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SYMPOSIUM: RESOLVING IRELAND'S FISCAL CRISIS

The Magnitude of the Problem

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1. INTRODUCTION

The Macroeconomic and Fiscal Framework document accompanying the April 2009 Supplementary Budget detailed the measures that had been taken since July 2009 to address the weakening public finances. They included:

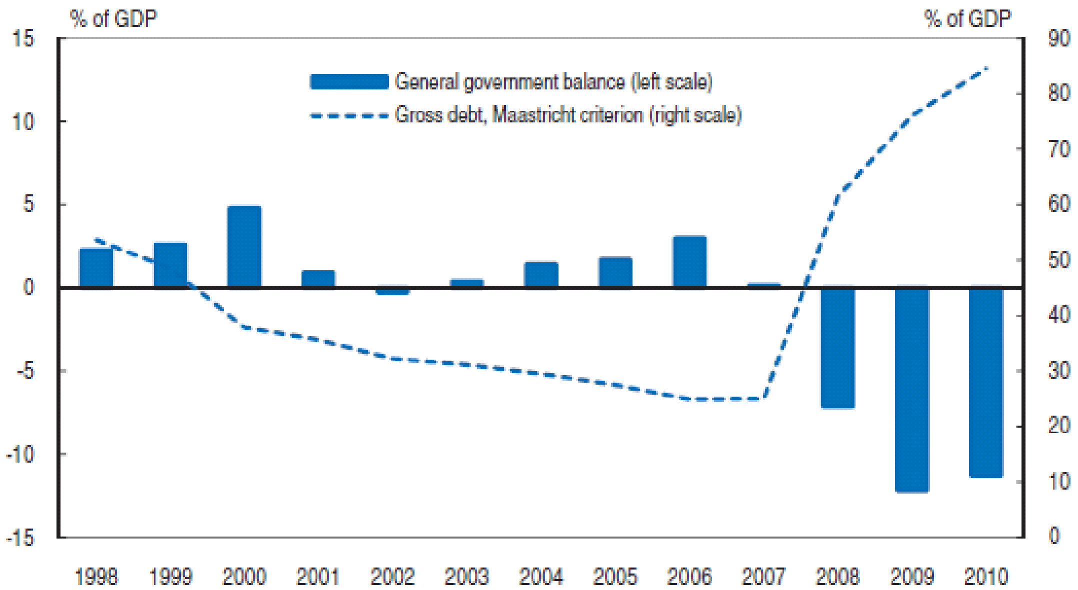
- July 2008 – delivered savings of €400 million in 2008 and €1 billion in 2009.
- October 2008 – Budget 2009 delivered strict containment of expenditure and a range of revenue raising measures of almost €2 billion.
- January 2009 – published the Addendum to the Irish Stability Programme Update setting out a medium-term plan to return the General Government Deficit below the 3% of GDP deficit limit by 2013. Underpinning that plan was the need to find savings of up to €2 billion in 2009.
- February 2009 – expenditure savings of €2 billion in a full year announced. The most significant component of this package was the introduction of a pension-related pay deduction for public servants. In addition, the postponement of the next round of the Social Partnership pay agreement 'Towards 2016' secured savings on the pay bill. In 2010 these are estimated to achieve up to €1 billion in savings.

The adjustment measures added up to over €6 billion. The main thrust of the Supplementary Budget measures was to raise tax revenue in 2009 by €1.8 billion by way of PRSI and health and income levies and the General Government Balance was budgeted at -10.8% of GDP, down from a pre-adjustment balance of -12.8%.

As the year proceeded, it became clear that the intended stabilisation of revenue at €34.4 billion would undershoot by around €2 billion, a fact that was confirmed in the pre-Budget Outlook, November 2009. A measure of the collapse in tax revenues is given by dramatic revisions made to tax receipts for 2009. In Budget 2007 tax receipts for 2009 were budgeted to be €56.3 billion; in Budget 2008 €51.8 billion; in Budget 2009 €42.8 billion; in Supplementary Budget, April 2009, €34.4 billion; estimated outcome in pre-Budget Outlook November 2009, €32.2 billion, a level of revenue last seen in 2003.

The magnitude of the evolving problem is well illustrated by two graphs, Figure 1 from the OECD (June 2009) mapping the sharp deterioration in the fiscal position and Figure 2 projecting the sharp rise in debt interest in pre-Budget Outlook, November 2009.

