Costs of Doing Business in Ireland 2011

June 2011

Forfás

National Competitiveness Council

Introduction to the NCC

The National Competitiveness Council was established by Government in 1997. It reports to the Taoiseach on key competitiveness issues facing the Irish economy and offers recommendations on policy actions required to enhance Ireland's competitive position.

Each year the NCC publishes two annual reports.

- **Benchmarking Ireland's Performance** is a collection of statistical indicators of Ireland's competitiveness performance in relation to 17 other economies and the OECD or EU average.
- **Ireland's Competitiveness Challenge** uses this information along with the latest research to outline the main challenges to Ireland's competitiveness and the policy responses required to meet them.

As part of its work, the NCC also publishes other papers on specific competitiveness issues.

The work of the National Competitiveness Council is underpinned by research and analysis undertaken by Forfás – Ireland's policy advisory board for enterprise, trade, science, technology and innovation.

Chairman's Preface

Ireland is battling to restore economic stability and to return to a sustainable path of economic growth and to protect our reputation as an excellent location to do business. A determined focus on our international competitiveness is central to our recovery. As a small, open economy, dependent on trade as a source of revenue, it is imperative that Irish enterprises are in a position to compete successfully for business in international markets. Cost competitiveness is one of the key determinants of any firms' success.

This report from the National Competitiveness Council addresses Ireland's cost environment. On a positive note, notwithstanding the firestorm of bad news relating to the fiscal and banking crises, the business environment remains resilient. Indeed, there have clear been significant improvements in cost competitiveness over the last year or so.

At the broadest level, the European Commission have acknowledged that Ireland represents a rare example of an economy which has successfully achieved reductions in costs – we know that since the beginning of 2008, the differential between Irish and euro area prices has narrowed. This has been driven by a number of factors: we know that labour costs, which account for a significant proportion of the overall cost base for firms have grown at a lower rate than in our key competitors. Painful as it has been for many, the sharp reduction in property values means that firms can acquire or rent premises at rates which as recently as three years ago would have been unimaginable. In terms of utility and professional service costs, in general prices have declined from their peak, all of which means that Ireland has become a much more attractive location to do business.

I must, however, express a major note of caution. There is no room for complacency. While improvements in our cost base have boosted our international competitiveness, Ireland has a long way to go to restore structural and enduring cost competitiveness. To date we have achieved reductions in cost primarily as a result of cyclical factors – by and large, the collapse in consumer demand, both domestically and internationally, has impacted positively upon prices. If we are to face down emerging threats such as increasing global oil prices, a resumption of inflation, and potential adverse currency movement's vis-à-vis sterling and/or the dollar, Irish policy must deliver outcomes which embed lasting, structural reform. Only structural reform will ensure that the gains we make are of a permanent nature and will not quickly be eroded upon any resumption in growth.

The analysis and recommendations herein focus on delivering just this sort of reform. The recommendations focus on (i) ensuring that the labour market operates in a manner which supports both competitiveness and employment; (ii) reinvigorating the property market and eliminating those factors which contributed to the creation of a bubble; (iii) maintaining a competitive cost environment for key utilities such as energy and waste; and (iv) boosting levels of competition in the non-traded sectors of the economy. Implementation of the Council's recommendations would represent a major step in ensuring Ireland's future competitiveness and prosperity.

At the same time, the Council are very much aware that cost competitiveness is only one element of Ireland’s international offering. In parallel with reducing costs, we must protect and maintain policies which offer competitive advantage such as our pro-enterprise tax regime, and address issues currently proving challenging for enterprise – we must, for example, ensure that viable enterprise can access sufficient and timely credit. At the same time, we must also enhance the productivity of our firms and our wider economy. As noted in the Council’s recent statement on competitiveness priorities, higher productivity is the glue which sustains high living standards and competitiveness. Productivity is an overarching concept, which encompasses skills, education and training; innovation; and infrastructure. Each of these elements will be considered in detail in the NCC’s forthcoming report Ireland’s Competitiveness Scorecard which will benchmark Ireland’s performance against a range of key competitor countries. The lessons drawn from this analysis will then be used to develop a set of policy recommendations designed to further boost Ireland’s competitiveness in the Council’s Competitiveness Challenge 2011 report, due to be published towards the end of this year.

Finally I would like to thank the members of the Council and the advisors from the relevant Government departments for their input on this report. I would also like to acknowledge the research and analytical support provided by the Forfás executive.

Dr Don Thornhill

Chairman, National Competitiveness Council

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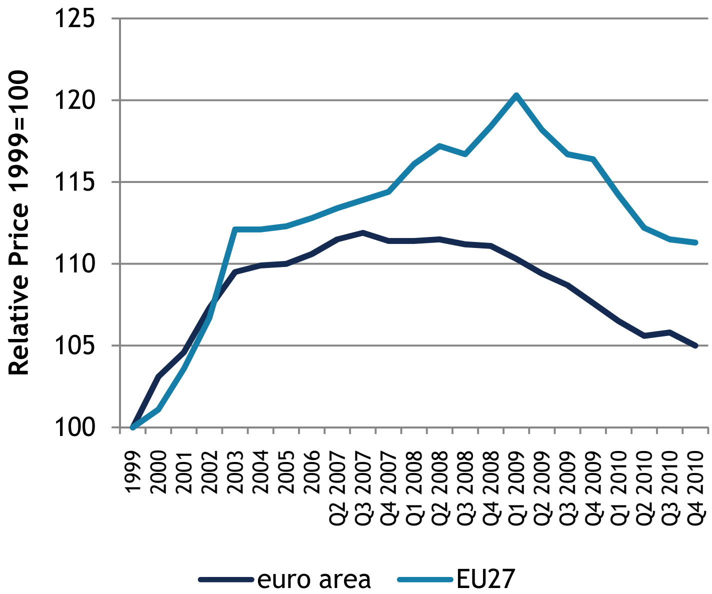
Executive Summary

Cost competitiveness improved further in 2010, building on the advances made in 2008 and 2009. Ireland's international cost competitiveness is now at levels not witnessed since February 2003[1]. As Ireland repositions itself once again as an export growth led economy, cost competitiveness will be central to the performance of our exporters. Cost competitiveness, however, is important for all enterprises, not just those who export. The performance of all enterprises will ultimately determine our competitiveness and so it is important that markets operate efficiently, regardless of whether these are exposed to international trade or are servicing domestic consumers.

Data from the European Commission illustrates that the gap in cost competitiveness between Ireland and the euro area (EA 16) and the broader EU 27 has decreased over the past number of years[2].

Figure 1: Ireland's Price Indicators Relative to Euro Area and EU27 (Based on HICP) (1999=100)



Ireland's Real Effective Exchange Rate[3] (REER) vis-à-vis the euro area increased by 11.5 percent between 1999 and 2008 – this deterioration was the combined result of an appreciation in the euro against the currencies of many of our trading partners and higher price inflation in Ireland.

Since 2008, Ireland has regained some competitiveness as a result of deflation (caused by the recession) and exchange rate developments: between Q2 2008 and Q4 2010, Ireland's price index fell back to 105.0. Nevertheless, prices levels in Ireland remain above euro area averages and further correction is required.

Source: European Commission

Ireland's cost base was impacted by nominal wage and price declines across many sectors along with an upturn in economy-wide productivity measures. The Central Bank of Ireland measures the impact of both exchange rate movements and price changes - they have estimated that between April

1 Central Bank of Ireland, Real Harmonised Competitiveness Indicators (HCI), Online Database
2 European Commission, Directorate-General for Economic and Financial Affairs, Price and Cost Competitiveness - Quarterly data on price and cost competitiveness of the European Union and its Member States, ECFIN/E-4 Fourth quarter 2010
3 The real effective exchange rate is the nominal effective exchange rate (a measure of the value of a currency against a weighted average of several foreign currencies) divided by a price deflator or index of costs.

2008 and January 2011, Ireland's nominal Harmonised Competitiveness Indicator (which is a trade weighted exchange rate) depreciated by 6.25 percent. The real HCI (which also takes account of consumer price inflation) declined by 13 percent over the same period[4].

In international terms, competitiveness is the ability to achieve success in foreign markets - cost competitiveness is but one component of competitiveness[5]. Given Ireland's reliance on trade and the open nature of our economy, however, international cost competitiveness is a crucial determinant of our economic wellbeing. In 2008, the export intensity (exports as a percentage of total sales) for all enterprises in Ireland was 49 percent[6]. This signifies that, at a national level, enterprises in Ireland depend on exports for nearly half of all their sales.

This report, using the most up to date internationally comparative cost data looks at a wide range of enterprise relevant costs across four key dimensions - labour, property, utilities, and business and professional services[7]. The overall cost environment within which enterprise operates is also considered. The price of a number of key business input costs in Ireland are compared with prices charged in other jurisdictions (where available). In addition, changes in enterprise costs over time are also examined to understand how costs are evolving. The drivers of these costs are considered to determine what factors are fuelling these costs and to isolate what policy actions can be undertaken to enable prices to adjust efficiently to market forces.

Where costs are found to be sticky or adjusting by less than one might expect given economic circumstances, a more in depth analysis of the factors which influence costs has been conducted. The ultimate goal of this paper is to identify a set of practical actions which can deliver structural reform, ensuring that markets operate in a manner which supports Ireland's international cost competitiveness.

Key Findings

Notwithstanding the cost competitiveness gains made since 2008, further progress is required in order to ensure Irish enterprises can compete internationally.

- Even though prices in Ireland have fallen since 2008, the cost of a range of business inputs remain relatively expensive compared to other jurisdictions, including property costs, calls from landlines, and legal fees. A large number of these inputs arise in the locally traded sector.
- Even though many enterprise costs are decreasing in Ireland, this does not necessarily mean that we are experiencing significant improvements in relative cost competitiveness. The pace of this decline must outstrip that of our trading partners in order to close the gap.

4 Central Bank of Ireland, Online Statistics
5 Competitiveness is a broad concept that encompasses a diverse range of factors and policy inputs (including education and training, entrepreneurship and innovation, Ireland's economic and technological infrastructure and the taxation and regulatory framework). A wide range of competitiveness indicators are examined in the National Competitiveness Council's annual Benchmarking Ireland's Performance report.
6 CSO, Census of Industrial Production, Annual Enterprise Statistics on Distribution and Services, External Trade, Service Exports and Imports.
7 It is important to note, however, that as much of the data is collected on an annual basis the data may not capture the most recent cost developments.

- Where costs have decreased, these have largely been as a result of the cyclical rather than structural factors. There is a danger that if structural barriers preventing costs from adjusting are not removed, once an economic recovery kicks in, recent competitiveness gains will be rapidly eroded. For instance, while the cost of industrial electricity for large energy users in Ireland decreased significantly (-27%) in 2010, these welcome price falls were largely the result of cyclical factors - the steep decline in global fuel prices (gas and coal) and temporary national subsidies which are to be phased out by the end of 2012. As such, lower prices are unlikely to be sustainable into the medium term without more fundamental policy reform.
- Changes in cost and price competitiveness depend not only on cost and price trends but also on exchange rate movements. Exchange rates are volatile and not under our control. In order to improve cost competitiveness we should concentrate on cost factors that can be influenced domestically.

The importance of Various Costs to Enterprise - Sectoral Cost Profiles

- According to KPMG analysis, a large proportion of costs for service sectors (89 percent) and research and development centres (87 percent) are location sensitive – these are the costs over which Ireland has most influence[8]. In manufacturing sectors, 44 percent of costs are determined locally, while the majority of costs (e.g. raw materials, capital goods) are largely set on world markets.
- For manufacturing sectors, the contribution of labour costs to total location sensitive costs varies from 45 percent in the plastic sector to 56 percent in the medical devices sector. Transport and utilities are also a significant cost input for a number of manufacturing sectors.
- Within service sectors, labour costs account for 74 percent of total location sensitive costs. Taxes and property leasing costs are significant for service operations.
- For R&D sectors, 70 percent of total location sensitive costs are accounted for by labour. The leasing of property is a major cost element across all benchmarked R&D sectors.

Labour Costs

- Labour costs are the largest single location sensitive cost component for services (83 percent) R&D (80 percent) and manufacturing (52 percent) operations.
- Labour cost growth rates in Ireland slowed significantly in 2008 and the first half of 2009. Over this period, growth rates were lower than the EU-27 and euro area-16 average growth rates.
- Total labour costs include wages, taxes on income and employer and employee social security contributions. Ireland has the tenth highest total labour costs level in the OECD and is in line with a number of western European countries (Figure 3.2). Ireland has the fifth highest net wage level in the OECD-28, 35.5 percent above the OECD-28 average. This is a result, in part, of Ireland's low (but increasing) tax wedge on labour.

8 KPMG, Competitive Alternatives, 2010

- During 2010, Ireland experienced a more pronounced decline in ULC (-4.4%) relative to the OECD-25 (-0.46%) and the euro area-14 (0.85%), indicating an improvement in competitiveness (Figure 3.4).
- Ireland has the second highest statutory monthly minimum wage (€1,462) amongst the countries benchmarked (although Ireland's rate is actually set in terms of an hourly rate of €8.65). The minimum wage is more prevalent in certain sectors, notably in hotels and restaurants, wholesale and retail and other locally traded service industries.
- The NCC has developed a number of recommendations designed to ensure that the labour market operates in a manner which supports both competitiveness and employment – they are designed to ensure that the labour market adjusts in an efficient and timely manner and so that wage developments reflect economic developments.

Labour Market Recommendations

Ireland needs to maintain incentives to stay in or return to the labour market, and to encourage employment growth.

- Given Ireland's large debt burden which has arisen as a result of the property collapse, economic recession, and bank bailout, it is inevitable that taxes will rise further. The required increases are likely to have a further impact on domestic demand which has already been adversely affected by recent policy changes. The proportion of employment supported by the domestic activity has fallen from 50 percent in 2007 to 40 percent in 2011, largely as a result of the collapse in consumption. In addressing the fiscal and labour market challenges which confront us, the Government must be cognisant of the impact of its actions on domestic demand. The key is to ensure that additional taxation measures are designed to protect job creation and facilitate a recovery in consumer demand. A competitive tax wedge is vital to encourage employment growth across all income categories and to incentivise people to remain in or return to the labour market.
- High replacement ratios between social welfare and net pay for employment weaken the incentives to return to the labour force. A major challenge exists to protect those on low incomes and social welfare benefits while ensuring that incentives to remain in or return to the labour market are strengthened and that businesses are incentivised to take on additional staff.

While the steep rise in unemployment has affected people across society, those with lower educational attainment are more likely to be unemployed. There are risks of workers disengaging from the labour force as they experience long term unemployment. We need to ensure that the education and training system delivers for the unemployed and workers in vulnerable sectors.

- Activation: Activation measures aimed at improving the employability of unemployed persons by providing 'progression pathways' of relevant job search, training, education and employment opportunities for different target groups.
- Participation: Ensuring that the training and education needs of target groups such as young unemployed, those previously employed in sectors most affected by restructuring, long term unemployed, older workers and women returners are provided for through enterprise relevant programmes.
- Upskilling: Boosting our human capital by enhancing education and skills levels in line with the National Skills Strategy is essential to meet the needs of the Smart Economy and the need to improve productivity.

Property Costs

- The value of commercial properties in Ireland peaked in Q4 2007. Since 2008, property prices have been in a steep decline. The value/ cost of retail properties fell by 29 percent, offices by 28 percent, and industrial premises by 27 percent between Q4 2008 and Q4 2009.
- The cost of constructing and renting both industrial and office units declined sharply in Ireland during 2010. However, in relative terms, the impact of these decreases on Irish cost competitiveness has been reduced as there have also been significant cost decreases in many other countries.
- In terms of commercial office space in Dublin, the vacancy rate rose from 5 percent in 2000 to 15 percent on average between 2002 and 2008. Take up of office space peaked in 2006-08, before dropping back suddenly as demand fell. This increased the vacancy rate and now nearly one in four square metres of space in the Dublin office market is vacant.
- The industrial market in Dublin went through a similar pattern as the office market. In the case of the industrial market, however, the vacancy rate began to rise earlier – in 2006 – and now stands at almost 25 percent.
- The NCC has examined the key drivers of commercial property prices over recent years. Based on this analysis, a series of recommendation to improve the efficiency of the market are proposed. These recommendations focus on three main objectives:
  - (i) Providing certainty to all stakeholders about the long term viability of the commercial property market;
  - (ii) Reinvigorating the commercial property market in Ireland in the short term - despite recent negative experiences, a properly functioning property market is a vital part of any vibrant economy; and
  - (iii) Supporting sustainable development over a longer time horizon.

Property Recommendations

To provide certainty about the long term viability of the commercial property market, the NCC recommends that:

- NAMA should provide more information on:
  - (i) The loans that it has acquired and how it proposes to deal with unfinished developments, as well as its criteria for future provision of development finance.
  - (ii) How NAMA assets will be disposed of - an orderly programme of disposals and interventions is desirable – in essence, this means that properties should brought to the market on a phased basis over the course of the next few years.
- A lack of information is creating uncertainty. The Property Services Regulatory Authority should collect data on both purchasing and leasing relating to (1) Price (2) Quantity (e.g. floor space) (3) Quality (e.g. location, finish) for commercial *and* residential property.

To reinvigorate the property market in Ireland in the short term, the NCC recommends that:

- A broadly based and equitable valuation based residential property tax should be introduced as quickly as possible. This would represent a shift away from transaction based taxation.
- The feasibility of introducing legislation to facilitate downward rent adjustments for existing leaseholders should be explored further.

