may be considered to be compatible with the common market.

The existing provisions of December's temporary framework refer to the credit squeeze effects on the real economy. They do not take account of the serious disturbance caused by the 30% shift in the value of sterling on Irish exporters. As a result the de minimus levels are insufficient to offset the serious disturbance caused by sterling weakness, over and beyond the credit crunch. The levels need to be raised significantly through a targeted support measure to allow grants for significant productivity enhancement measures by export manufacturing companies with a high level of exposure to the sterling area.

### **Creating new employment**

Creating new employment is also a priority. The temporary state aid framework introduced by the EU Commission for 2009 and 2010, presents the opportunity to incentivise enterprises to employ those currently on the Live Register. The plague of long-term unemployment is fresh in all our memories and the experiences of the 1980s must not be repeated. The most urgent priority for all stakeholders in the Irish economy

must be to get Ireland working again. Unless ambitious measures are taken now there is a real danger that structural unemployment could persist for a decade or so. IBEC urges Government to urgently introduce a stimulus for employment creation for those on the Live Register through a employer PRSI offset to otherwise.

### **Recommendations**

- A Government backed trade credit insurance scheme should be introduced immediately
- A further tranche of funding should be provided through an expanded employment subsidy scheme and through the Enterprise Stabilisation Fund
- Introduce a dedicated bursary system for graduate internships
- Apply a reduced employers' PRSI rate or similar stimulus for any new jobs created during 2010

## **6.4 Promoting graduate internship programme**

### **Promoting graduate internship programmes**

IBEC is extremely concerned that Ireland's highly qualified graduates will eventually emigrate or that their skills will atrophy, leaving a skills shortfall in the labour market for the medium term. The FÁS pilot Work Placement Scheme for graduates announced in April is a welcome step. However the scheme is confined to those who have graduated prior to 2009 and is restricted to six months work experience. Participating employers must also be able to demonstrate that they have not implemented any redundancies (whether compulsory or voluntary) in the previous six months.

The scale of this scheme is far too limited to tackle the growing number of graduates entering the labour market. We estimate that there will be in the range of 15,000-18,000 additional new graduates looking for work in Ireland in the coming months. It is vital that Government expands this scheme to incorporate some of them. We would also suggest that the present term of six months is too short and the blanket no-redundancy requirements are too restrictive. It should be possible to develop a scheme that minimises displacement and is flexible enough to appeal to companies of different size and circumstances.

The reality is that many companies are prepared to offer internships as part of their social commitment, as well as offering the possibility of identifying and eventually recruiting new talent. An IBEC pilot scheme, with defined learning outcomes for the intern, has received favourable reaction from member organisations. The Confederation has recommended that, where possible, these placements should be paid internships. Some companies are also uncomfortable with offering an 'unpaid' internship. However they would require support if the graduate were to be remunerated. This support could come in the form of assistance through the social welfare system or alternatively through a dedicated bursary system for graduate internships.

### **Recommendation**

- Review and extend the FÁS pilot Work Placement Scheme with more flexible provisions around the redundancy requirement.
- Introduce a dedicated bursary system for graduate internships

## Annex 1 Cost to Irish economy of cross-border shopping

|   |                |
|---|----------------|
| <b>Irish consumer and retail spending</b>   |                |
| Total personal consumption in Irish economy   | €90 bn         |
| - of which retail sales (excluding motor trade) ex. taxes   | €33 bn         |
| - bars  | €7.7 bn        |
| - off-licence trade   | €2.6 bn        |
| - Hotels and restaurants  | €8 bn          |
|   |                |
| TNS data show that NI stores have 2.6% of Irish grocery market  | €900 mn        |
| Nielsen data indicate 10% of off-licence trade has been lost to NI  | €260 mn        |
| Assume 2/3 of this is spirits; 1/3 beer and wine  |                |
| Spirits purchased in NI   | €172 mn        |
| Excise and VAT loss to Exchequer  | €100 mn        |
| Wine, beer etc bought in NI   | €88 mn         |
| Excise and VAT loss to Exchequer  | €25 mn         |
| Non-alcohol retail purchases  | €640 mn        |
| VAT content of this (assumed at 10% average)  | €64 mn         |
| <b>1. Total VAT and excise loss to the Exchequer</b>  | <b>€190 mn</b> |
|   |                |
| Jobs lost in retail and wholesale sector (3% of total)  | 9,300          |
| Average earnings per employee   | €40,000        |
| Value of wages lost   | €370 mn        |
| Cost to exchequer of jobs lost (basic welfare rate plus income tax lost)  | €186 mn        |
|   |                |
| Jobs lost in Irish food industry (1% of jobs lost due to lower Irish purchases in NI shopping baskets)                        | 500            |
| Value of wages lost   | €20 mn         |
| Cost to exchequer of jobs lost (basic welfare rate plus income tax lost)  | €10 mn         |
| <b>2. Total employment related cost to Exchequer</b>  | <b>€196 mn</b> |
|   |                |
| Annual shopping trips to NI (250,000 households X 13 trips p.a. = 5 mn trips) Incidental spend of €30 per trip on lunches etc | €100 mn        |
| VAT content in this @13.5%  | €13.5 mn       |
| Employment supported by €150 mn hospitality spend   | 1,300          |
| Cost to exchequer of jobs lost (basic welfare rate plus income tax lost)  | €26 mn         |
| <b>3. Cost to Exchequer of loss associated with incidental expenditure on shopping trips</b>                                  | <b>€40 mn</b>  |
|   |                |
| <b>TOTAL Cost to Exchequer (1-3 above) <sup>1</sup></b>   | <b>€426 mn</b> |

<sup>1</sup> Corporation tax losses not included in above due to estimation difficulties. Losses do not include any multiplier impacts which are likely to occur.