Figure 1: The Fiscal Position has deteriorated sharply [1]

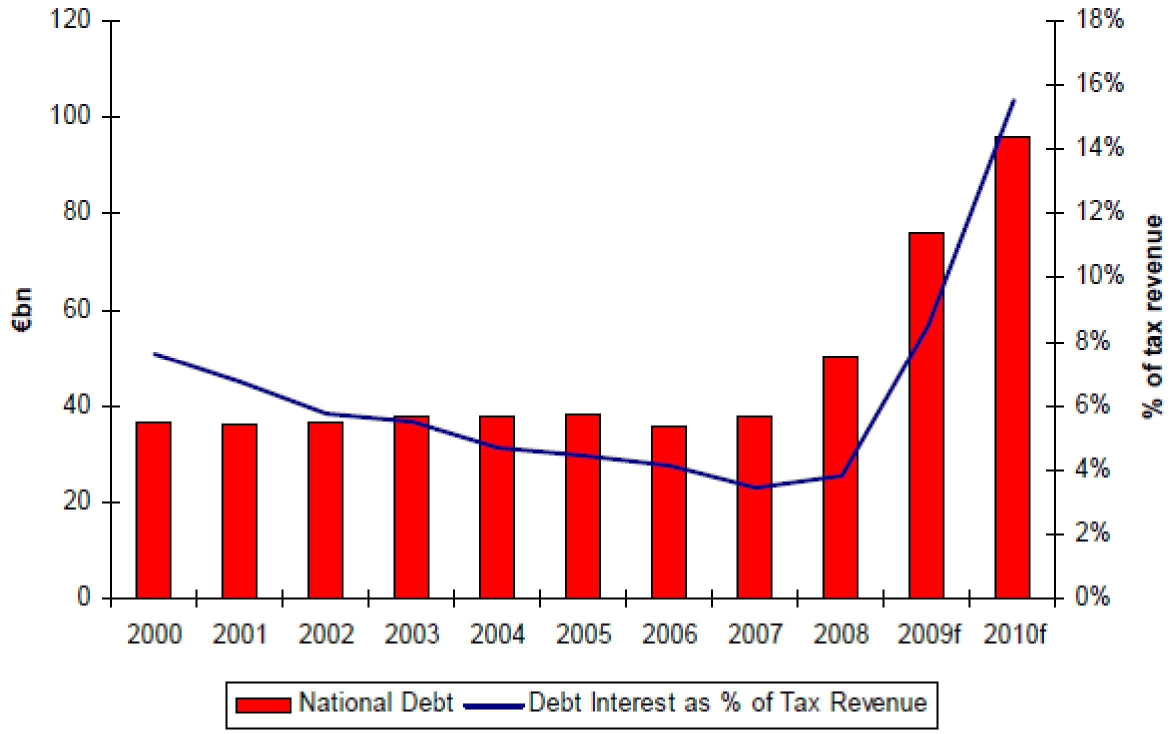


1. The balance includes additional fiscal measures outlined by the authorities for 2010 in the April 2009 Supplementary Budget.

Source: OECD Economic Outlook Database and provisional update to June 2009 *Economic Outlook 85* projections.

StatLink http://dx.doi.org/10.1787/732183113706

Figure 2: National Debt



The need for urgent effective correction is clear, and in IBEC's view should in no way be long-fingered or postponed. The very sharp rise in the debt has serious consequences. First, it usurps significant amounts of tax revenues that could be put to better use; second, it greatly reduces the flexibility of the economy to cope with any other shocks; thirdly, it is by no means certain that Ireland will be able to continue to borrow to finance a mounting deficit and makes the economy vulnerable to increased interest rate spreads and credit rating downgrades. The interest element of servicing the national debt was 3.5% of tax revenue in 2007; in 2009 it is estimated to be 8.5% of tax revenue and by 2010 it will be 16%. Failure to take action quickly risks getting into a vicious circle as the Department of Finance puts it of 'running to stand still'. Such high interest rate ratios were last seen in the mid 1990s, having taken a decade to reduce from over 30% in the 1980s (from Budgetary Statistics, Department of Finance, 2009).

The recent extension of the excessive deficit procedure for Ireland from 2013 to 2014 was in no way a softening by the European Commission (2009) of its excessive deficit procedures. It was indeed a recognition of the deteriorating outlook for the Irish economy. As the Commission noted, 'overall, it can be concluded that, assessed against the economic forecast underlying the initial Council recommendation, adopted on 27 April 2009, unexpected adverse economic events with major unfavourable budgetary effects have occurred in Ireland'. The Commission want on further to make the point that 'the worsening of the deficit in 2009 is exclusively due to a much worse than anticipated downturn and revenue falling significantly beyond what could be expected on the basis of standard elasticities and has occurred in spite of significant consolidation measures.'