To support sustainable development over a longer time horizon, the NCC recommends that:

- Local Authorities develop more robust and transparent charging mechanisms for local authority charges that match levies with the economic cost of providing development.
- A demand led, planned approach is a prerequisite for sustainable development. In all cases, a demand assessment should be undertaken to inform development plans and zoning.
- Other steps to reform planning in Ireland should also be considered, including:
  - Increasing the population density of Irish cities; and
  - The rollout of ePlanning.
- The rollout of infrastructure projects, which supports sustainable development of commercial property, should be prioritised such that provision is:
  - Demand led;
  - Tackles issues of national or regional importance;
  - Has an impact that could not be achieved with a different approach or with greater efficiency of government investment;
  - Generates value for money, leverage and commercial return; and
  - The project could not be delivered by another body.
- Coordination in the rollout of different infrastructure services should be improved to maximise efficiency and reduce costs.

Utility Costs

- The cost of industrial electricity for large energy users in Ireland decreased significantly (-27%) in 2010. Ireland is now the fifth cheapest of the 14 benchmarked countries and costs are lower than the euro area average. Despite reductions also being recorded for electricity costs for SMEs in 2010, Ireland remains the fourth most expensive location benchmarked, although the gap with the euro area average continued to narrow. These reductions, however, would appear to be temporary in nature – the phasing out of a temporary rebate for large users and global fuel price changes are likely to result in higher prices in the future.
- Ireland is relatively competitive in terms of industrial gas prices and Irish industrial gas prices were 12 percent below the euro area average in 2010. This is a significant improvement.
- The average cost of treated water services in Ireland increased by 0.8 percent between 2010 and 2011. Based on the internationally comparable data (2009 is the most recent data available) Ireland is competitive with our main trading partners on this measure. Waste water services increased by 4.1 percent between 2010 and 2011. No internationally comparable data is available for waste water costs.
- Based on 2010 survey data, the average price that could be negotiated for landfill fees in the Irish market ranged from €86 to €111 per tonne (including the levy). Singapore and New Zealand are the cheapest location for landfill (Figure 5.5). However, Ireland's cost competitiveness is likely to have improved as Irish prices have continued to fall sharply. Massachusetts is the cheapest location for thermal treatment at a cost of €46 per tonne - Flanders the most expensive of the benchmarked locations at €110 per tonne (Figure 5.6).
- With regard to telecommunications, speed, access and cost are key in determining competitiveness. Ireland is the eighth most expensive location of the 13 countries benchmarked for a basket of business calls and is the fourth most expensive for a high usage basket of mobile calls including VAT.
- The NCC recommendations are primarily focused on the two areas of most concern – energy costs and waste costs.

Utilities Recommendations

- Significant investment in Ireland's energy transmission and distribution infrastructure is planned over the period to 2025 which will be financed through future increases in electricity prices. This investment will enable renewable technologies to connect to the grid and to ensure that key regional centres can support energy intensive investment projects. Given reduced levels of economic activity, the NCC believes that potential exists to extend delivery over a longer period of time and delay projects which are no longer justified by projected demand growth.
- The NCC recommends that subsidies for peat generated electricity should be phased out due to the cost implications for electricity customers (estimated by the Commission for Energy Regulation to add 5 percent to all bills in 2010/2011) and the impact on the environment.
- The NCC recommends that the existing REFIT scheme should be revised so that the price supports are transitional as they are for other technologies, with decreasing support levels over time to address cost competitiveness concerns. In addition, the price support should be changed from a fixed guaranteed price to a premium on the wholesale price. The premium should be subject to a cap to protect customers in the event of high fossil fuel prices.
- Applying much higher - or new - waste levies will increase the costs of doing business further, particularly for those in manufacturing (in key sectors such as food and pharmaceuticals). Increases in the landfill levy should reflect the pricing of externalities (i.e. putting a price on environmental and other damage caused by landfill).
- The NCC recommends that a waste-to-energy levy should not be considered until a competitive waste-to-energy market is established here.
- A volumetric levy on incineration levels should not be introduced as it stands to inhibit economies of scale which are essential to bringing Irish waste costs more into line with our competitors. Such a cap would also run counter to the internationally accepted waste management hierarchy.
- The NCC supports the introduction of user charges for consumers (e.g. water charges for households) which broaden the tax base.

Business and Professional Service Costs

- For many professional and business service sectors, only limited price data is available.
- The Services Producer Price Index (SPPI) shows that the costs of selected services in Ireland are now 0.7 percent above 2006 levels[9]. This contrasts with the experience in other EU states examined, where the costs of these services have increased significantly relative to 2006 prices - the UK (+10.1%), Netherlands (+6.6%), Finland (+13%) and Sweden (+7.8%).
- Over the course of the economic downturn, four of the five business and professional sectors examined have shown substantial corrections in prices. Furthermore, where downward adjustments have taken place, the scale of these adjustments has outpaced that of any other country examined. Since 2006, however, the index indicates that legal services prices increased by 12 percent[10]. World Bank data also indicates that Irish legal cost compare poorly to those in other countries.
- Data from the Harmonised Index of Consumer Prices shows that insurance costs also increased by 34 percent between 2006 and 2011.
- While price moderation has occurred in a range of business services, in many cases Irish prices are coming down from a high base (e.g. World Bank data has found that the cost of enforcing a legal contract are third highest amongst the 19 countries benchmarked). Further price reductions are required if Ireland is to achieve sustainable and enduring price competitiveness.
- In policy terms, the NCC has focused on those sectors where prices remain high despite the recession. Recommendations relate to issues such as barriers to competition, market structure, and consumer empowerment.

9 The Services Producer Price Index (SPPI) is an experimental survey by the CSO which measures changes in the average prices charged by domestic service producers to other businesses for a selected range of services. In most cases these services are provided to business customers only and so individual price indices should not be considered indicative of more general price trends in the economy. The index covers transaction costs from business to business and excludes consumers who are covered in the Consumer Price Index (CPI). Similar indices are produced by the national statistics offices of several other EU member states allowing for a degree of comparison.

10 SPPI Q4 2010 data on legal services is based on responses received from 18 companies and covers 118 price observations. The majority of firms that responded employ between 10 and 49 employees. The survey does not include data on prices for barrister services. Given the small sample size used to create the sub-indices for accountancy and legal costs caution should be used when analysing the results.

Business and Professional Service Recommendations

The regulation of a sector influences the manner in which prices in that sector can accurately adjust to market forces. In this regard, the NCC recommends that:

- No professional body should be allowed to restrict the number of entrants into that profession;
- Independent regulation is generally preferable to self-regulation. This would not preclude members of professional bodies from being represented as a minority on any regulatory body;
- Where possible, a variety of pro-competitive mechanisms should be used instead of traditional restrictive rules (e.g. requiring the publication of historical or survey-based price information is a less restrictive mechanism rather than regulatory price controls).

Competition Policy

Anti-competitive practises keep prices artificially high. The Government has a role to play in ensuring that competition policy facilitates market operation. Good competition policy must work in tandem with strong regulations in economic, social and environmental policy. To deliver pro-active competition policies, the NCC recommends that:

- Government Departments should be formally required to consider and respond to recommendations of the Competition Authority in a timely manner, with specific timelines set down for such consideration and implementation of such recommendations, as appropriate. The Department of Enterprise, Jobs and Innovation should co-ordinate a report to Government on each Department's response to recommendations of the Competition Authority.

Data on Professional Services

- Ensuring that robust and internationally comparable price data is available is essential to understand the operation of the professional services sector. Given the importance of this sector, the CSO should continue to work with stakeholders to further develop the Services Producer Price Index, and to develop comparable data on price levels.

Sector Specific Recommendations - Legal Services

NCC recommendations on legal services draw extensively on the work of the Competition Authority and the Legal Costs Working Group. Greater detail can be found from these sources.

(i) Regulation of the Legal Profession

The NCC recommends the establishment of an independent regulator for the legal profession. This recommendation has also been included in the EU/IMF Programme of Financial Support for Ireland and the Programme for Government. The NCC recommends that this new body should incorporate the regulation of training for solicitors and barristers, and would be tasked with approving those institutions who wish to provide such training.

(ii) Legal Service Costs

The opaque manner in which legal costs are formed and assessed prevents consumers from understanding the relationship between legal services rendered and final costs. In order to deliver increased transparency and efficiency to legal services costs the NCC recommends that a Legal Costs Assessment Office be established to replace the Taxing Master's Office, as recommended by the Legal Costs Working Group and echoed in the EU/IMF Programme of Financial Support for Ireland.

- The Legal Costs Assessment Office should have a remit to cover costs arising from all courts, not just the High and Supreme Courts as is the case currently for the Taxing Master;
- Legal costs should be assessed on the basis of work done, rather than on the size of awards; and
- The general practice of allowing junior counsel's fees at two-thirds that of senior counsel has been recognised as anti-competitive (e.g., by the Competition Authority). In many instances, however, the practice continues – this was acknowledged by the Dáil Committee of Public Accounts in their Third Interim Report on the Procurement of Legal Services. Parties with responsibility for overseeing legal costs should ensure that the practice is no longer tolerated.

(iii) Competitive Tendering

The State, as one of the largest consumer of legal services in the economy should ensure that legal services are subject to the same competition as other services. The NCC recommends that, where practicable, legal services to be provided to the State by solicitors and barristers in private practice should be procured in accordance with the guidelines set out by National Public Procurement Policy Unit (NPPPU), requiring prospective legal service providers to compete with one another on the basis of cost and quality.

(iv) Structural Reform of the Legal Profession

- The NCC recommends considering the creation of a single tier counsel system.
- The NCC recommends that solicitors be permitted to act as lead counsel when advocating in court with a barrister.
- The NCC recommends that suitably qualified professionals, in addition to solicitors, be allowed to provide conveyancing services.

Sector Specific Recommendations – Legal Services (Continued)

(v) Empowering the Consumer

There a number of actions which could be used to empower the consumer and thus address inefficiencies in the market and allow prices to adjust in response to wider economic conditions and price movements elsewhere.

- The current restrictions which prevent consumers from switching solicitors should be abolished;
- Individual consumers and enterprises should be allowed to directly access legal advice from barristers – access to such advice is currently restricted by the Bar Council; and
- Both solicitors and barristers should be required to issue detailed and meaningful fee and/or fee estimate letters to prospective clients.

(vi) Procedural Reform

The procedural reforms recommended by the Legal Cost Working Group are designed to make the operation of the courts more efficient and to reduce cost, and so should be implemented.

Sector Specific Recommendations – Insurance Services

- The NCC supports the recommendations contained in the 2005 report on non-life insurance by the Competition Authority. While a substantial number of Competition Authority recommendations have been accepted by Government, a small number of recommendations relating to the collection and publication of insurance related data remain outstanding. The NCC recommends that insurance related data be published in accordance with the recommendations set out in the 2005 Competition Authority Report. This would deliver transparency to the market and prevent rigidities that arise as a result of asymmetric information.

Indirect Business Costs

- A comparison of consumer costs between a number of major international cities indicates that Dublin's cost competitiveness improved between 2009 and 2010 as the city moved from sixth most expensive to ninth most expensive location amongst 18 benchmarked cities.
- Following a period of significant increase, the consumer price index peaked in 2008 when prices were 28 percent above 2001 prices. Since then the index has fallen and prices in February 2011 were 4.5 percent below the peak level. However, the pace of decline in the consumer price index slowed towards the end of 2010 and increased in February and March 2011.
- Between February 2010 and February 2011, Ireland experienced a 0.9 percent increase in the harmonised index of consumer prices (HICP), the smallest increase in the European Union. During the same period the euro area HICP increased by 2.4 percent.
- Ireland is an expensive location for purchasing groceries. For a comparable basket of food and non-alcoholic beverages in 2009, Ireland ranks as the second most expensive European country, 19.4 percent above the euro area-16 average.

- In 2005, health and education cost indices (which are influenced by public sector policy, but which contain significant private sector elements) were 15 percent above the overall CPI. Despite falls in the overall CPI in 2010, prices for both health and education continued to rise. In March 2011, they were 28 and 35 percent higher than the CPI respectively.

Reductions in the cost of living are essential if real incomes are to be maintained. While Ireland has already regained some cost competitiveness, further progress is required if Ireland is to return to strong economic and employment growth. There are also risks which threaten to undermine recent competitiveness gains – the CPI suggests that domestically driven inflation is on the rise, global oil prices have increased, EU interest rates seem certain to increase further over the coming months, and sterling is likely to remain weak for the foreseeable future.

It is difficult for small open economies, particularly those that share a currency with larger regions, to control their rate of price inflation, as this is, to a significant degree, determined by events outside domestic control. Nonetheless, as noted throughout this report, there are a number of policy levers available to Government which can be used to restore Ireland's cost competitiveness. Implementation of these recommendations would represent a major step in ensuring Ireland's future competitiveness and prosperity.

1. Introduction

Generating sustainable broad based export-led growth is essential to rebuilding our economy. In order to deliver growth, policies need to facilitate the convergence of Irish business costs towards the levels of our trading partners. In the absence of a currency devaluation policy lever to manage cost competitiveness pressures, the policy focus needs to be on achieving enhanced competitiveness through cost reductions in key business inputs and productivity growth[11]. While painful in the short term, the alternative is a prolonged period of weak or negative growth, high unemployment and emigration.

The NCC has benchmarked Ireland's cost competitiveness for a number of years. This year's report, however, goes beyond the benchmarking exercise of previous editions, and addresses three key issues:

1. How does Ireland compare on key business input costs?
2. Are the markets for various business input costs functioning efficiently?
3. What actions are required to improve cost competitiveness?

1.1 Overview of Ireland's Cost Competitiveness

Defining national cost competitiveness is complex. National competitiveness is a broad concept that encompasses a diverse range of factors and policy inputs including education and training, entrepreneurship and innovation, Ireland's economic and technological infrastructure and the taxation and regulatory framework. An economy is under-competitive in cost terms, if the levels of prices and wages are sufficiently high to generate an increase in the unemployment rate and/or capital disinvestment'[12].

Strong domestic growth in recent years created conditions which led to significant increases in the costs of doing business in Ireland. Key business inputs such as pay and incomes, rents, utilities and business services rose sharply for an extended period. Ireland's national cost competitiveness has improved since 2008 because of favourable exchange rate movements and downward price adjustments within the Irish economy.

As illustrated in Figure 1.1, Ireland experienced a 31 percent loss in cost competitiveness (real Harmonised Consumer Index (HCI)) between February 2002 and April 2008. This represents the peak of the boom in price levels.

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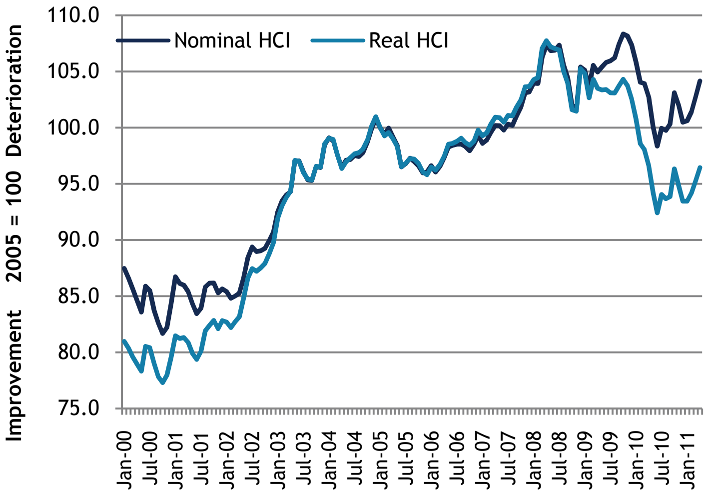
11 Productivity growth is the preferred mechanism to improve competitiveness as it can support cost competitiveness in tandem with high and increasing wage levels. Many firms, however, may have limited opportunities to increase value added significantly in the short term. The more productive the labour force and the capital stock are, the higher the level of wages that is consistent with a state of "price and wage" competitiveness. This illustrates the importance of skills development, innovation, infrastructure, etc. in the longer term.

12 According to Lane, price and wage competitiveness can be defined as 'a state in which medium term full employment is achieved and the return on capital matches the global risk-adjusted cost of capital". See Lane, P., Assessing Ireland's Price and Wage Competitiveness, National Competitiveness Council, Forfás 2004

Figure 1.1: Harmonised Competitiveness Indicators, 2000-2011 (January 2005 =100)[13]



Source: Central Bank of Ireland, Forfás calculations

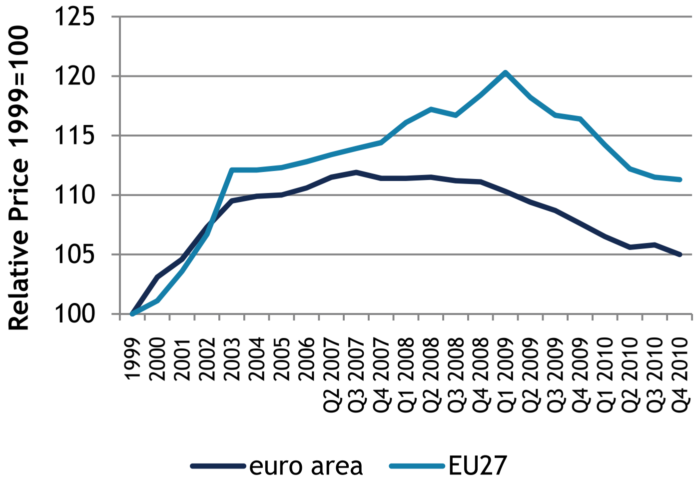
Since then, Ireland has regained some of its lost cost competitiveness as a result of falls in relative prices and favourable exchange rate movements vis-à-vis our key trading partners: between April 2008 and January 2011, Ireland's nominal HCI (which is a measure of Ireland's trade weighted exchange rate) depreciated by 6.25 percent. The real HCI (which also takes account of consumer price inflation) declined by over 13 percent.