"The authorities have taken effective action in 2009 to contain the fiscal deterioration. However, the unexpected adverse economic events with major unfavourable budgetary effects which have occurred in Ireland led to a revision of the deficit target for 2009 to 12.5% of GDP despite the significant consolidation efforts. Furthermore, the growth outlook for 2010 appears more unfavourable than projected in the Commission services' January 2009 interim forecast. This warrants an extension of the deadline for the correction of the excessive deficit from 2013 to 2014.

Against this background, bringing the deficit below 3% of GDP by 2014 will require significant consolidation efforts. A credible and sustainable adjustment path would require the Irish authorities to, in particular, specify consolidation measures in the budget for 2010 in line with the package announced in the April 2009 supplementary budget, and ensure an average annual structural budgetary adjustment of 2% of GDP over the period 2010-2014. In addition, the Irish authorities should specify the measures that are necessary to achieve the correction of the excessive deficit by 2014 cyclical conditions permitting and accelerate the reduction of the deficit if economic or budgetary conditions turn out better than currently expected."

There is, therefore, little comfort for those who have argued that correction of the deficit should be more gradual and effected over a period of eight or more years.

2. INTERNATIONAL LESSONS

Ireland has no option but to embark on an intense period of fiscal consolidation to restore stability to the public finances, and to prepare for the significant challenge of an ageing population. To argue for more graduation is to view the current crisis in isolation from the long-term reality of an ageing population. Not surprisingly, there are lessons from previous crises that are of some comfort and others that make harsh reading.

The OECD (2007) has analysed a large number of fiscal consolidation episodes since the late 1970s. It found that large initial deficits, with high interest rates have been important in prompting adjustment and boosting the overall size of the consolidation. This in part reflects public awareness of the problems which helps overcome resistance to the harsh realities of the consolidation effort. It cites the consolidation efforts to qualify for euro area membership that were helped by the known fiscal targets required. This was certainly true of Ireland's successful consolidation in the 1990s as the deadline approached. Knowledge, too of the late 1980s/90s consolidation was helped by a shared understanding of the need for consolidation by the social partners. It is by no means clear that the same level of shared understanding of the need for consolidation exists in 2009. The magnitude of the size of the correction may yet harness minds to the task.

The quality of the adjustment process is also important. An emphasis in the OECD study of the consolidation process emphasises that cutting current expenditures is associated with overall larger consolidation and a large weight on social spending cuts increased the chances of stabilising the debt/GDP ratio. This is associated, importantly, with a higher level of determination by government to consolidate through expenditure reductions rather than revenue raising which in turn can gain a sympathetic response from private savings which helps to bolster demand.

While the study shows that most adjustments were modest and of short duration, it points out that intense efforts are difficult to maintain over time either because of adjustment fatigue or because the large easier to implement measures tend to be done first. However, it has to be noted that large improvements also reduce the need for continued consolidation.

Spending restraint is more effective. The OECD says that empirical studies suggest that spending restraint – especially with respect to government consumption and transfers – is more likely to generate lasting fiscal consolidation and better economic performance. The OECD quote that Van Hagen et al (2002) had found that the likelihood of sustaining consolidation efforts seem to rise when governments tackled politically sensitive items on the budget such as transfers, subsidies and government wages. Spending-based consolidation resulted in lower household savings and higher GDP growth and tax increases are a much more costly way of achieving fiscal sustainability compared with spending restraint. Back tracking, or the consolidation phase being unwound by one third within two years is more likely to occur when the improvements were small and were usually associated with spending increases.

Alesina and Perotti (1995) found that successful fiscal adjustment relied mostly on cuts in transfer programmes and in government wages and employment. Unsuccessful adjustment virtually ignored these two expenditure components, aiming most of the adjustment at the revenue side. Their research found that fiscal adjustments may not be contractionary and on the contrary successful fiscal adjustments are often associated with increases in growth, crowding in of private investments and reduction in unemployment. They found that it is not, however, possible to successfully reduce government debt without a sizeable retrenchment of the two components of spending which are notoriously more politically difficult to cut: transfers and the government wage bill. They also found that relatively drastic fiscal adjustments are not associated with macroeconomic catastrophes such as major recessions with surges in unemployment. In developed economies transfer programmes and pension systems are increasingly becoming the key component of the fiscal imbalance. One note of caution for the Irish adjustment process is that unified governments rather than coalition governments were more likely to carry through successful fiscal adjustments.

Jens Henriksson (2007) makes a number of observations that are instructive, some of which are also found in the OECD study. He makes the point that expenditure cuts succeed more than tax increases; and cuts in current expenditure are more sustainable and less damaging to the economy. Strong public finances are associated with strong macroeconomic fundamentals and hence solid growth. A country is not free if it is heavily indebted and must suffer the scrutiny of markets and rating agencies and media. It is, therefore, very important that the government has a credible consolidation policy with set goals which it sticks to. This has the important dual effects of generating confidence at home, which is essential to both business investment and consumer spending, and abroad which impresses investors and market participants. Another essential feature he identifies is for governments to keep long-term goals in mind. An example explored by Suonperä (2009) is Finland. She shows that Finland's long-standing emphasis on science and technology which was developed in the 1960s was not forgotten in the financial crisis of the early 1990s. Despite the fact that private sector funding to R&D fell by 5.9% in 1991 this was offset by strong growth in public funds so that R&D expenditure overall continued to grow. An important lesson for Ireland is not to neglect productive investment. Throughout the crisis Finland maintained its long-term strategy of prioritising investment in R&D. Investments in R&D and, in particular, education have a substantial lag, which is why stability and certainty in terms of public policies and sources of funding are crucial.

3. THE GENERAL CONSENSUS AMONG IRISH ECONOMISTS

There is substantial agreement among most Irish economists of the need to make substantial and immediate adjustments to the exchequer finances and that the bulk of that adjustment should come from current expenditure reductions. As Professor Patrick Honohan (2009) has said, bringing the finances back to a sustainable position does not require reinventing the economy. The goal of policy should be to regain as far as possible many of the structures and relativities of just a short number of years ago.

He goes on to say that it is necessary to rebalance public spending and taxation through setting both of them at levels that are sustainable over time and not sensitive to cyclical economic conditions. More generally, restoring

the structure of the broader economy to that which prevailed around the start of this decade would help bring about a return to sustainable employment-generating growth.
He proposed that the fiscal crisis – then emerging into full view – could best be addressed by looking back a few years to where we had been around the turn of the millennium in terms of the shares of taxation and spending in GNP. Those years define the end of the thoroughly healthy and sustainable path of aggregate activity. Getting back to those shares seemed like an appropriate target. In his view wider rebalancing of the structure of the economy (going beyond just tax and spending) to something much closer to that of the year 2000 would leave us best placed for a resumption of employment-generating growth on a sustainable basis.

Wage discussions need to recognise the increased purchasing power of money in an environment where inflation is falling; if not then our wage structures will move out of line with competitors. Retaining wage competitiveness to sustain and increase employment is a key priority, even if it means cuts in nominal wages.

Professor John FitzGerald (2009) too, has contributed useful analysis with regard to the estimation of the size of the structural deficit, and how rapidly this should be eliminated over the next five years to 2014. He estimates the structural deficit to be of the order of 6 or 7 per cent of GDP. Drawing on lessons from Ireland in the 1980s and Finland in the 1990s suggests the importance of taking rapid action. FitzGerald makes the point that there will not be a major recovery in employment until the domestic private sector recovers confidence. He suggests that if it is right that one big push on fiscal policy would be enough to set the economy and the public finances on a recovery path then, once that recovery is established in 2011 and 2012, domestic demand will recover. However, if the private sector faces further years of uncertainty concerning cuts and increases in the tax burden, then confidence will be very slow to return, delaying a return of actual output to its potential level. Tough action now, he says, is likely to result in enhanced confidence in financial markets about the sustainability of the Irish recovery. FitzGerald makes a number of conclusions. First, that Budget 2010 be designed to make adjustments of about €5 billion. As normal wages are currently above their long-run equilibrium level, more of the incidence of taxes should fall on employees rather than business. Secondly, in 2010 it would be best to avoid increasing taxes on labour in the medium-term, though recognising that up to 2009 labour taxes in Ireland were very low for those on average or below average wages. Thirdly, there is an argument for temporarily shifting some of the burden from employers' social insurance contributions to employees' or to income tax. Fourth, the composition of investment should be examined to ensure it produces the maximum impact on productive capacity of the economy. There is a need to adjust to a stable level of infrastructural investment likely to be about 4% of GNP. Fifthly, current expenditure cuts in 2010 of more than the €1.5 billion in the April 2009 Budget would be appropriate. Finally, the welfare system needs to be prepared for a world where wages and prices are lower than they were in 2008.