Since the beginning of 2011, however, the HCI has resumed its previous upward trajectory as inflation has once again turned positive.

Research from the European Commission published in May 2010 acknowledges that Ireland has registered significant gains in cost competitiveness in 2008 and 2009 and that the gap in cost competitiveness between Ireland and the euro area (EA16) and the broader EU27 has decreased[14]. The Commission highlights that Ireland is the only Eurozone country that provides clear evidence of 'competitiveness rebalancing'. Ireland's relative price indicator vis-à-vis the euro area (the Real Effective Exchange Rate) increased by 11.5 percent between 1999 and 2008, according to the European Commission (Figure 1.2)[15].

13 The nominal HCI is a nominal effective exchange rate for the Irish economy that reflects, on a trade-weighted basis, movements in the exchange rates vis-à-vis 56 trading partners. The real HCI (deflated by consumer prices) takes into account relative price changes along with exchange rate movements.
14 European Commission, Surveillance of Intra-Euro-Area Competitiveness and Imbalances, 2010.
15 European Commission, Directorate-General for Economic and Financial Affairs, Price and Cost Competitiveness - Quarterly data on price and cost competitiveness of the European Union and its Member States, ECFIN/E-4 Second quarter 2010

Figure 1.2: Relative Price Indicators Based on HICP, 1999=100



This deterioration was the combined result of an appreciation in the euro against the currencies of many of our trading partners (nominal HCI) and higher price inflation in Ireland. Since 2008, Ireland has regained some competitiveness as a result of deflation (caused by the recession) and a weakening of the Euro: between Q2 2008 and Q4 2010, Ireland's price index fell back to 105.0.

Source: European Commission

It is important to determine if progress to date is sufficient to restore competitiveness and whether further adjustments are necessary. European Commission research suggests that the Irish real effective exchange rate (REER) or HCI remains approximately six percent overvalued or overpriced – though it highlights that this figure should be treated as approximate[16]. Similar assessments from the European Central Bank and the IMF estimate that Ireland's real exchange rate is overvalued by between four to fifteen percent[17]. Therefore, despite significant progress to date, Ireland still has some way to go to achieve cost competitiveness relative to our key trading partners and to generate a rapid improvement in employment and investment levels.

Further, recent price falls in Ireland are largely a cyclical response to the Irish and international recession (e.g. reduced demand, spare capacity, falling interest rates, falling fuel and food prices) rather than a response to structural changes in the Irish economy. While weak economic growth continues to moderate inflation in Ireland, structural or policy induced changes are necessary to ensure that prices do not escalate and erode competitiveness when the Irish economy returns to growth.

1.2 What Drives Costs?[18]

As a result of the long economic boom and credit fuelled bubble, costs have overshot. During a boom, it can be expected that prices and costs will increase. Wealthy countries are generally expensive countries. The high rate of domestic price inflation in Ireland in recent years partly relates to convergence in average Irish and European price levels due to faster economic growth in Ireland. Higher inflation due to this 'convergence effect' is not, in itself, a major concern,

16 European Commission, Surveillance of Intra-Euro-Area Competitiveness and Imbalances, 2010.
17 ECB, IMF 2009 Article IV Ireland Consultation and European Commission Quarterly Report on the Euro Area Volume 8, No.1 (2009)
18 This section is largely based on research conducted by Philip Lane, Trinity College Dublin for the National Competitiveness Council in 2004.

reflecting a natural rise in the cost of domestic services justified by higher incomes and living standards[19]. Analysis by the European Commission, however, has found that even allowing for Ireland's relatively high level of GDP per capita, the price level in Ireland prior to the current crisis had been relatively high in comparison with other euro area economies (see Figure 7.1)[20]. In GNP per capita terms (where net factor incomes from the rest of the world are excluded), Irish price levels were even more out of line compared with the benchmarked countries. Factors contributing to the rise in costs that are of greater concern from a competitiveness perspective are:

- Economic overheating caused by pro-cyclical fiscal policy (fast growth in public spending and tax cuts) while euro area interest rates were low;
- Rapid credit growth and the unsustainable boom in the construction industry;
- The circular impact of rapid house price inflation on wage growth; and
- Regulatory and other restrictions to competition as outlined in various Competition Authority reports.

Despite recent falls in the costs of doing business, we are concerned that the readjustment is, in some cases, occurring too slowly due to a range of barriers.

1.3 High Costs Damage Enterprise Development and Growth

A high cost environment impacts on enterprise development[21] across a range of areas:

- FDI Enterprise Base: A wide range of factors, including cost competitiveness contribute to our attractiveness in winning and retaining overseas investment. Despite relatively strong productivity growth in many sectors and the containment of unit labour costs, the profile of FDI projects that Ireland has traditionally won has changed (e.g. the labour intensity of investment projects).
- Indigenous Enterprise Base: The performance of our indigenous exports is heavily dependent on our competitiveness vis-à-vis the UK[22]. Ireland's higher cost base and the appreciation of the euro against sterling in 2009 placed the food and drink sector under extreme pressure both at home, in the UK and in third markets where Irish produce competes with UK produce. The euro has since depreciated somewhat against sterling in 2010 and 2011. Looking to the future, the

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19 In an economy catching up with its richer neighbours, labour productivity tends to rise faster in sectors producing internationally tradable goods (particularly in capital intensive manufacturing industry) than in those involved in the more labour intensive and generally non-traded service sector. Increases in labour productivity growth in traded manufacturing industries are usually followed by wage growth throughout the economy (both manufacturing and services compete for employees in the same labour market). Thus, a combination of wage growth across both traded and non-traded sectors, but lower labour productivity gains in the services sector, leads to more rapid increases in the cost of services. In this way, services inflation is often higher in those regions of a monetary union enjoying the most rapid growth in productivity and incomes. This is known as the 'Balassa-Samuelson effect'.

20 Directorate-General for Economic and Financial Affairs, The Economic Adjustment Programme for Ireland, European Economy, Occasional Papers 76, February 2011, pg 14

21 A recent Central Bank article provides a useful assessment of cost competitiveness in Irish manufacturing by developing labour cost competitiveness indicators for four important manufacturing sectors. See O'Brien, D., Assessing the Cost Competitiveness of Irish Manufacturing Sectors, Quarterly Bulletin 02 / April 2011

22 . For example, this is evidenced by a very strong trading relationship with Ireland exporting 44 percent of its estimated €7.12 billion. Bord Bia, Performance and Prospects: Food and Horticulture Export 2009/2010/ 2009 – compiled from preliminary monthly figures from External Trade publication. Includes live animals and excludes beverages and is therefore not a direct comparison with export figure in previous footnote.

IMF assumptions imply that the sterling/euro exchange rate will average 0.85 in 2010 and 0.83 in 2011[23].

- Sub-Supply Base to Exporters: While internationally trading sectors account for a significant share of national value added, they represent a much smaller share of national employment. The more employment intensive locally trading sectors have generally faced significant increases in a range of costs over recent years. Increases in the broader cost environment damage the costs competitiveness of exporting firms as they source essential goods and services. They also reduce the multiplier benefits of export driven growth if internationally trading firms are driven to source a higher proportion of their raw materials and services overseas because of high domestic costs[24].

At a firm level, high costs encourage companies to minimise the use of expensive resources. This can make marginal business opportunities unviable which results in lost output and employment. In cases where high prices are a genuine reflection of market demand and supply (e.g. scarcity), prices serve an important role in ensuring the best use of scarce resources. However, if prices remain high (despite the potential availability of resources – labour, property, etc.), enterprise development and broader economic development are impeded. Unless steps are taken now to address those factors preventing markets from operating in an optimum manner (i.e. ensuring that prices adjust in a timely manner to changes in economic conditions), a resumption of economic growth could see business costs escalate rapidly once again, negating recent cyclical competitiveness gains and cutting off the recovery.

1.4 Methodology

Chapter 2 uses sectoral cost profiles to assess the importance of various costs to 17 sectors of the economy. The cost profiles have been developed using KPMG's Competitive Alternatives 2010 report[25]. The following cost components are captured:

- Labour Costs;
- Property (leased facility);
- Utilities;
- Transport;
- Interest and Depreciation;
- Total Taxes (net of grants); and
- Location Insensitive Costs.

Using the Competitive Alternatives study, the NCC has created indicative cost profiles for a number of sectors which are of importance to the Irish economy. The profiles provide an indication of the

23 ESRI, Quarterly Economic Commentary, Autumn, 2010
24 This could arise due to Ireland being too expensive or firm levels factors such as the centralisation of procurement and a lack of strong linkages to the local market and/or structural change towards sectors with a lower need for domestic inputs. From 2000-2008, the share of raw material and services purchases by foreign owned manufacturing and international services firms in Ireland has fallen from 36 percent of purchases to 20 percent. See Forfás, Annual Business Survey of Economic Impact (ABSEI), 2008
25 Ireland is not included in the study. The benchmarked locations are Australia, Canada, France, Germany, Italy, Japan, Mexico, Netherlands, the UK and the US.

varying importance of the different cost components to individual sectors. However, it should be noted that the costs structures of individual firms are likely to vary significantly within sectors.

For chapters 3 to 6, internationally comparable unit cost data was collected for Ireland and a number of key trading partners[26]. Given that the prices of internationally traded business inputs are set on world markets (e.g. industrial equipment or commodity raw materials), this report concentrates on the costs that are largely domestically determined such as labour, property, energy, water, waste, communications and business services. Where comparable data is available, costs are compared over time. Where possible, Ireland's cost levels are compared to a relevant peer group average, the OECD and euro area average or else compared to as wide a group of countries as possible. The report uses the most up to date internationally comparative cost data. As much of the data is collected on an annual basis there may be a time lag in capturing more recent changes in cost levels. Recent changes in Ireland's cost environment, which are not captured in the international data, are reflected in the text where applicable. Finally, Chapter 7 considers the general cost environment – using data from the Consumer Prices Index and the Harmonised Index of Consumer Prices.

26 Details of the data sources used in the completion of this report are included in the appendix to this report.

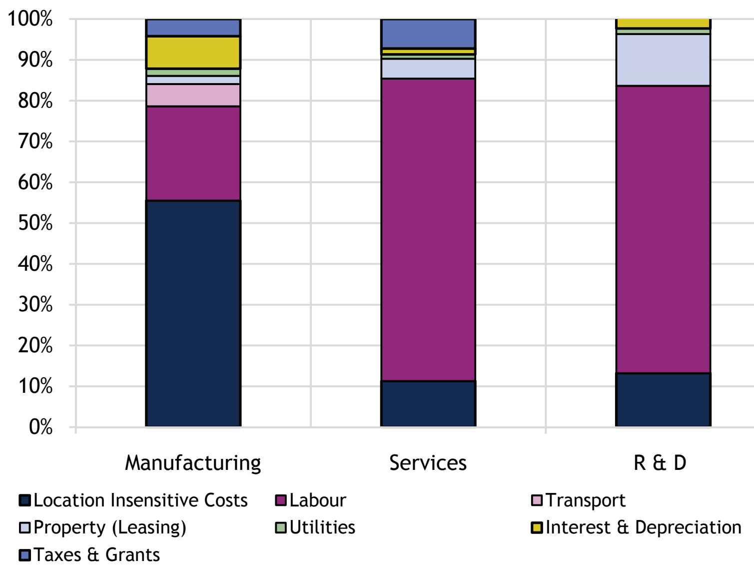
2. Cost Profiles

This chapter assesses the relative importance of key business inputs across the main exporting sectors. From a competitiveness perspective, it is essential that public policy focuses on reducing costs that comprise a significant percentage of business costs (as set out in this chapter) and that are out of line with those in competitor countries (chapter three to six).

2.1 Summary Cost Profiles[27]

The summary cost profiles present a breakdown of the cost components for manufacturing, services and research and development (R&D) operations. They illustrate the relative importance of location sensitive and location insensitive costs (i.e. goods and services produced on international markets where the price is determined by global supply and demand conditions).

Figure 2.1: Summary Cost Profiles for Manufacturing, Services and R&D Operations



Source: KPMG, 'Competitive Alternatives, 2010', Forfás calculations

A striking, though not unexpected, feature of the comparison of the summary cost profiles is that relative to manufacturing, location insensitive costs form a small component of total costs for services (11%) and R&D (13%). Over half of the total costs in manufacturing (56%) are accounted for by location insensitive costs. There are also differences within manufacturing - 38 percent of total costs in the medical devices sector are location insensitive compared to 68 percent in the chemicals sector.

Location insensitive costs include inputs for which the price is set in international markets, such as materials and equipment. As location insensitive costs do not influence decisions on where to

27 The cost profiles discussed below have been developed using KPMG's Competitive Alternatives 2010 report, which uses case study business operations for 17 different sectors and benchmarks the cost of doing business for these model firms in 10 global locations. Ireland is not included in the study. The benchmarked locations are Australia, Canada, France, Germany, Italy, Japan, Mexico, Netherlands, the UK and the US. In past reports, the NCC used internally developed cost profiles. For this report we have adapted KPMG's profiles as they are more timely and comprehensive. Nonetheless, the profiles are broadly similar. As the profiles are based on a single case study firm in each sector, the profiles should be regarded as indicative rather than representative of the cost structure across sectors.

invest, these cost elements have been excluded from the detailed sectoral cost profiles discussed below[28].

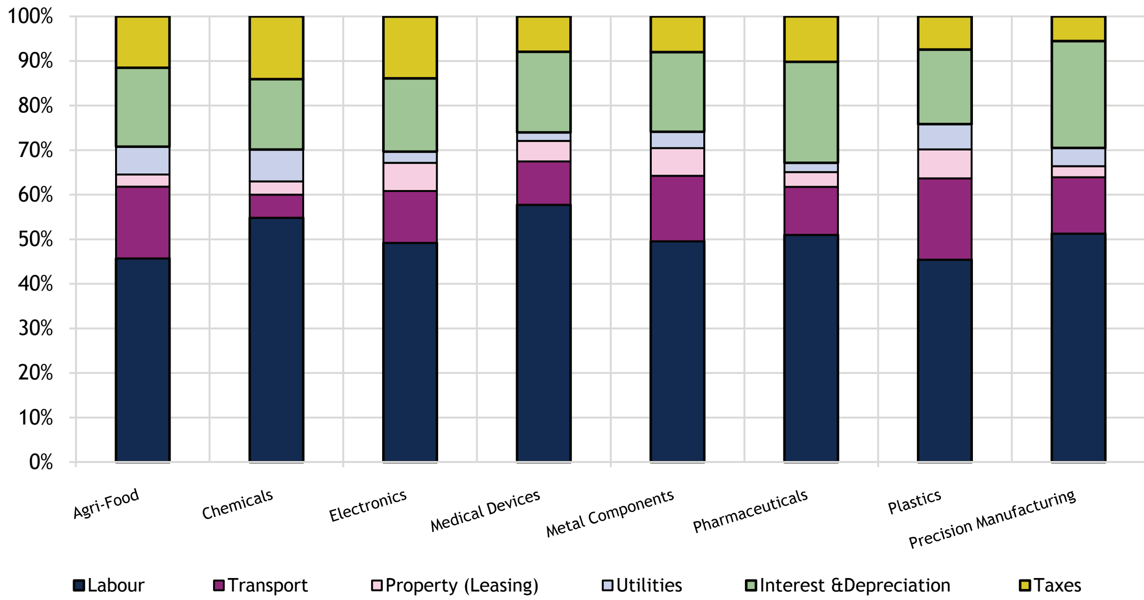
2.2 Sectoral Cost Profiles

The following sectoral cost profiles provide an indication of the contribution of various location sensitive cost components to total costs in a number of key sectors. As the profiles are based on a single case study firm in each sector, the profiles should be regarded as indicative rather than representative of the structure of costs across sectors.

2.2.1 Manufacturing Sectors Cost Profiles

The contribution of labour costs to total location sensitive costs varies from 45 percent in the case study plastics firm to 56 percent in the case study medical devices firm. Transport costs are a major component of locally determined costs for the case study plastics (18%) and agri-food operations (16%). Utilities are also an important cost input for the agri-food (6%) and chemicals (7%)

Figure 2.2: Manufacturing Sectors' Cost Profiles (Location sensitive costs)



Source: KPMG, 'Competitive Alternatives, 2010', Forfás calculations

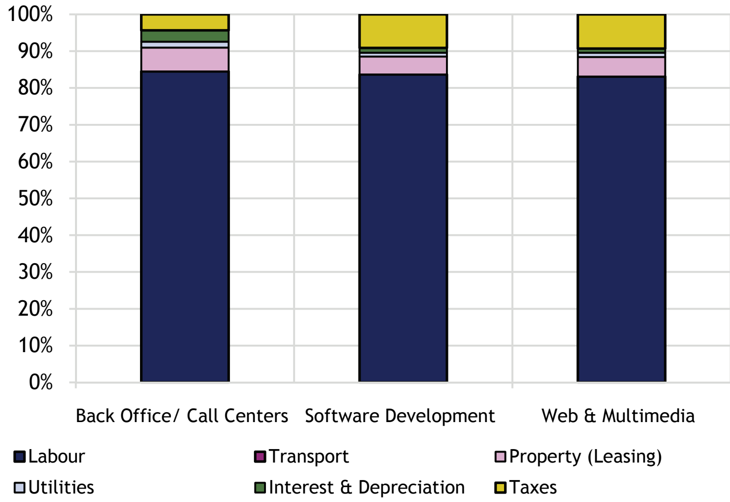
2.2.2 Service Sectors Cost Profiles

On average, location insensitive costs account for just 11 percent of total cost for the case study services firms, making services operations highly sensitive to locally determined costs. In 2009,

28 It should be noted that the assumption that location insensitive costs do not influence decisions on where to invest may not hold in all cases. For example, peripheral locations may face additional transportation costs on commodity products. Domestic policies such as taxes and tariffs may also impose additional costs on 'location insensitive costs'.

services exports accounted for 47 percent of total Irish exports compared to 25 percent in 2001[29]. Given the increasing importance of services exports to the Irish economy, ensuring Ireland is a cost competitive environment for firms in the services sector to do business should be a policy priority. Location insensitive costs have been eliminated from Figure 2.3.