Professor Philip Lane (2009) cautions that international evidence suggests that tough fiscal decisions are hard to implement and therefore the focus for the Government must be the structural deficit requiring redeployment of resources to maintain the most acute services. He also makes the point that the preservation of service levels would be greatly facilitated by a further round of pay reductions. Given the great degree of uncertainty, he says the bias in fiscal policy should be towards greater prudence as under-spending is more easily rectified than over-spending.

The report by McCarthy (2009) and the Commission on Taxation (2009) have provided a wealth of relevant information on which the government can draw in framing its adjustment package. Budget 2010 is not just a budget for the next year, but under the excessive deficit procedure must include a credible consolidation plan that aims to reduce the deficit to 3% of GDP by 2014. As we have pointed out in our pre-Budget Submission 2010 (2009) EU rules do not distinguish between structural and cyclical deficits which could place undue pressure on meeting the 2014 target date if the global upturn proves to be less solid. Nevertheless, IBEC has given strong support to government taking strong corrective and immediate action.

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 adjustment 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.

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. 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.

In our view 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 greater than that set out in Budgetary projections of the April 2009 Supplementary Budget. IBEC recommends a total adjustment package of €5 billion – with €4.5 billion 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 in 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 billion 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 million 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 billion 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 billion 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 billion identified in the Supplementary Budget. IBEC proposes that €4 billion is cut from the current expenditure budget for 2010. This reduction should comprise of €1.3 billion in the social welfare bill; €1.4 billion in the public sector pay and pensions bill; and €1.3 billion 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 billion 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. THE IRISH TAX STRUCTURE

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.

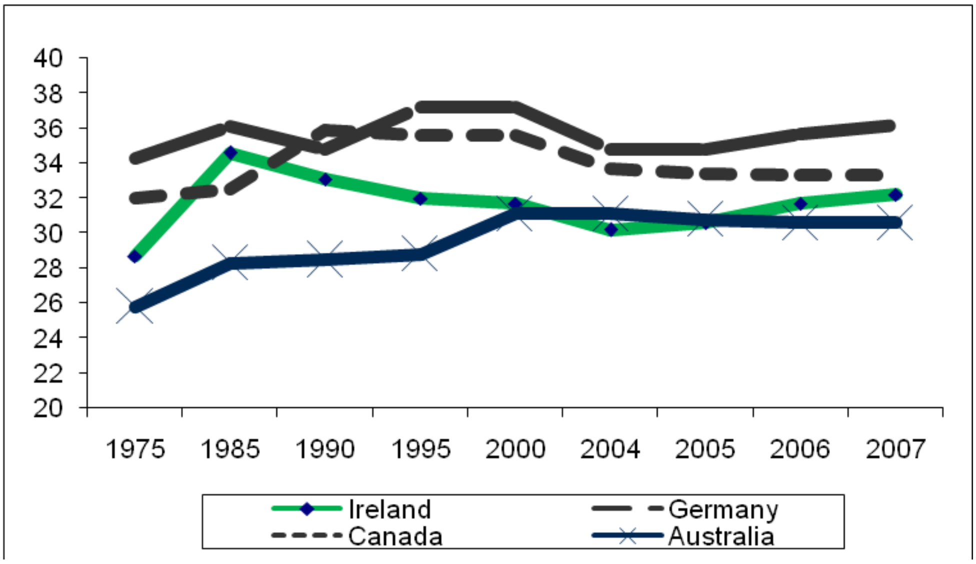
IBEC believes that the overall structure of the Irish system is largely appropriate, with the exception of an overreliance on asset transaction based taxes, and Government should tread carefully in relation to potential reforms. The policy of charging relatively low taxes on the mobile factors of production – 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.

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.

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[1] 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.

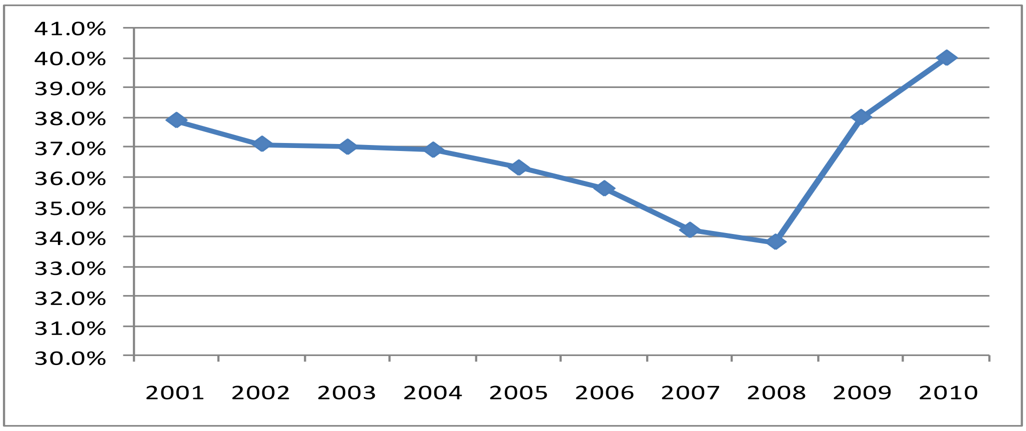
Figure 3: Tax Burden in selected countries % of GDP



[1] Canada tax revenue as percentage of GDP was 33% in 2008; in Australia it was 31%.