Figure 2.3: Services Sectors' Cost Profiles (Location sensitive costs)



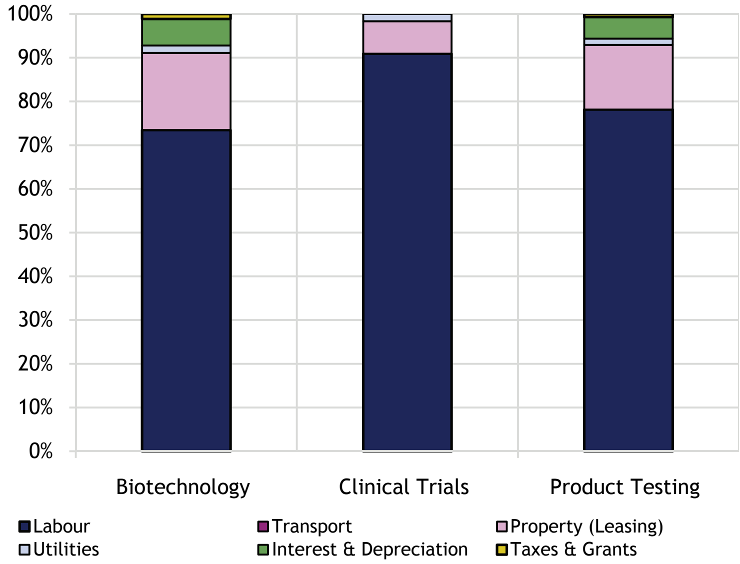
Source: KPMG, 'Competitive Alternatives, 2010', Forfás calculations

Labour costs are the main component of costs in services sectors. They account for 76 percent of location sensitive costs for back office and call centre operations and 74 percent for software development, and web and multimedia operations. Taxes (less grants) account for nine percent of costs for software development and web and multimedia, while property leasing costs are significant for back office/ call centre operations (6%).

29 CSO Balance of Payment March, 2010

2.2.3 R&D Sectors Cost Profiles

Figure 2.4: R&D Sectors' Cost Profiles (Location sensitive costs)[30]



Source: KPMG, 'Competitive Alternatives, 2010', Forfás calculations

Labour costs comprise a large component of location sensitive costs for the case study R&D operations. They account for 91 percent of costs within the clinical trials firm, 78 percent within the product testing operation and 73 percent within the biotechnology firm. The leasing of property is a major cost element for these firms also (18 percent for biotechnology, 15 percent for product testing). Interest and depreciation charges are also significant for biotechnology and product testing facilities.

30 On average 13 percent of costs for R&D operations are determined on global markets. Of the three R&D sectors benchmarked in this report, clinical trials operations are the most sensitive to locally determined costs (93%).

3. Labour Costs

3.1 Summary

As discussed in chapter 2, labour costs are the most significant location sensitive cost for all sectors. The core objective of enhancing competitiveness, however, is to provide Ireland's people with the opportunity to improve their living standards and quality of life[31]. This section examines trends in relative labour costs, unit wage costs, and tax wedges across a range of countries. Professional fees also represent a form of remuneration or wages. Given the impact which these fees can have on competiveness, and considering the fact that in some cases, professional fees have not adjusted as one might have expected, the issue of professional fees is dealt with in greater detail in Chapter 6.

Labour Cost Growth Rates and Unit Labour Costs

Labour cost growth rates show the change in the cost of employing workers over time. Ireland's growth rates exceeded the EU-15 average between 2004 and 2007. However, growth rates in Irish labour costs slowed significantly in 2008 and the first half of 2009 and growth rates were lower than the EU-27 and euro area-16 average (Figure 3.1).

Total labour costs include wages, taxes on income and employer and employee social security contributions. Ireland has the tenth highest total labour costs level in the OECD (Figure 3.2). Ireland has the fifth highest net wage level in the OECD-28, 35.5 percent above the OECD-28 average. This is a result, in part, of Ireland's lower tax wedge on labour.

Between 2000 and 2006, the average annual increase in total compensation per employee was significantly higher in Ireland (6.2%) than the euro area (2.3%). However, the rate of increase in average compensation began to slow in Ireland in 2007 (Figure 3.3). In 2010, average employee compensation continued to grow in the euro area (1.6%) while it fell in Ireland (-1.9%).

In 2005, Irish unit labour costs (ULCs) grew by 6.15 percent, significantly ahead of both the euro area and OECD averages (1.9 and 2.09 percent). In 2008, however, Irish ULC growth rates fell below the euro area and OECD average. During 2010, Ireland experienced a more pronounced decline in ULCs (-4.4%) relative to the OECD-25 (-0.46%) and the euro area-14 (0.85%), indicating an improvement in competitiveness (Figure 3.4). At an economy wide level, therefore, Irish labour wage rates adjusted for productivity are becoming more competitive. It is important to note, however, that ULCs are heavily influenced by composition effects. Recent improvements in Ireland's ULC are a result of a reduction in output from low productivity sectors, an upturn in high value added export oriented sectors, and a reduction in compensation per employee.

31 For the National Competitiveness Council, the goal of national competitiveness is to provide Ireland's people with the opportunity to improve their living standards and quality of life. Improving living standards depends on, among other things, raising incomes (and providing employment). To raise incomes, productivity gains are necessary but in an economy with a small domestic market, this requires a healthy exporting sector to achieve economies of scale necessary for productivity gains. For a vibrant exporting sector, Ireland must maintain its national competitiveness.

Finally, Figure 3.5 measures statutory monthly minimum wages and minimum wage as a percentage of the average wage. Ireland has the second highest statutory monthly minimum wage (€1,462). The minimum wage is more prevalent in certain locally traded sectors, notably in hotels and restaurants, wholesale and retail and other locally traded service industries[32].

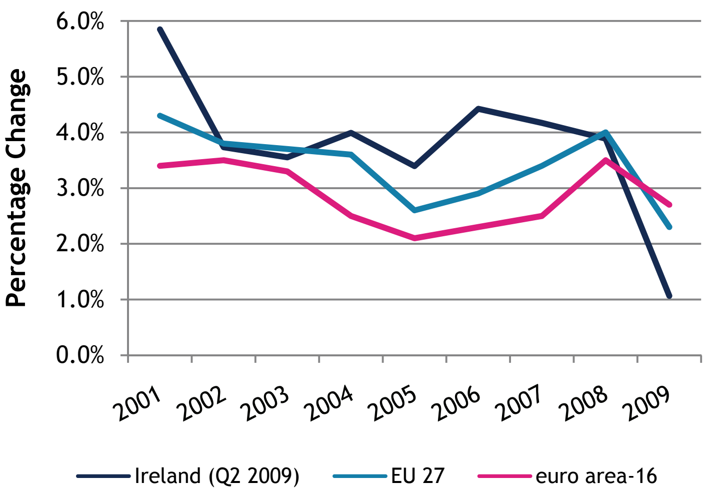
Social Security Contributions and Labour Taxation

There are significant disparities across locations in relation to the levels of social security contributions and labour taxation. Ireland has one of the lowest levels of employers' social welfare contributions (Figure 3.7). The Irish rate (10.8%) is significantly lower than the OECD average (15.2%) and the euro area average (27%), which reduces the total cost of employing workers in Ireland.

Ireland's tax wedge on labour (i.e. the gap between what the employer pays and what the employee receives) for a married couple (with two children) with a combined salary of 167 percent of the average wage rose from 14 percent in 2008 to 19.8 percent in 2009 as a result of increases in income and health levies (Figure 3.8). The tax wedge is significantly higher for higher income earners – a potential disincentive for highly skilled internationally mobile workers (Fig. 3.9). For a single worker (with no children) on 167 percent of the average wage, the tax wedge has increased from 34 percent in 2008 to 39 percent in 2010. The tax wedge is important from a competitiveness perspective for a number of reasons – it affects the cost of labour for the employer, it partly determines labour supply, and it can impact on Ireland's ability to attract high skilled labour.

3.2 Labour Cost Indices and Unit Labour Costs

Figure 3.1: Labour Cost Index, 2009

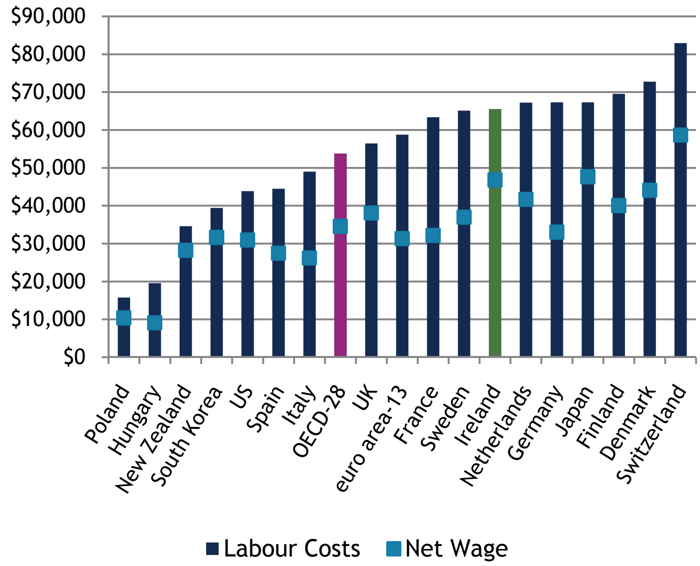


Source: Eurostat, Population and Social Conditions, CSO, Labour Cost Index

Figure 3.1 illustrates the trend in labour cost growth in Ireland compared with the euro area-16 and EU-27. Data for the euro area-16 and EU-27 is provided to the end of 2009, while the most recent data for Ireland is to the end of Q2 2009[33]. The rate of growth in Irish labour costs has fallen from a high of 5.9 percent in 2001 to 1.1 percent at the end of Q2 2009. In 2009, the euro area-16 and EU-27 growth rates declined by 1.7 percent and 0.8 percent respectively, while within the first six months of 2009 Irish labour costs fell by 2.8 percent.

32 CSO, National Employment Survey, 2007
33 Quarterly data is not available for the EU-27 and euro area 16 group

Figure 3.2: Average Total Labour Costs and Net Wages, 2009

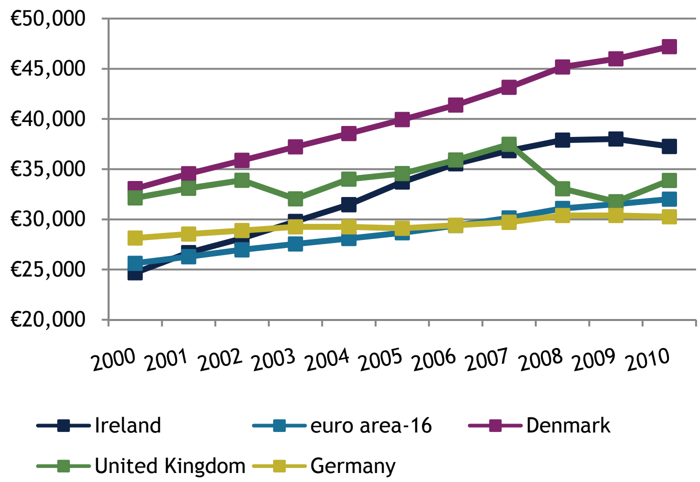


Source: OECD, Taxing Wages 2009, OECD, Comparative Price Levels March 2009, Forfás calculations

This indictor shows total labour costs for a single person with no children earning the average wage. Total labour costs include wages, taxes on income and employer and employee social security contributions. Ireland has the tenth highest total labour costs level in the OECD and is broadly comparable with a number of western European countries.

The chart also shows average net wage levels. Ireland has the fifth highest net wage level in the OECD-28, 35.5 percent above the OECD-28 average. This is due, in part, to Ireland's low tax wedge[34] on labour. Since publication of the OECD report, however, taxes on labour have increased, reducing net wages.

Figure 3.3: Total Compensation[35] per Employee Across the Entire Economy, 2000 – 2010f



Source: Eurostat, National Accounts, Groningen, Total Economy Database

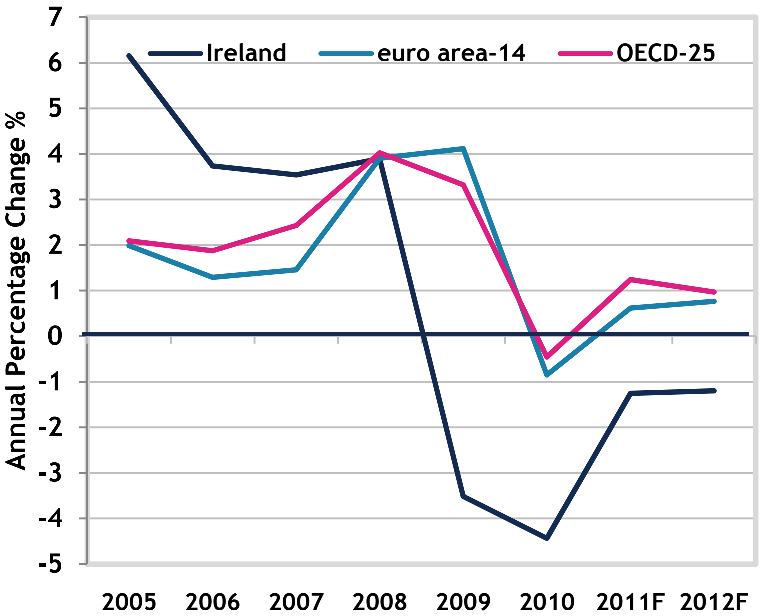
At the beginning of the period, compensation per employee in Ireland was slightly below the euro area average and Ireland had the lowest compensation level of the benchmarked countries.

Between 2000 and 2006 compensation per employee rose rapidly in Ireland (6.3%) compared to the euro area (2.3%).

In 2010, average employee compensation continued to grow in the euro area (1.6%) while it fell in Ireland (-1.9%).

34 The labour tax wedge is the difference between what the employer pays and what the employee receives.
35 Total compensation is the total expenditure borne by employers for the purpose of employing staff. It includes employee compensation (including wages, salaries in cash and in kind, employers' social security contributions), vocational training costs, other expenditure such as recruitment costs, spending on working clothes and employment taxes regarded as labour costs minus any subsidies received.

Figure 3.4: Annual Change in Unit Labour Cost, 2005 – 2012F[36]

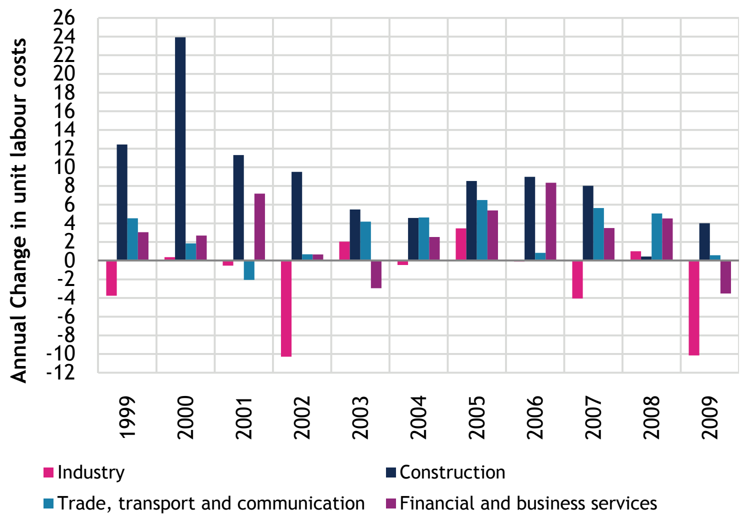


Source: OECD, Unit Labour Cost Quarterly Indicators, EU Commission AMECO database

Unit labour costs (ULC) measure the average cost of labour per unit of output. In 2005, Irish ULC's increased by 6.15 percent compared to an average of 2.1 percent and 1.9 percent in the OECD-25[37] and the euro area-14 respectively.

In 2008, the rate of ULC growth in Ireland fell below the euro area-14 average. During 2010, Ireland experienced a more pronounced decline in ULC (-4.4%) relative to the OECD-25 (-0.46%) and the euro area-14 (0.85%), indicating an improvement in competitiveness. The European Commission forecast that Irish ULC's will continue to decline in 2011 and 2012.

Figure 3.5: Annual Change in Unit Labour Cost by sector, 2005 – 2009



Source: OECD, Unit Labour Cost Annual Indicators

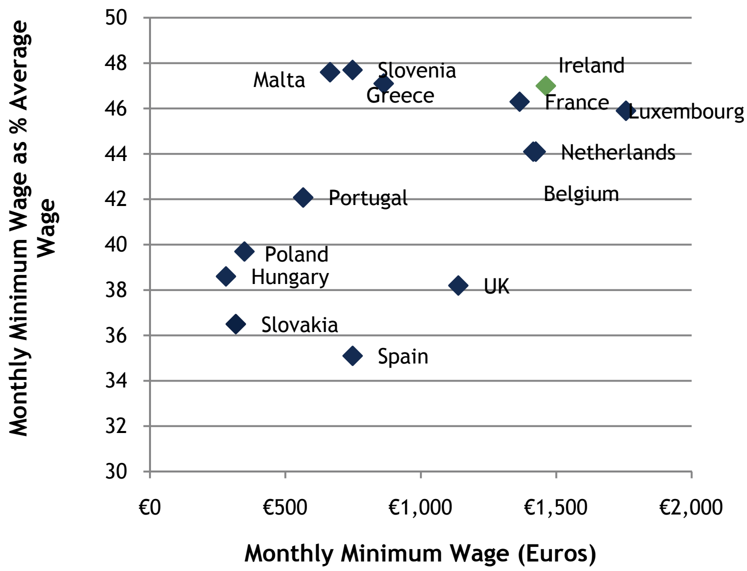
Figure 3.5 examines unit labour cost data by sector. While industry and financial and business services experienced negative growth in unit labour costs in 2009, modest growth was recorded for the construction and trade, transport and communications sectors. Unit labour costs are also driven by compositional effects. It is possible for example, that the changing sectoral composition in industry (i.e. the continuing shift towards high value-added sectors) was an important explanatory factor behind the sharp fall in unit labour costs across the economy[38].

36 Quarterly Unit Labour
Costs are derived from annual and quarterly National Accounts and are thus are subject to regular revision as National Accounts data are revised. Data for 2011 and 2012 are forecasts from the EU Commission. OECD average for 2012 relates to OECD 22, forecasts are not available for New Zealand, Australia and South Korea for 2012. Figures for EA14 average in 2009 and 2010 relate to EA13 average as data for Cyprus hasn't been reported.

37 The OECD average excludes Iceland and Switzerland and Portugal, the euro area average excludes Malta and Portugal.

38 Central Bank, Quarterly Bulletin Q1 2011

Figure 3.6: Monthly Minimum Wage and Minimum Wage as a % of Average Wage[39], 2010



This indicator measures statutory monthly minimum wages and minimum wage as a percentage of the average wage. Ireland has the second highest statutory monthly minimum wage (€1,462). A number of EU member states[40] operate non-statutory minimum wage rates on a sectoral basis and have rates which are significantly higher than Ireland's (e.g. Denmark[41]). In terms of the purchasing power of the NMW, Ireland's ranking changes to 5th behind Netherlands, Luxembourg, Belgium, and France[42].

When measured as a percentage of the average wage, the minimum wage in Ireland is the fourth highest amongst the 15 countries benchmarked.

Source: Eurostat, Minimum Wages, CSO Earnings Hours and Employment Costs Survey, Forfás calculations

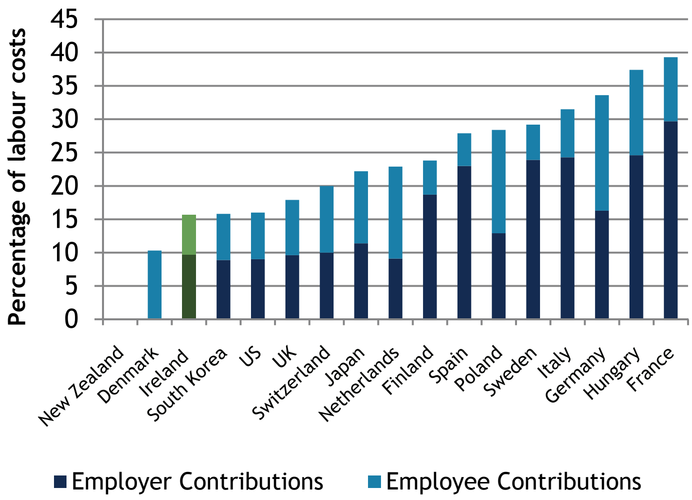
It should be noted that in Ireland (along with a number of other countries), the minimum wage is not set on a monthly basis. Instead, the minimum wage in Ireland is set according to an hourly rate. Comparing the hourly Irish rate of €8.65 with equivalent hourly rates elsewhere, the Irish minimum wage rate is the third highest amongst the countries benchmarked.

3.3 Social Security Contributions and Labour Taxation

Social security costs are the statutory contributions that the employer and employee are required to make towards unemployment and sickness benefits on behalf of employees.

39 For countries where the national minimum wage is not set monthly (i.e. Ireland, France, Malta, UK and US where either hourly or weekly rates apply) rates are converted into monthly rates according to conversion factors directly supplied by the countries. For Ireland, the monthly minimum wage is calculated using the following formula: hourly rate x 39 hours x 52 weeks / 12 months. In addition, when the minimum wage is paid for more than 12 months per year (as in Greece, Spain and Portugal, where it is paid for 14 months a year), data have been adjusted to take these payments into account. The average monthly wage refers to the average monthly wage within industry, services and construction sectors (NACE section B to S).
40 These include Denmark, Finland and Sweden.
41 According to the European Industrial Relations Observatory (EIRO), under Denmark's collective agreement for the industry sector - which normally determines the level to be followed by the other sectors - the minimum hourly pay was increased to approximately €13.19 March 2007 under a 2007-2010 agreement. Further increases of €0.34 were implemented on an annual basis over the next two years.
42 Eurostat, Minimum Wage Statistics, January 2011. See http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/Minimum_wage_statistics

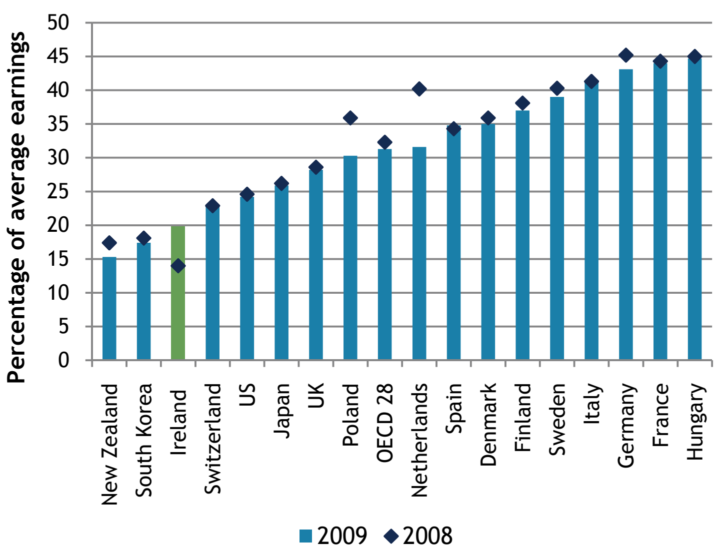
Figure 3.7: Employer and Employee Social Security Contributions, 2009



Ireland has the third lowest rate of total social contributions. From the employer perspective, the rate of contributions (9.7%) is the seventh lowest amongst the countries benchmarked[43]. In many countries, however, there is either a cap on employer social security costs or a reduced rate above a certain income threshold. In Ireland, a flat rate is charged on the full salary. As salaries increase, Ireland's competitive position is quickly eroded.

Source: OECD, Taxing Wages, 2009

Figure 3.8: Income tax plus employee and employer contributions less cash benefits as % labour costs (Married, 2 Children, 167% Average Wage), 2009



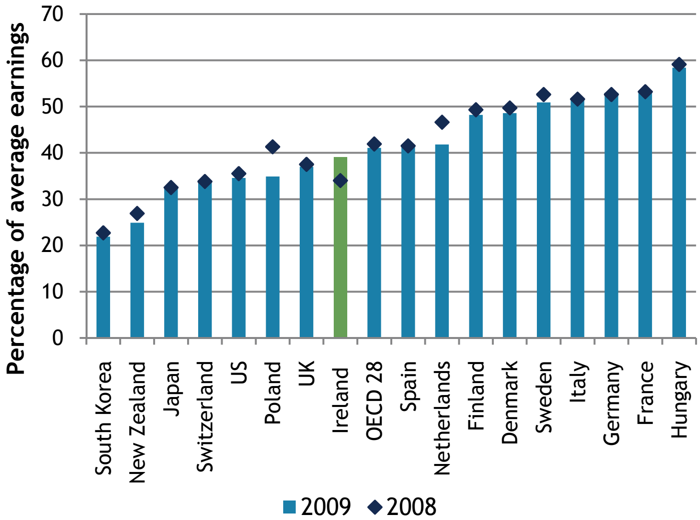
Ireland's tax wedge on labour (i.e. the gap between what the employer pays and what the employee receives) has increased significantly since 2008. For a married couple with two children on a combined income of 167 percent of the average wage the tax wedge is 19.8 percent in 2009 – an increase from 14 percent in 2008.

While Ireland still ranks as one of the most competitive countries by this measure, the tax wedge in most OECD countries is unchanged or falling since 2008.

Source: OECD, Taxing Wages, 2009

43 Note that a significant proportion of European employer social contributions support state pensions, which in some cases are higher than the Irish state pension.

Figure 3.9: Income tax plus employee and employer contributions less cash benefits as % labour costs (Single, No Children, 167% AW), 2009



Source: OECD, Taxing Wages, 2009

For a single person with no children on 167 percent of the average wage, the tax wedge is 39 percent in 2009 (up from 34 percent in 2008).

This is a potential disincentive for highly skilled internationally mobile workers.

As this data relates to 2009 it does not take into account changes to the tax wedge as a result of the introduction of the Universal Social Contribution and changes to personal tax credits in Budget 2011. The effects of these will have further increased Ireland's tax wedge on labour.

Marginal income tax rates for employees have also increased since 2008. An international comparison of marginal income tax rates carried out by the OECD, shows that Ireland's marginal income tax rate for employees increased from 47 percent in 2008 to 50.7 percent in 2009. Budget 2011 increased the marginal tax rates further to 52 percent[44]. Furthermore, the income threshold at which this takes effect is low in Ireland relative to other countries with high marginal tax rates. Of the nine OECD countries with marginal income tax rates above 50 percent in 2009, Ireland had the second lowest threshold at which the marginal rate took effect. A ten percent reduction in the threshold at which the higher rate of tax is paid has further decreased this threshold from €36,400 to €32,800 in Budget 2011.

3.4 Policy Focus - Labour Market Efficiency

The purpose of this section is to examine the operation of the Irish labour market and to identify actions which can improve its efficiency. The remainder of the chapter provides:

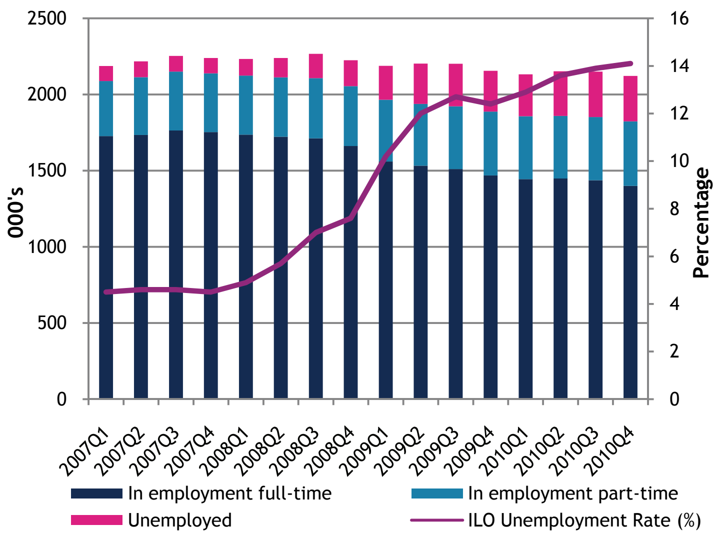
- An analysis of labour market costs and their drivers; and
- A series of policy recommendations to improve labour market efficiency, support enterprise development and encourage employment growth as the economy recovers.

44 Marginal income tax for employees: 41 percent higher income tax rate, 7 percent Universal Social Contribution and 4 percent employee PRSI.

3.4.1 Overview of Labour Market

In order to place labour cost developments in context, it is necessary to briefly examine a number of key labour market trends (summarised in Figure 3.10 below). Total employment in the Irish economy now stands at 1,823,200 (Q4 2010), a decline of 64,500 on the previous year and a decline 231,400 compared to two years ago. Unemployment has increased from 267,400 in Q4 2009 to 299,000 (+6.9%) in Q4 2010.

Figure 3.10: Labour Market Trends - Employment, Unemployment, Q1 2007 – Q4 2010



Source: CSO, QNHS

The current ILO seasonally adjusted unemployment rate is 14.7 percent. The most recent Central Bank *Quarterly Bulletin* forecasts an unemployment rate of 13.7 percent for 2011 and 13.4 percent for 2012.

There has been a notable increase in part-time employment as more people are placed on reduced working hours or have moved to shorter working weeks. Long term unemployment has also increased from 4.1 percent in Q4 2009 f 2009, to 7.3 percent in Q4 2010.

3.4.2 Focus on Domestic Wage Developments

Observed decreases in hourly rates and weekly rates in Ireland, based on CSO data, are relatively modest[45]. At the aggregate level, hourly earnings excluding irregular bonuses have fallen by 2.0 percent in the year to Q4 2010. The corresponding figure including irregular earnings was an annual decrease of 1.9 percent. In weekly terms, average weekly earnings fell by 2.5 percent over the year to Q4 2010 (Table 3.1).

Table 3.1: Summary of Earnings Data, Q4 2010

	Hourly (Excluding Irregular)	Hourly (Including Irregular)	Weekly (Including Irregular)	Numbers Employed	Hours Worked
Annual Change to Q4 2010	-2.0%	-1.9%	-2.5%	-2.5%	-0.9%
Quarterly Change to Q4 2010	1.8%	3.0%	2.3%	-1.4%	-0.9%

Source: CSO Earnings, Hours and Employment Costs Survey (EHECS)

45 CSO, Earnings and Labour Costs Survey, Q3 2010

It is important to bear in mind that overall labour costs reflect three different variables – hourly earnings, hours worked and the total number of persons employed. The fall in weekly earnings referred to above, therefore, is a result of a combination of changes in hours worked as well as changes in hourly earnings.

Figure 3.11: Employment, Hours and Earnings, Q1 2008 – Q4 2010

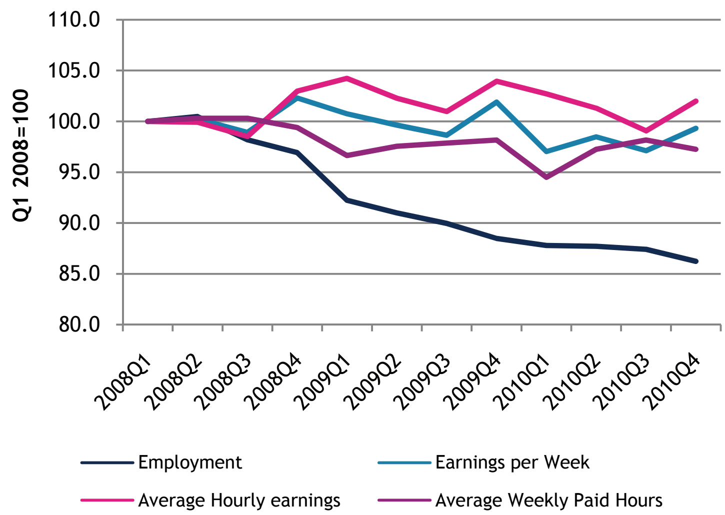


Figure 3.11 highlights that instead of introducing cuts to wage rates, many employers have taken other measures to control labour costs. This is borne out by the available data on numbers employed and hours worked – many firms have continued to reduce numbers employed and/or contracted hours worked, more consistently and to a greater extent, than adjusting pay rates (average hourly earnings).

Source: CSO, Earnings and Labour Costs Database

3.4.3 Policies that Influence Labour Costs

- **Inflation:** Wage increases have generally tended to be strongly influenced by the prevailing rate of inflation. ESRI research indicates a close upward correlation between consumer prices and wage demands. Relative to historical levels, the Irish consumer price index peaked in September 2008. Since then the index has fallen and prices in January 2011 were 6.2 percent below the peak level. Based on CSO earnings data[46], average weekly wages have declined by less than 1 percent between Q1 2008 and Q4 2010, indicating that real wages have increased over the period in question[47].
- **National minimum wage (NMW):** At first glance, relatively few workers in Ireland are earning the NMW rate – according to the CSO, in October 2007 4.9 percent of employees in Ireland (83,700) were earning €8.65 per hour or less[48]. It is likely, however, that the presence of the minimum wage influences wage levels for those who earn close to the NMW rate – the earnings of another 26 percent of the labour force, for instance are within 1.5 times the NMW. The NMW impacts on sectors in different ways – sectors such as wholesale and retail, hotels and restaurants, construction and other services sectors have significantly more NMW workers than internationally trading sectors. While the sectors and occupations where the greatest job losses have occurred generally coincide with the sectors where the NMW is most prevalent, these sectors have also experienced a major collapse in demand for their output.

46 CSO, Earnings and Labour Costs Survey, Online Database
47 This does not take account of the introduction of the income levy or the public service levy etc. which reduced take home pay. House prices also affect wage expectations.
48 The NMW was reduced from €8.65 per hour to €7.65 per hour as of 1st February 2011. It was subsequently agreed to increase the rate back to €8.65.