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.

Figure 4: Effective income tax rate for single person with income of €100,000



A recent 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 19th highest effective income tax rate out of the 81 countries surveyed in 2009. In 2008, Ireland was 40th 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 63rd (out of 81) highest effective tax rate in 2008 to the 39th 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.

5. 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.

There are recommendations that IBEC believes should 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.

Other recommendations of the Commission, IBEC believes require further consideration:

- 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.

6. THE McCARTHY REPORT

IBEC supports the expenditure cuts proposed by the McCarthy group (2009). We recognise that for the necessary consolidation to take place sectional interests cannot take precedence over sound policy. Naturally, we do not agree with every proposal put forward by the group and have made our reservations known in a submission to the Joint Committee on Finance and the Public Service (2009).

I do not wish to elaborate on the differences we have with the report as for the most part the thrust of our response is very positive. I would, however, like to outline our view with regard to innovation and R&D on which we do have a serious reservation.

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 ecosystem. The Government must ensure that supports for R&D match those offered to industry and higher education institutions by other countries 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 public investment in research and development. Grants to academic institutions and 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. In short, innovation is fundamental to our future competitiveness.

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 us 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 STI and believe that this should be addressed.

Perhaps one main element of current government expenditure should be mentioned – that of the most difficult area, social welfare. There are a number of reasons why social welfare cannot be left out of the reforms. Firstly, the payments are a very large expenditure item amounting to 37% of current rated expenditure; secondly, social welfare expenditure has increased by 183% over the last nine years or 4.5 times the rate of inflation; thirdly, because an unintended 5% real increase was given in 2009 when the government in October 2008 had expected a rise of close to 3% not a fall of close to 13% (HICP basis). However, the most important reason to reduce social welfare payments is the detrimental effect that it has on the incentive to work as a result of the fall in wages and prices in 2009.

7. MEASURES TO PROTECT 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 2nd) and France (October 5th). 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.

Graduate internship programme

IBEC is 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.

8. RESTORING COMPETITIVENESS IS KEY

Finally, restoration of stability to the public finances requires adjustments to other parts of the economy to bring back the balance that existed around the turn of the decade. We must restore the contribution of the traded sector to economic growth that pertained in the 1990s. A major element in achieving this is to recognise the magnitude of the loss of competitiveness that has taken place since 2000. Arguably, Ireland entered the single currency at an exchange rate possibly 10% more competitive than fundamentals suggested; in part this was the result of Ireland's experience in 1992/93 of coping with a sterling devaluation which resulted in the eventual devaluation of the Irish pound.

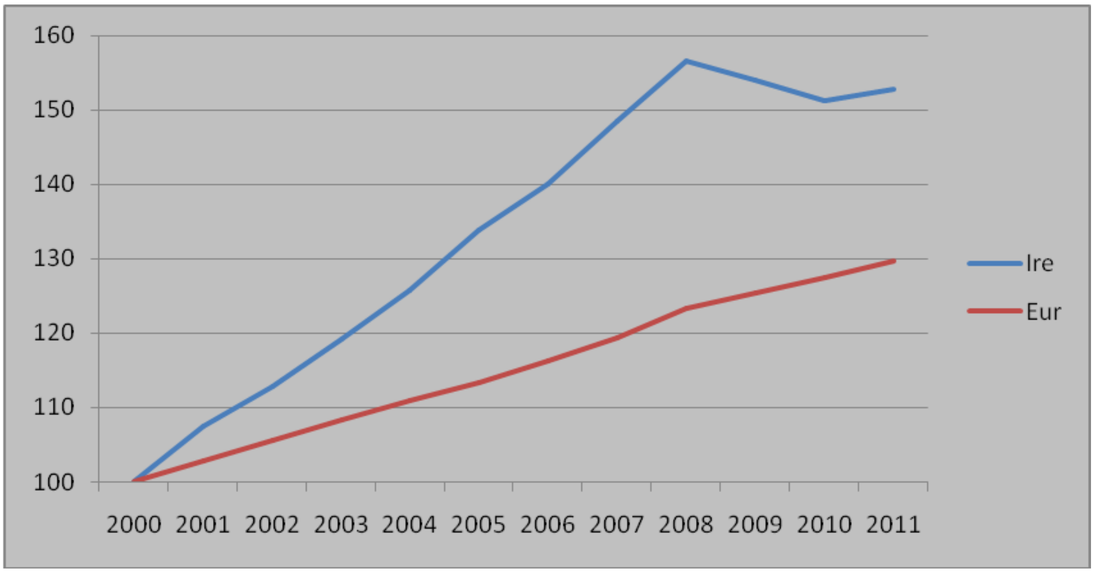
Dr Heiner Flassbeck[2] had warned a sceptical meeting of IBEC's Economics and Taxation Policy Committee in August 1998 that Ireland's entry into the euro currency at a super competitive rate would inevitably result in a period of high wage inflation as the effective exchange rate adjusted to the level warranted by economic fundamentals. He warned that the difficulty would be in failing to control an overshoot and becoming seriously uncompetitive. In such an event and in the absence of negotiated wage reductions, a return to a competitive economy would come about through high unemployment, which would force down relative wage differentials. How right he was to be concerned about a period of inflation and the resultant loss of competitiveness; his warnings on the need for nominal wage reductions are equally prescient. The following chart and graph demonstrate the extent of our loss of relative competitiveness.

Figure 5: Labour Costs

	2000	2008	% change
Netherlands	36,835	49,036	33.1
Ireland	30,343	46,577	53.5
Germany	37,909	43,571	14.9
EU-15	33,178	39,922	20.3

[2] Dr Heiner Flassbeck, Head of the Research Department in Deutsche Institut Fur Wirtschaftsforrschung (DIW) addressed the IBEC Economics & Taxation Policy Committee on 26th August 1998 to develop some new economic thinking appropriate to the new economic order of the Euro.

Figure 6: Competitiveness: compensation per employee



Although competitiveness is far more than labour cost differentials, they do play an important part in influencing the cost of all goods and services which feed into final prices of traded goods and services. It is clear that a wide gap has opened up in Ireland's relative competitiveness that will be addressed either by policy induced restraint or market forces. Without such a correction, unemployment will remain persistently high. This would result in increased budgetary pressures through lost taxation and higher social welfare costs, which would make consolidation of the public finances even more difficult to achieve.

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SYMPOSIUM DISCUSSION

Don Thornhill:- Successive policy reports (going back to if I recall correctly to NESC reports in the 1970s, led by Louden Ryan - and maybe further back) have emphasised the important distinction between the externally traded and non-traded sectors of the economy in respect of the design of policy incentives. In particular reports, such as those of the two Commissions on Taxation and those of the National Competitiveness Council, have called for the elimination of tax concessions which benefit the non-traded sector - in particular building and construction. Yet this advice has been overlooked by policy makers. We heard this evening from the presentations from Colm, Blair and David just how damaging the overheating of the construction industry was for our economic competitiveness and welfare. Much of this overheating was driven by tax incentives for non-traded activities such as the construction of car parks, hotels, housing and nursing homes. Short of a constitutional amendment have the panellists any suggestions as to how legislative or procedural constraints could be placed on the political recourse by our political leaders to providing what are essentially distortionary taxation incentives to non-traded economic activities particularly in building and construction?

Sean Barrett: I support the members who have thanked our speakers for their presentations. We are also indebted to the Society for organising the discussion of this most important topic.

The rigidity of the parliamentary whip system, referred to by Dr Hardiman, contrasts with a rare occasion twenty five years ago when a parliamentary revolt stopped emergency legislation to imprison, fine heavily and withdraw the travel agent's licence in the case of persons charging too little for airline tickets. The peculiar circumstances were the expulsion earlier of Mr Desmond O'Malley from the Fianna Fáil parliamentary party but not from the party as a whole. There was also considerable concern at the high cost of access transport to this outer offshore island and that the Department was a "downtown office" of Aer Lingus and an example of regulatory capture. The parliamentary revolt of 1984 was a huge success. Fares fell by over 50% on the first day of price competition and new market entry on the Dublin-London route and have continued to fall in real terms. The Aer Lingus which the disputed legislation was designed to protect had 2.2m passengers. This year the four Irish airlines will have almost 80m passengers. One must credit in this case the minister who had the courage to change his mind, the late Jim Mitchell. More parliamentary revolts are required.