- **Collective agreements:** It is estimated that between 170,000 and 300,000 workers are covered by either Employment Regulation Orders (ERO's) or Regulated Employment Agreements (REA's) regarding the terms and conditions of their employment[49]. In many cases, those covered by ERO's and REA's overlap with those earning wage levels within 1.5 times the NMW. An examination of the hourly rates guaranteed by ERO's suggests that these agreements are offering a premium of approximately nine percent over the NMW rate. REAs are predominantly related to the construction sector and guarantee hourly or weekly rates well in excess of the NMW. The additional conditions of employment covered by ERO's and REA's (such as travel to work costs, Sunday working rates etc.) can have a significant impact on employment costs.
- **National policy**: The evidence suggests that buoyancy in the broad economy drove labour costs over the past decade rather than national collective agreements and that the national agreement did not hinder decisions on wage cuts up to late 2007/early 2008[50]. In the context of the recession, no national wage agreement is currently in place for private sector workers.
- **Social welfare and replacement rates:** Jobseekers' Benefit is designed to offer income maintenance during periods of frictional or cyclical unemployment[51]. The replacement rate measures the proportion of out-of-work benefits received when unemployed against take home pay if in work. As such, it sets a de facto rather than legal minimum wage. In general, if an individual can receive more than 70 percent of non-work income in benefits, they will demand a higher wage in the market to retain a monetary incentive to work[52]. It is estimated that between 15 and 20 percent of those on the Live Register have replacement rates in excess of 70 percent[53]. Single workers with no families (who comprise a significant component of the Live Register) generally have lower replacement rates.
- **The taxation system:** The taxation system is broadly supportive of labour market efficiency but some issues of concern are emerging. The difference between the employers' cost of hiring an individual and the individual's actual take home pay, due to income and payroll taxes, is known as the tax wedge. A high tax wedge increases labour costs and has a negative influence on the employer's decision to retain or hire individuals. It also lowers take home pay and can affect an individual's participation decision as measured by replacement rates. Increases in personal taxes reduce take home pay for employees without any labour cost savings for the employer. In Ireland, the labour tax wedge has risen for all income categories assessed by the OECD since 2008 while the tax wedge in most OECD countries is unchanged or falling. A competitive tax wedge, therefore, is a vital tool to encourage employment growth across all income categories and to incentivise people to remain in or return to the labour market.
- **Firm level policies:** The available evidence in Ireland and internationally suggests that economy wide wage levels rarely fall. While it is easier for new enterprises and existing troubled

49 The various agreements on pay and conditions made by Joint Labour Committees (JLCs) are known as Employment Regulation Orders (EROs). Agreements which result from negotiations between trade unions and employers are called Collective Agreements. If a Collective Agreement has been registered with the Labour Court, it is known as a Registered Employment Agreement (REA).
50 Keeney, M., and Lawless, M., Wage Setting and Wage Flexibility in Ireland - Results from a Firm-level Survey, European Central Bank, Working Paper Series No 1181, April 2010
51 Jobseekers' Allowance (and other assistance payments) may serve as income support on a long-term basis – subject to satisfying scheme conditions.
52 The Department of Finance has noted that while there is no pre-determined level of replacement rate which would influence every individual's decision to work, a replacement rate greater than 70 percent is considered excessive. See Department of Finance, Replacement Rates and Unemployment, 2009
53 A detailed breakdown of those cohorts with replacement rates above 70 percent can be found in: Forfás, Review of Labour Cost Competitiveness, October 2010

enterprises to justify lower wage levels to their employees, the majority of businesses are reluctant to lower hourly wage rates[54].

3.4.4 Conclusions and Recommendations

Labour market expectations and wage demands are not divorced from happenings elsewhere in the economy. If employees genuinely believe that the cost of living is falling, this will be reflected in nominal wage demands. It is important, therefore, that appropriate and credible actions are taken to address all elements of the cost base in Ireland in order to protect real incomes. A long term opportunity arises for shifting negotiations on pay away from increases in living costs and focusing instead on improvements in productivity[55].

Over recent months, there have been a number of developments, most of which are related to Budget 2011, the National Recovery Plan and the joint EU-IMF Programme for Ireland.

- Social welfare rates have been reduced;
- Changes to both PAYE and the income and health levies have been introduced which have resulted in lower take home pay for employees;
- The national minimum wage was reduced from €8.65 per hour to €7.65 per hour as of 1st February 2011. It was subsequently agreed to restore the €8.65 rate.
- An independent review of Employment Regulation Order (EROs) and Registered Employment Agreement (REAs) wage setting mechanisms has commenced.

There remain aspects of the broader labour market that require attention. In the latest Competitiveness Challenge report, the NCC highlighted the need to ensure that the social welfare system does not create poverty traps and the need to ensure that employed persons do not become disengaged from the workforce.

Social Welfare

As noted above, high replacement rates discourage recipients from entering the labour market. It is important to remember, however, that a relatively small proportion of social welfare recipients have replacement rates in excess of 70 percent. Furthermore when discussing replacement rates one must acknowledge the impact of secondary benefits (e.g. rent allowance, fuel allowance, medical cards, basic supplementary welfare allowance etc.). Where high replacement rates exist, a number of options should be considered:

- Replacement rates should be revised over time to ensure no replacement rates exceed 100 percent. In the longer term, no replacement rate should exceed 70 percent. Policymakers must also be cognisant about the impact that changes in taxes on employment or social contributions can have on replacement rates.

54 Bewley, Truman F., Why Wages Don't Fall During a Recession, 1999, Harvard University Press

55 Flexibility in wage contracts in response to possible currency fluctuations with major trading partners would also be a desirable feature. Geary and Honohan proposed a mechanism for the sharing of currency risk between employers and employees through such a flexible wage contract – see Geary, P.T. and Honohan, P., Can Better Contracts Help Solve Ireland's Sterling Dilemma, 1995

- The issue of secondary benefits is quite complex and varies according to individual and household circumstances. However, potential still exists to reform this area, for example:
  - Department of Social Protection have identified that replacement rates in excess of 70 percent which occur as a result of individuals receiving rent allowance may be addressed through a movement to the rental accommodation scheme;
  - Potential may exist to allow some secondary benefits to be retained for a period of time after take up of full time employment, depending on income levels – this would reduce the impact from the loss of social welfare entitlements upon taking up employment.
- Reform the social welfare system so that benefits decline in line with the length of time a person is out of work – this would be in line with European approaches to social welfare. It is important to note, however, that the European model is predicated on relatively high contributions bestowing a relatively high post-employment income that generally declines over time (but is normally longer than Irish entitlement - the Irish system has low contribution levels and a flat rate payment system that lasts for 9/12 months).
- High quality social welfare systems (i.e. generous protection) should be accompanied by high levels of conditionality in order to ensure their sustainability. Conditionality of social welfare needs to be strengthened.

Activation and Upskilling

To meet the current challenges of high unemployment there will need to be a focus on the efficiency, quality and effectiveness of activation programmes for the unemployed to ensure the best use of the education and training budgets. This will require collaboration and co-ordination between employment services, training and education providers and enterprise. Working from a shared view of the future skills needs of the economy, an innovative and integrated approach can be followed to determine agreed education and training priorities. The *Review of Labour Market Programmes*[56] recommended that the focus of labour market programmes should be on three main areas:

- **Activation** – Activation measures aimed at improving the employability of unemployed persons by providing 'progression pathways' of relevant job search, training, education and employment opportunities for different target groups. This includes the need to ensure that the responsibilities and mutual obligations of individuals able to take up opportunities are made clear and that any disincentives to participation are minimised.
- **Participation** – Ensuring that the training and education needs of target groups such as young unemployed, those previously employed in sectors most affected by restructuring, long term unemployed, older workers and women returners are provided for through enterprise relevant programmes.
- **Upskilling -** Boosting our human capital by enhancing education and skills levels in line with the National Skills Strategy is essential to meet the needs of the 'Smart Economy' and the need to improve productivity. Notwithstanding our current economic difficulties, a recent report from the Expert Group on Future Skills Needs highlights the fact that job vacancies continue to arise[57]. Vacancies exist for both professional occupations (ICT, engineering (e.g. energy systems), health and finance) and occupations at the lower end of the skills scale (e.g. security guards, catering staff and carers). The jobs on offer generally require candidates with specific

56 Forfás/DETE, Review of Labour Market Programmes, 2010
57 Expert Group on Future Skills Needs, Vacancy Overview 2011, Forfás, March 2011

profiles that include: experience, specific expertise (e.g. IT, financial), third level qualifications, and language skills. This indicates a need for job seekers to reskill/upskill and, where possible, to avail of work placement programmes and internships in order to gain experience.

4. Property Costs

4.1 Summary

This chapter assesses the key property costs for businesses, and focuses on the construction and rental costs of industrial units and offices. Over the past decade, soaring capital values and rental prices damaged Ireland's cost competitiveness vis-à-vis selected regional competitors. From similar levels in 1996, rents and capital values were much higher in Dublin than what they were in competitor locations from 2000-07. Since then, costs have fallen back sharply.

- In terms of occupancy costs per workstation for prime office space, Dublin has recorded a fall of around 30 percent - one of the highest falls in Europe in 2008-09. This has brought rents down to the continental Europe average[58].
- The value of commercial properties in Ireland peaked in Q4 2007. Since Q1 2008, property prices have been in a steep decline - the value of retail properties fell by 29 percent, offices by 28 percent, and industrial premises by 27 percent between Q4 2008 and Q4 2009 (Fig. 4.1).

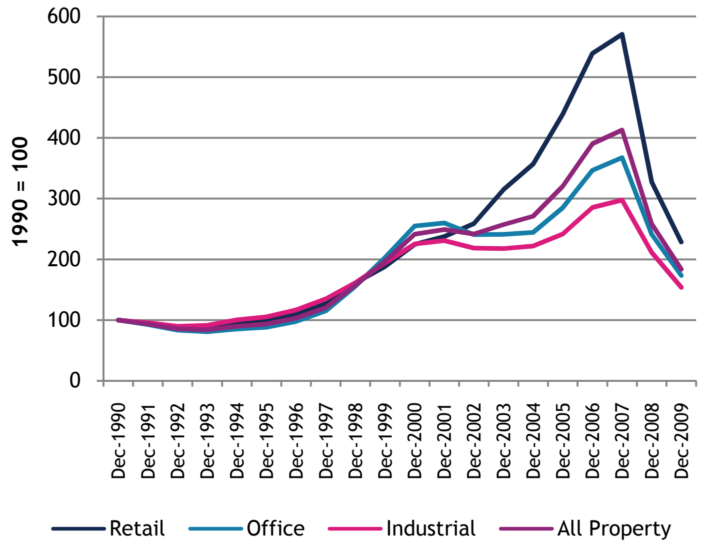
The cost of constructing and renting both industrial and office units declined sharply in Ireland during 2009. However, in relative terms, the impact of these decreases on Irish cost competitiveness has been reduced as there have also been significant cost decreases in many other countries. The main developments include:

- The cost of constructing a prime industrial site fell by 14 percent in Ireland between 2008 and 2009 – the second sharpest fall across the 13 benchmarked countries. However, Ireland remains the third most expensive benchmarked location (Fig. 4.2).
- The costs of renting a prime industrial unit fell by 18 percent in Ireland between 2008 and 2009. As a result of price falls elsewhere, however, Ireland's ranking improved by just one place and Ireland remains an expensive location (Fig. 4.4).
- The cost of renting prime office space in Ireland is relatively competitive. Having fallen by almost 25 percent in 2008, and 18 percent in 2009, office rental costs fell by another 12 percent in Ireland in 2010. Ireland is now a cheaper location than Germany and Spain. (Fig. 4.5).

58 Total occupancy costs are defined as the average total cost of leasing prime net usable space. It includes rents and outgoings but excludes leasing incentives. DTZ Research, 2010

4.2 Property Cost Indicators

Figure 4.1: Index of Capital Values in Ireland, 1990-2009 (1990=100)

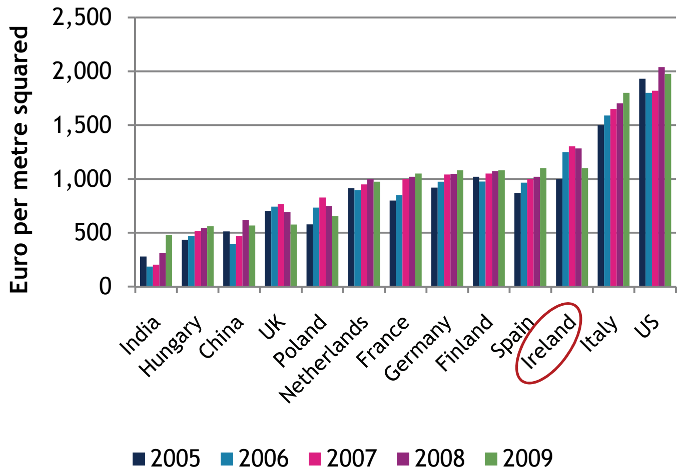


This indicator illustrates the growth in capital values between 1990 and 2009. Commercial property prices increased rapidly between 1993 and 1999. There was then a lull before prices exploded again from 2002, going up by more than 60 percent to 2006. The fall in prices has been as dramatic, with all the gains from 1999 having been wiped out over the last three years.

In 2009, retail values decreased by 29 percent, with office and industrial property values down 28 percent and 27 percent respectively.

Source: Society of Chartered Surveyors / IPD Irish Property Index, Central Bank of Ireland

Figure 4.2: Cost of Constructing a Prime[59] Industrial Unit, 2005 - 2009



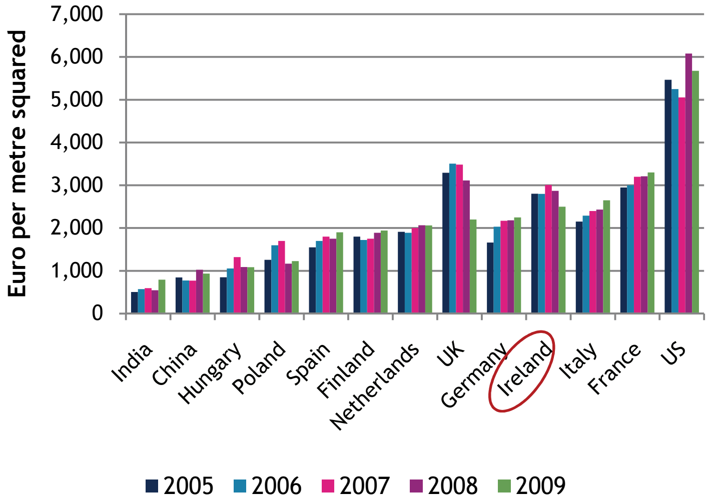
The cost of constructing a prime industrial site in Ireland declined by 14 percent between 2008 and 2009. Of the benchmarked group only the UK had a larger decline (-17%) in 2009.

Despite the relatively large decline in construction prices, Ireland remains the third most expensive location for building this kind of unit. However, Irish construction costs are now on par with Spain and just 2 percent above Germany and Finland. Construction costs in the US remain very high.

Source: Gardiner and Theobald, International Constructions Costs 2006 – 2010

59 Prime sites refer to those in the most expensive location within each country. Irish figures refer to prime location sites in Dublin.

Figure 4.3: Cost of Constructing a Prime[60] Office Unit, 2005 - 2009

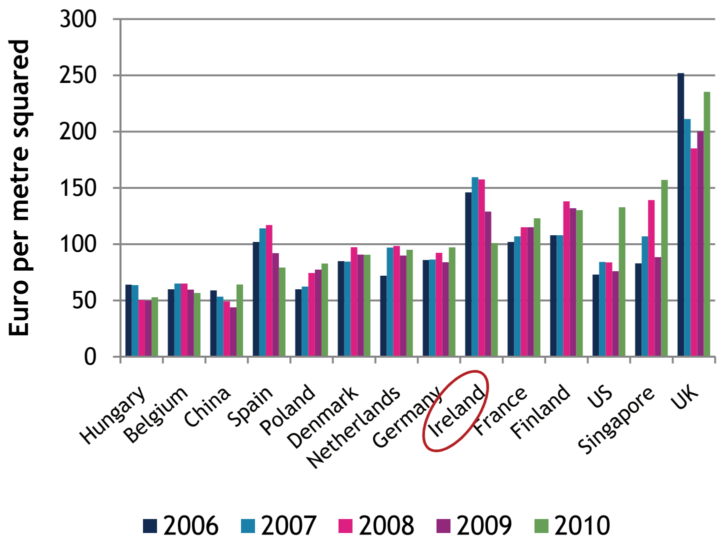


Ireland was one of five benchmarked locations where the cost of office construction declined in 2009.

The cost of constructing a prime office space fell by 13 percent in 2009 in Ireland. The UK recorded a significantly greater decrease during this period (-29.3%), and is now a cheaper location for building prime office sites than Ireland. Construction costs in the US remain extremely high.

Source: Gardiner and Theobald, International Constructions Costs 2006 – 2010

Figure 4.4 Cost of Renting a Prime Industrial Unit, 2006 - 2010



Ireland is the sixth most expensive location for renting a prime industrial site out of the 14 locations benchmarked.

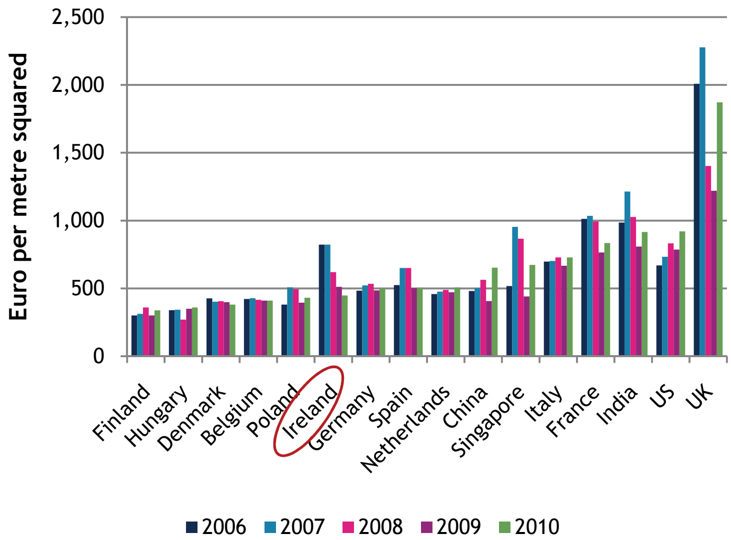
Rental costs in Ireland for industrial sites fell by over 20 percent from 2009 levels. This is a continuation of a trend evident in 2008 and 2009. Cumulatively, prices have fallen by almost 37 percent since their peak in 2007.

Ireland's ranking on this indicator, has improved by three places since last year.