The 1984 aviation experience also indicates a need for greater economic expertise in large spending departments such as transport in this example, but also in health, education, industry and agriculture. The lack of economic expertise in these departments has been exacerbated by the creation of several hundred quangos. These become independent of their parent departments by setting up public relations sections with the object of increasing their budgets and HR sections which divide the economic rents among the staff. The Department of Finance must reassert a leadership role over the spending departments and agencies in order to impose a value for money culture, sadly lacking throughout this decade.

Colm McCarthy's statement that "cost benefit in Ireland has become a branch of the public relations industry" is, of course, true. Where neither the Department of Finance nor the spending departments or agencies carry out these analyses in the public sector, and the banks did not do project appraisals in the private sector, it is hardly a surprise that we have an economy in its present mess. Transport 21, published in November 2005, failed to publish any costings for the individual projects but claimed that the lot could be delivered for €34.4 billion and assumed without analysis that there would be at least that amount of benefits. The €6 billion national roads programme commenced in 2000, increased its cost to €18 billion by 2003 and half the projects were incomplete by the end of the NDP in 2006. The ability of the construction sector to wreck the wider economy was seen first in the Public Capital Programme before it struck the housing market but the lesson was not learned.

In the immediate term, the PCP must be scaled down. Mr McCarthy's Table 1 estimates that 2013 GDP will be 29% less than the volumes assumed in the current NDP. We will therefore "need" far less capital investment than if the economy had continued to grow. The national roads programme should be dramatically reduced when the intercity motorway programme is completed shortly. The two Dublin underground railways should be scrapped immediately. The Airport Metro will be slower to the airport than the present unsubsidised private bus services to the airport and Swords using the Port Tunnel and the widened M50. The east-west underground DART to link with the Airport Metro at St Stephen's Green is a wasteful duplication of the existing resleepered and resignalled double track heavy rail connection between Connolly and Heuston Platform 10, the Point-Connolly-Heuston Luas light rail line, and the Liffey quays quality bus corridors between Heuston and the city centre. No economic assessment of either underground rail project has been undertaken. The planning system is apparently happy to sanction projects on technical feasibility alone without any economic analysis.

I caution against David Croughan's advocacy of extra national R&D spending. This area is a candidate to be the next bubble to hit the Irish economy. No project appraisal is taking place as noted by Declan Jordan of UCC at this Society last year. An Bord Snip Nua noted that in TCD and UCD some 70 people are employed filling in forms about research and are engaged neither in research or lecturing. The large increases in the R&D budget in Ireland have diverted resources from undergraduate lecturing have displaced lecturing by bureaucracy, have inflated research pay costs to a level uncompetitive compared to Germany and have created a new avenue for tax avoidance in the private sector. Rent seeking is not directly productive activity and this must be explained to our science and engineering colleagues whose ignorance of basic economics must be a matter for concern. Nokia in Finland is held out as an example for Ireland to follow in R&D. The *Economist* of October 17th reported a third quarter loss by Nokia of €426m.

Colm McCarthy's Table 2 shows that Ireland reduced private sector employment by 216,500 between the first quarter of 2008 and the second quarter of 2009, a fall of 12.9%.

Because of the dominance of Irish trade unions by the public sector and the dominance of the private sector by our dysfunctional banks the collapse of the Irish private non-banking sector has been largely ignored. The re-balancing of the Irish economy must start with fewer bankers, builders and bureaucrats. The failure of the social partners to address these issues, NAMA, and the Bord Snip report and appendices concerns me hugely as a government nominee to the NESC. At our last meeting we discussed not these vital Irish issues but EU foreign policy. An Bord Snip indicates that we have serious cost problems in areas such as health and education yet the producers in these sectors have sought to present these as problems of underfunding caused by low taxation. The Snip report examined a health budget of €16 billion. Combined with a private spend of about a quarter more this gives an Irish health budget per head of $7,000, that is twice the cost in the UK, France, Denmark, Sweden, Finland and Australia. The Irish health cost per head is 2.3 times the OECD average in 2007 of $2,966 for twenty countries and is second only to the United States.

I do not agree with Blair Horan that Ireland is a low tax country or that low taxes caused the Irish economic crisis. The Lenihan budgets have brought Irish income taxes to German levels and our indirect taxes have exported much of our retail sector to Newry, Enniskillen and Derry.

Ireland has to face public expenditure issues because of unsustainable borrowing and a government share of 55% of GNP. The failure to engage with the Bord Snip data especially in health and education is a waste of valuable time. We should learn from 1987 and not opt by default for a rerun of that entire harmful decade.