Source: Cushman and Wakefield, Industrial Space Across the World, 2007 - 2011

60 Prime sites refer to those in the most expensive location within each country. Irish figures refer to prime location sites in Dublin.

Figure 4.5: Cost of Renting a Prime[61] Office, 2006 - 2010

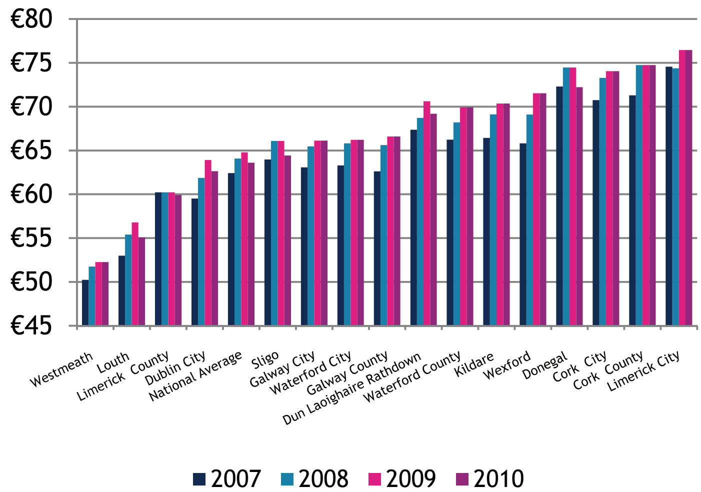


Whereas between 2008 and 2009, office rental costs declined across 15 of the 16 benchmarked locations, 2010 saw resumption in rental growth in most locations. Most notably, rents in London grew by over 50 percent – but still remain lower than the peak 2007 rate.

Rents in Ireland, however, continued to fall. Having fallen by almost 25 percent in 2008, and 18 percent in 2009, office rental costs fell by another 12 percent in Ireland in 2010. Ireland is now a cheaper location than Germany and Spain.

Source: Cushman and Wakefield, Office Space Across the World, 2007 – 2011

Figure 4.6: Annual Rate on Valuation by Local Authority[62], 2007 - 2010



Commercial rates are a form of taxation levied by local authorities on the occupiers of commercial and industrial property. Local authorities determine the annual rate of valuation (AV) and this is used to calculate commercial rates for each eligible property[63].

The average AV peaked in 2009 at €64.78 but in 2010, this decreased by an average of 1.8 percent to €63.60.

Source: Department of Environment, Community & Local Government

61 Prime sites refer to those in the most expensive location within each country. Irish figures refer to prime location sites in Dublin.
62 The listed local authorities are those operating in NSS Gateways with the exception of Fingal and South County Dublin which are not comparable due to revaluation of all commercial and industrial property by the Valuation Office.
63 The annual commercial rate for each property is calculated by multiplying the annual rate of valuation by the rateable valuation (RV) for the property which is determined by the Valuation Office.

The Residential Property Market

While the focus of this chapter is on commercial property, it is worth reflecting briefly on the residential property sector. The property boom of the last decade was a residential as well as a commercial property boom. The substantial increases recorded in residential prices (in both rental and purchase prices) also had implications for the commercial property market, and the competitiveness of the economy. Increases in residential prices led to increases in the cost of living and fed into increased wage demands. This in turn caused the business costs to rise and contributed to an inflationary environment.

Purchase Prices: According to the recently published Daft.ie House Price Report*, house prices fell by €35,000 in 2010 - the fourth year in a row a fall has been recorded. The average asking price in Q4 was just under €220,000, compared to a peak of more than €365,000 in mid-2007.

In terms of affordability, in 2007 the average nationwide price for a house peaked at nearly €300,000 or more than eight times average industrial earnings. The average national house price fell by 34 percent between 2007 and 2010. As of Q4 2010, housing affordability for those in employment has returned to levels last experienced in 2000. The quarterly EBS / DKM Affordability Index demonstrates that in January 2011 the average first time buyer working couple was paying 12.9 percent of their joint income to service their mortgage compared with 26.4 percent in December 2006.

Much like the commercial property market, the performance of the residential market is differentiated according to geography. Having considered a number of variables (the fall in prices from the peak, the total stock sitting on the market, and the yield on property), the Daft.ie report concludes that "for the next few years, Ireland will be a collection of different property markets in the same country. At one end, there is Dublin, at the other end are the non-city parts of Connacht, Ulster and Munster, and in between are the other main cities and Leinster. With house prices continuing to fall, albeit at a slower levels than in previous years, yields on residential property, in Dublin city at least, are starting to approach investable levels for the first time in a decade".

Rental Prices: Also drawing on data from Daft.ie, rents nationally, fell by 0.6 percent during 2010 (compared to falls of 10 percent and 15 percent in 2008 and 2009), suggesting a degree of stabilization. Other key trends in the rental market for residential property include:

- Rents in Dublin actually rose in year-on-year terms, up 2 percent in December, the first time they've risen compared to a year previously since late 2007;
- Rents fell by an average of 2.1 percent in the other cities and by 3.7 percent outside the major cities;
- Rents are at levels last seen in 1998, based on a composite of CSO and daft.ie figures. The average rent in Dublin was €1,074 in December 2010, compared to €1,066 in late 1998.

These developments suggest that the major rental markets (in Dublin, its surrounding area and the other cities) are coming back into balance. It also represents the first step in a balancing out in the sales market: knowing the stable rent of a property is essential in order to determine its long-term economic value.

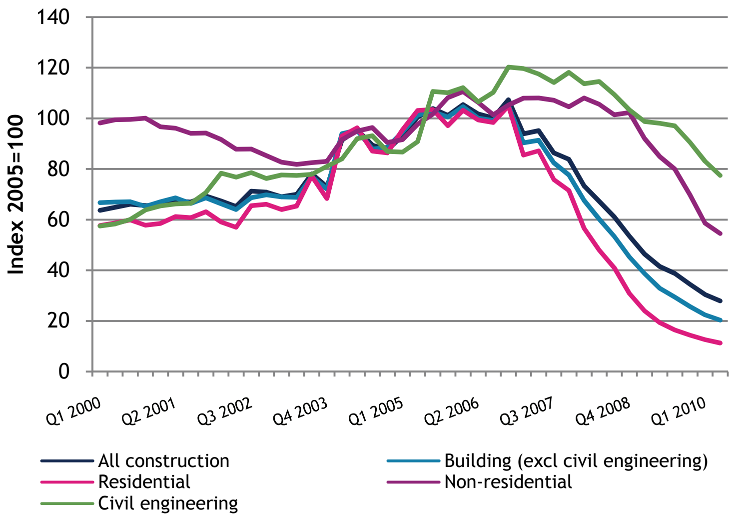
*The Daft.ie House Price Report, An analysis of recent trends in the Irish residential sales market, 2010 Q4

4.3 Policy Focus – Commercial Property in Ireland

The purpose of this section is to analyse the efficiency of the Irish commercial property market and made recommendations to improve the functioning of the market. The focus is on the commercial property market (office and industrial). Specifically, this section considers the barriers preventing the commercial property market from functioning in an optimum manner. It then sets out a series of recommendations designed to improve the efficiency of the market in order to minimise the potential for future boom-bust cycles[64].

The previous section of this chapter has already focused on the price of commercial property in Ireland, both from a construction and rental perspective. In order to properly understand the dynamics at play in the Irish commercial property market, it is also important to acknowledge that what occurred in Ireland was a construction boom as well as a property price boom, as demonstrated by Figure 4.7.

Figure 4.7: Volume of Production Index for Construction, 2000-2010 (2005=100)



Between 2000 and 2006, the volume of construction activity doubled. Activity began to fall precipitously from the end of 2006 and by mid-2010, had fallen by one-third from its 2006 peak. However, much of this was due to house building. Non-residential building (largely commercial property) had a flatter cycle in terms of building and construction activity. However, by mid-2010, it had lost over 40 percent of its volume from the peak.

Source: Department of Environment, Community & Local Government

4.3.1 Take-up and availability

Take-up and availability are useful indicators of demand and supply conditions in commercial property market. Take up reflects replacement demand, as well as expansion demand. Availability, of course, refers to the availability of floor space. It is expected that some space will be vacant as there is market churn. Some stock is also in poor condition and therefore unlikely to be occupied without upgrading.

64 This section draws on work undertaken by Forfás in conjunction with DTZ Sherry Fitzgerald.

Figure 4.8: Take up and availability of office space in the Dublin office market, 2000-10

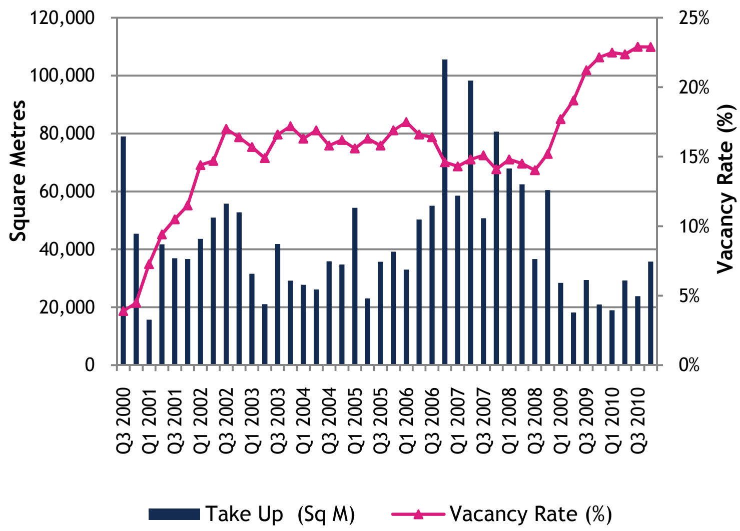
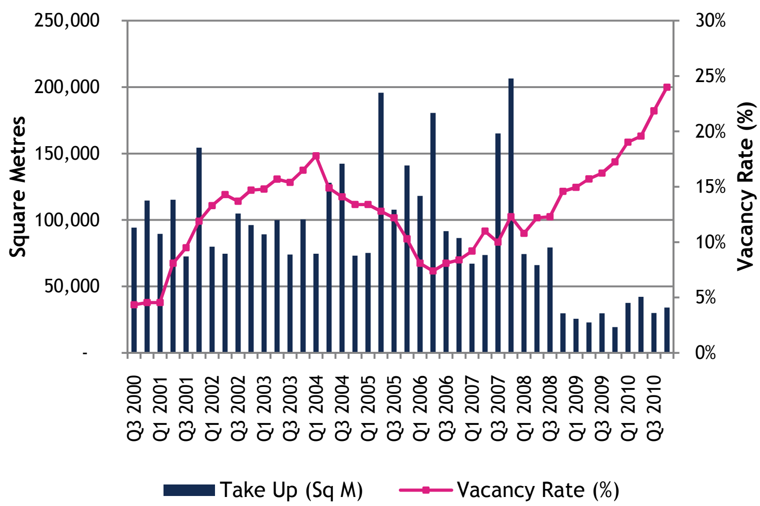


Figure 4.8 shows the take up and availability of stock in the Dublin office market over the last ten years. From a vacancy rate of 5 percent in 2000, 15 percent became the norm between 2002 and 2008. Take up of office space peaked in 2006-08, before dropping back suddenly as demand fell. This increased the vacancy rate and now nearly one in four square metres of space in the Dublin office market is vacant.

Source: DTZ Sherry Fitzgerald Research

Of the current available stock in Dublin, three-quarters is estimated by DTZ Sherry Fitzgerald to have been built since 1990[65]. Of this, around 30 percent is prime (i.e. the highest quality in the best location), 27 percent secondary and the remainder in suburban locations. Office vacancy rates are also high in the regional centres of Cork (23%) and Limerick (20%), although the rate is lower in Galway (15%).

Figure 4.9: Take up and availability of industrial space in the Dublin Industrial market, 2000-10



As illustrated in Figure 4.9, the industrial market in Dublin went through a similar pattern as the office market. In the case of the industrial market, however, the vacancy rate began to rise earlier – in 2006 – and now stands at almost 25 percent.

Source: DTZ Sherry Fitzgerald Research

65 DTZ Sherry Fitzgerald, Assessing the Drivers of Property Costs in Ireland (Unpublished report commissioned by Forfás). McCartney (2008) has found that more than two-thirds of the office supply in Dublin in 2008 had been constructed post-1990.

McCartney argues that the Natural Vacancy Rate (NVR) in the Dublin office market rose to 15 percent in 2000-09, up from 5 percent in 1978-98[66]. The NVR is the rate that corresponds with market equilibrium and rent stability. Spaces can remain vacant for frictional reasons, or landlords waiting for better offers. The rate rose due to the construction boom, speculative development and low interest rates, meaning that landlords could hold on to property for longer. In this context, the drop required from the current vacancy rate of 23 percent is perhaps not as large as commentators had believed and Dublin may recover quicker than expected, with this recovery rippling out to the rest of the country in time[67]. It is important to note that the NVR varies by location and type of space - it is likely to be higher in out-of-town areas than prime areas. In particular, the commercial property market in Dublin differs significantly from the market elsewhere in the country.

Those working in the industry are concerned that the costs of building makes economic returns unlikely in the current market and, therefore, new commercial buildings will not be developed for some time. The supply of new stock is, however, drying up quickly. Planning permission for non-residential construction has fallen from a floor area of 2.75 million square metres in Q3 2007 to just 415,000 square metres by Q3 2010, and to 254,000 square metres in Q4 2010[68].

This is not a great concern for many places with a surplus of property, but the lack of new Grade A office space in Dublin may lead to a shortage. Those who we consulted within the sector estimated that there was only 18-24 months of existing available supply left of such stock and little prospect of it being replenished in the current environment. It is this space that is in greatest demand and needs to be available to attract new FDI. Therefore, although, overall, there may be an overhang of property space for some time, there is likely to be a shortage of new prime space in the short to medium term. This reflects international experience – according to a recent Economist report, high vacancy rates are not the same as an excess of high quality office space. It would appear that in many developed economies, the majority of vacant commercial properties are located in non-prime areas[69].

4.4 Drivers of Demand and Supply

Property costs are a reflection of the interaction of demand and supply drivers, so any analysis of recent property cost trends must consider these drivers and the factors that underpin them. The demand drivers are those that produce occupier-led demand for space. The supply drivers are the factors that encourage developers to produce office and industrial, although there is inevitably some overlap between them.

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66 McCartney, J, Predicting Turning Points in the Rent Cycle using the Natural Vacancy Rate – An Applied Study of the Dublin Office Market, Paper to the Statistical and Social Inquiry Society of Ireland, 2 November 2010
67 McCartney's estimate is considerably higher than that of local industry practitioners. DTZ Sherry FitzGerald's and Knight Frank's view is that the NVR is 7 percent. This is a significant issue for market recovery because the 7 percent figure implies that, based on long term average absorption rates, real office rents in Dublin will continue to fall for about eight years before the market reaches equilibrium, while it may take only half of this if McCartney's calculation is correct. Net absorption, however, was negative in 2009 and highly subdued in 2010. At the moment, this points towards a longer recovery period.
68 CSO, Database Direct
69 The Economist, Prime numbers: Commercial property has bounced back, but only in the best locations, Published in The Economist, Print Edition 3rd March 2011

4.4.1 Demand Drivers

A range of factors encouraged demand for office and industrial space. In the main, economic growth and the expansion of the economy are the primary explanations for increased levels of demand for commercial property:

- The growth of the Irish economy: From the 1990's onwards, Ireland frequently exhibited growth rates between 6 and 10 percent, more than three times the European average rate. Initially built on competitiveness factors, the latter stage of the boom was credit driven.
- Success in attracting FDI: In 2000-09, average take up of office space in Dublin city centre was 115,000 square metres, at least 30 percent greater than in its regional competitors[70]. Half of this was accounted for by overseas occupiers[71]. Financial services firms, in particular, were attracted to the Dublin market with the advent of the International Financial Services Centre. The share of Dublin office take-up accounted for by financial services firms rose from less than 7 percent in 1999 to 45 percent by 2007[72].

4.4.2 Supply Drivers

There was a rapid increase in new supply in the period 1999-2010, during which Dublin's total stock of modern new office space rose by 129 percent[73]. The size of the Central Business District (CBD) in Dublin, at 2.1 million square metres, is slightly higher than that of Edinburgh; about one-quarter greater than other competing cities such as Manchester, Birmingham and Glasgow; and nearly double that of Belfast and Amsterdam[74.] McCartney also demonstrates that the Dublin market appears to have a 10-year cycle of office completions, with peaks in the numbers of offices completed swiftly followed by dips in 1991-92, 2001-04 and from 2008[75]. Take-ups and rents exhibited similar cyclical patterns. This type of pattern is also seen in other countries and is not unusual; in fact, it seems the natural order in commercial property cycles.

As the city centre built up, office development moved to the suburbs (out of town market), which accounted for more than one-third of the Dublin office market by 2008[76]. The factors that drove supply included:

- Cost and availability of credit: Banks were the most important sources of funding for the commercial property sector[77]. At the end of 2003, net indebtedness of Irish banks to the rest of the world was just 10 percent of GDP, but by early 2008, this had climbed to over 60 percent. The banks were also attracted by the boom in property. They increased the share of their assets in

70 Note that this figure represents both a flow figure but can also be seen as a driver of demand.
71 CBRE Research, 2009
72 McCartney, J., An Empirical Analysis of Development Cycles in the Dublin Office Market 1976-2007, ESRI Quarterly Economic Commentary, Winter 2008, pg68-92
73 McCartney, J, Predicting Turning Points in the Rent Cycle using the Natural Vacancy Rate – An Applied Study of the Dublin Office Market, Paper to the Statistical and Social Inquiry Society of Ireland, 2 November 2010
74 These cities represent Dublin's likely regional competitors in commercial property terms – they are largely in the same part of Europe and could be considered in the 'second tier' after international global capitals such as London, Paris, etc. CBRE Research, 2009
75 McCartney, J., An Empirical Analysis of Development Cycles in the Dublin Office Market 1976-2007, ESRI Quarterly Economic Commentary, Winter 2008, pg68-92
76 McCartney, J., An Empirical Analysis of Development Cycles in the Dublin Office Market 1976-2007, ESRI Quarterly Economic Commentary, Winter 2008, pg68-92
77 They lend for the purchase of land; for the development of new and existing buildings; to finance construction projects; to non-banks and finance companies that may finance real estate; and to non-financial firms based on real estate collateral.

property related lending from under 40 percent pre-2002 to over 60 percent by 2006[78]. A booming property market raised the capital base of the banks and they, in turn, were able to lend more. In addition, real interest rates have been very low since Ireland joined the Eurozone.

- Construction costs were running at annual rates of around 6 percent during the property boom, caused by a combination of rising costs of materials as well as labour costs. Increased costs of construction can increase the cost of buildings. However, it is not clear the extent to which construction costs were simply an effect of the boom or a key causal factor. The cost of land undoubtedly rose sharply in Ireland during the boom and there is strong anecdotal evidence that it has fallen sharply in the bust phase[79].
- Planning system: Local authorities have an incentive to allow commercial development in order to raise commercial rates or gain infrastructure improvement through planning gain. This produced supply led development, where councils competed to attract developers of commercial properties. In Dublin, the fragmentation of its planning system encouraged suburban local authorities to compete for rateable developments by zoning increasing amounts of land for commercial use.
- Taxation: a range of taxation schemes (e.g. Urban Renewal Scheme, Enterprise Areas, Rural Renewal Scheme, etc.) were introduced to stimulate development by offering tax advantage (e.g. accelerated capital allowance for capital expenditure, rent allowances, etc.) for property development. Mortgage interest relief supported the residential market.

4.5 Conclusions and Recommendations

At the broadest level, the intent of the recommendations set out below is to outline a series of policy actions to improve the efficiency of the Irish property market in order to reduce the costs of doing business in Ireland and reduce the potential for future boom-bust cycles by smoothing cycles. The recommendations are divided into three categories:

(i) Recommendations to provide certainty to all stakeholders about the long term viability of the commercial property market;

(ii) Recommendations designed to reinvigorate the commercial property market in Ireland in the short term - despite recent negative experiences, a properly functioning property market is a vital part of any vibrant economy; and

(iii) Recommendations to support sustainable development over a longer time horizon.

This categorisation is not in any way exclusive – in many cases recommendations, if implemented could have a positive impact across all segments of the market.

4.5.1 Market Certainty

In order for buyers and sellers to engage in activity, and to behave in a rational manner, steps are required to enhance confidence in the market. There are two major issues at play here – the lack of available information relating to all elements of commercial property transactions (i.e. price, quality

78 Honahan, P., Resolving Ireland's Banking Crisis, Paper prepared for UCD-Dublin Economic Workshop Conference, 'Responding to the Crisis', 12 January 2009
79 DTZ Sherry FitzGerald (2010) estimates that land prices have fallen by 60-95% from mid-2006.

etc.); and the role that NAMA will play in the property market over the coming decade.

Tackling imperfect information

Imperfect information restricts the ability of market agents and others to make rational decisions. Unless businesses and consumers feel that they have adequate information to make informed decisions (e.g. confident that they have up-to-date and accurate information relating to prevailing and future market conditions) they will be reluctant to engage with the market. International experience (e.g. Finland) suggests the provision of detailed relevant and timely data is a key element in ensuring an efficiently functioning commercial property market. In the case of commercial property, the only fairly comprehensive and widely available data is on the Dublin office market.

In Ireland, the Property Services (Regulation) Bill, 2009 is currently under consideration by the Oireachtas. The purpose of the bill is to establish a Property Services Regulatory Authority (PSRA). Once established, the PSRA will aim to achieve uniformity and transparency in licensing, regulation and the provision of property information to the public - its role will include providing transactional information within a property database[80]. Given the dearth of property related data in Ireland, the development of the database should be expedited. This database should act as a directory for both residential and commercial property. It is vital that information on both purchasing and leasing be captured relating to:

- Price
- Quantity (e.g. floor space)
- Quality (e.g. location, finish).

Role of NAMA

While the strategy and role of NAMA is clear, there remains some uncertainty about the potential impact that NAMA might have and this will need to be resolved before confidence can be injected back into the commercial property market.

NAMA is likely to be the primary source of working capital for developers for a number of years given the condition of the banks. If NAMA is too risk averse, all but the safest developments will be denied access to finance. The developments that it allows to go-ahead and those which it stalls or mothballs will have a very significant bearing on the market in terms of the product that developers can build and it’s pricing. More information is required to enable the market to plan effectively. In particular, there is concern that this uncertainty will reduce the likelihood of investors developing new, high quality office stock in Dublin – as noted previously, it is estimated that there is only approximately 18-24 months’ supply of such stock remaining. A lack of stock would push up prices again and would represent a loss of competitiveness vis-à-vis other locations.

NAMA needs a clear implementation plan which is transparent to all those involved in the commercial property market. It has significant ability to affect the market and determine prices for commercial

80 The Property Services (Regulation) Bill 2009, if enacted, will establish the Authority. It is scheduled to be operational in 2011.

properties in specific areas. While accepting the need to protect commercially sensitive data, more information is required on:

- The loans that it has acquired and how it proposes to deal with unfinished developments, as well as its criteria for future provision of development finance. This may emerge as NAMA becomes fully operational.
- How NAMA assets will be disposed of - an orderly programme of disposals and interventions that does not distort the market in either direction is desirable – in essence, this means that properties should brought to the market on a phased basis over the course of the next few years.

4.5.2 Reinvigorating the Commercial Property Market

At present, Ireland has a stock of commercial property consisting of both occupied and vacant properties. We also have a large pool of existing enterprises, and a pool of potential entrepreneurs/enterprise who would consider entering the Irish market if conditions were supportive of such a move. We must ensure, therefore:

(i) That the property related costs faced by enterprises already operating in Ireland are internationally competitive;

(ii) That potential new entrants are not dissuaded from establishing in Ireland as a result of excessive property prices; and

(iii) That those enterprises already in operation here are not placed at a disadvantage compared with new entrants as a result of legacy issues.

Two main issues requiring redress fall under this heading:

- Taxation and rates; and
- Rents.

Taxation and Rates

Ireland is one of the few developed countries in the OECD which does not raise significant revenues from a recurring property tax on residential property. The introduction of a property based tax on residential property to replace transaction taxes would provide a timely boost to the residential property market and would provide more certainty in relation to Government revenues (i.e. revenue would not be dependent on the vagaries of market conditions and would not be prone to large fluctuations year-on-year). Ultimately such taxation would help Ireland to avoid the worst extremes of property market cycles.

The NCC recommends that a broadly based and equitable valuation based residential property tax should be introduced as quickly as possible. A recurring property tax can be designed to be progressive (i.e. those in larger houses and/or living in more expensive areas would pay more). Given the time required to fully implement a valuation based tax and the necessity to raise additional tax revenues quickly, interim measures should be devised on a self assessment basis similar to the tax on second homes[81].

81 The proposal to abolish mortgage interest tax relief is a step in the right direction as Ireland is the only country in the OECD to give such relief without having a tax on primary residences.

This recommendation would also represent a move away from transaction based property taxes. Smaller occupiers that are expanding and creating jobs and that, therefore, may have to move every 3-5 years would appear to be punished by having to repeatedly pay stamp duty – the top rate of 6 percent is applied on transfers of commercial property and business assets above an aggregate consideration of €80,000[82]. Alternatively for business leasing their properties, stamp duty on rent is 1 percent of the average annual rent where the term does not exceed 35 years or is indefinite. Companies need to be able to move regularly and cheaply, therefore, stamp duties for these types of companies could be reduced on a sliding scale each time they move.

The issue of commercial rates is also a key concern for enterprise. Commercial rates are a property-based source of income that is levied by local authorities on the occupiers of commercial and industrial properties. Rates are calculated on the basis of the Rateable Valuation (an estimate of the annual rental value of a property determined by the Commissioner of Valuation and set out in a Valuation List) multiplied by the Annual Rate on Valuation (which is decided upon by the relevant City or County Council)[83]. The revenue raised by commercial rates is used to fund local authority services[84].

Rent and Rent Reviews

Occupational leases in Ireland have typically been long-term in nature; often up to 25 years. The duration of such leases has been falling in the UK, to around 10-20 years, and reviewed in the open market roughly every five years. In places such as Amsterdam, leases are typically for 5-10 years and reviewed annually in line with inflation.

Legislation has been introduced in Ireland to ensure that all new leases signed from March 2010 contain a provision that rents can be reviewed both upwards and downwards on review[85]. Previously, rents could only normally be reviewed on an 'upwards only' basis at review under the terms of lease. Upward only clauses incentivised landlords to hoard property and time lettings at the top of the market.

While this legislation is welcome, it does nothing for existing enterprises, tied into long term leases at rates significantly above current market rates. At a time of tightening margins, this is a concern. Furthermore, in creating a two-tier rental market, the continued existence of otherwise viable businesses may be threatened – new competitors could potentially be able to offer a good or service at a lower price due to their lower rental cost base. Existing firms have no recourse to a downward rent

82 While there are tiered rates under this aggregate consideration, there would not be applicable in the majority of commercial transactions. Transfers between intra-company groups are not liable to stamp duty, subject to criteria.
83 Some County Council's (e.g. Dún Laoghaire-Rathdown) have announced revised annual rates on valuation for 2011.
84 Note that the issue of reforming local government funding has already been considered as part of the work of the Local Government Efficiency Review Group. The recommendations set out by their in the report were designed to yield an estimated €511 million saving - representing 11 percent of 2010 current expenditure.
85 Land and Conveyancing Law Reform Act, 2009

review, and so they may find themselves unable to compete. The NCC recommends, therefore, that the feasibility[86] of introducing legislation to facilitate downward rent adjustments for existing leaseholders be explored further.

It is also worth noting that the State has another role to play in ensuring that commercial (and specifically office) rents are competitively priced. The National Recovery Plan 2011-2014 states that the Office of Public Works will lead a coordinated effort to reduce office rents by up to 15 percent and review the efficiency of property arrangements across the public sector. These commitments now need to be progressed.

4.5.3 Sustainable Development

Despite the current downturn, and regardless of exactly how much stock remains vacant at present, Ireland will inevitably require investment in and development of commercial property in the coming years. It is important, therefore, that policies are put in place now that facilitate this development in a manner that is sustainable, competitive and supportive of enterprise needs.

Tax Incentives and Development Levies

Tax incentives (also called tax expenditures) played an important role in stimulating the property boom. When used correctly to address specific market failures, taxation can be an effective tool. In order for taxation to be effective, however, it must be targeted where the market failure is occurring and on a time-allocated basis. It should be monitored and assessed and removed if the market failure has been tackled. When enacting such incentives it is important that a deadline is included and that the administrative process facilitates the collection of the data necessary to conduct evaluation, as outlined in the Commission on Taxation Report[87]. This avoids perverse incentives being created leading to oversupply, and ultimately a loss of value. In Ireland's case, the existence of attractive tax-based incentive schemes encouraged investment in property rather than in other productivity-enhancing activities. While a range of property reliefs have been wound down in recent years, it is important that the remaining schemes be addressed in the short term.

In terms of local development, the local authorities need to adapt and update the manner in which they implement levies on developments, employing the legal mechanisms for such levies under the Planning Act. Firstly, more prioritised and integrated plans based on realistic as opposed to aspirational estimates of future development requirements should reduce the cost of providing essential infrastructure. Reductions in construction costs have already reduced these costs. Local authorities should harness the efficiencies above, and develop more robust and transparent charging mechanisms for local authority charges that match levies with the economic cost of providing development. A move to a more coordinated planning system (as well as the downturn in property

86 The Attorney General has previously stated that the Government could not enact legislation requiring the removal of upward-only rent review clauses from existing leases because to do so would be unconstitutional. Article 15 of the Constitution restrains the Government's power to enact retrospective laws. Regulation of existing contractual obligations, however, has previously occurred. The Landlord and Tenant (Amendment) Act 1980 came into effect in respect of both new and existing contracts. Some concern has been expressed about the impact that the abolition of upward only reviews might have on investment – it has been suggested that the removal of the upwards only review will negatively affect liquidity and impact upon investor demand in an already deflated investment market. Similarly, changes in rental agreements could adversely impact upon pension funds.

87 Commission on Taxation, Report 2009

values) may mean that development will no longer take place where there is not already a suitable level of infrastructure, meaning that levies could be reduced. Reductions in levies may also help areas to attract inward investment. The design and use of development contributions should be re-examined to ensure that it provides a fair and equitable means of enabling infrastructure to facilitate development at the right locations and in a manner that does not prohibit inward investment and commercial activity. The Department of the Environment, Communities and Local Government intends to develop new guidelines on the operation of the development contribution schemes by the end of 2011.

Planning Reform

The strategic and coordinated planning system plays a vital role in facilitating commercial development and activity, both in planning for adequate supply in the right locations and in facilitating development through coordinated and enabling infrastructure. The multiplicity of development plans across 88 planning authorities in Ireland, however, has produced an excess supply of zoned land which in turn, has tended to facilitate over-provision of commercial property, often with buildings in the wrong place or of the wrong type for areas and without adequate infrastructure to serve them (e.g. public transport, sewage, etc.)[88]. The challenges of planning commercial development through local authority based planning is hindered by the lack of nationally and regionally authenticated demand forecast data in Ireland which might be used to inform the planning process. This is an area where the various enterprise agencies need to work proactively with the Department, regional and local authorities in addressing the need for and methodologies in providing information.

Some progress is being made. A more coordinated approach to planning is being realised (e.g. the Department of Environment, Community & Local Government core strategy and related provisions outlined in the 2010 Planning (Amendment) Act which provide for more coherent planning between national, regional and local levels and guidelines on spatial planning and national roads[89]). Efforts are underway by the Department of the Environment to map local authority development plans onto a national, multi-layered GIS system will also greatly help to inform the existing commercial zonings. Coordination at a regional level is also improving – new regional planning guidelines (RPGs) and regional competitiveness agendas (targeted at EI and IDA Ireland), and local initiatives, for example, in Cork, where both Cork City and County Councils are working together to agree on development plans, within the framework of the non-statutory Cork Area Strategic Plan (CASP).

Inevitably, to have a more strategic and coordinated approach, will require a greater role for central Government, regional, and local authorities agreeing to work together to coordinate their development plans. In particular, developments of regional or national importance should be dealt

88 Experience in the Netherlands highlights how planning can hinder an effective approach to development, with too many local planning authorities, making it difficult to coordinate a national approach to development and prioritise opportunity areas.
89 DoEHLG, Spatial Planning and National Roads – Consultation Draft, Guidelines for Planning Authorities, June 2010 – these guidelines provide the policy to guide planning authorities in planning where major projects will now be sited at or near major national roads and transport nodes.

with at a regional/national level (e.g. development of sufficient size or strategic importance for the region/country). This may mean a more active and coordinated role for the Department of Environment, Community & Local Government in guiding commercial development to appropriate locations, in addition to its current focus on residential property (e.g. in setting stronger guidance and advising on commercial development and in developing a framework to assess the demand for commercial floor space, much as it does for residential development through population and household projections)[90].

This guidance may involve helping local authorities to form development plans and ascertaining the impact of specific commercial proposals on development plans. It may also more clearly set out the rationale for zoning land for commercial purposes. Currently, the primary rationale in many parts of the country is to attempt to attract employment. However, a demand led, planned approach is a prerequisite for sustainable development. In all cases, a demand assessment should undertaken to inform development plans and zoning (i.e. evaluating demand and supply drivers, the prospects for growth, incentives and barriers to development, analysis of other developments and benchmarking with other similar areas of the country).

Other changes to planning in Ireland should also be considered:

- Increasing the density of Irish cities could lower land, construction and infrastructure costs, and offers the possibility of increasing the supply of both commercial and residential property in a more cost effective and environmentally sustainable manner – this has been recognised in the Department of the Environment's residential planning guidelines which recognises the importance of placing high density housing proximate to existing or due to be improved public transport corridors[91].
- Minimising delays in planning can have beneficial implications for the costs of infrastructure delivery. Greater certainty is required in relation to the time it takes for decisions to be reached by the planning authorities, particularly in relation to major planning applications. It is also important to ensure that the costs of the submitting an application for planning for a strategic infrastructure project do not deter potential investors[92];
- In this regard, the Council notes the work currently underway to modernise the foreshore consent process and integrate it within the wider planning system, and the short-term administrative improvements that have already taken place. Given the urgent need for reform of the foreshore consent process to support economic recovery and jobs, the Department of the Environment, Heritage and Local Government has commenced work on the development of the General Scheme of a Bill. Specifically, the Bill will seek to:
    - Integrate the foreshore and offshore consent processes for major strategic infrastructure

90 This is not a straight-forward exercise - there is a substantial difference between being able to estimate population growth and zone accordingly for residential development and being able to forecast more unpredictable commercial demand. If, however, satisfactory evidence can be identified to help inform zoning and infrastructure decisions, then the planning system will be better geared to predict and cater for new commercial development.
91 Department of the Environment, Heritage and Local Government, Guidelines for Planning Authorities on Sustainable Residential Development in Urban Areas (Cities, Towns & Villages), May 2009
92 Chambers Ireland have recently published a research paper, Strategic Infrastructure Planning: Making it Better, which sets out a series of recommendations designed to improve the efficiency of the planning system, to reduce the costs of planning and to ensure decisions are taken in a timely fashion. Chambers Ireland have noted that, on average, An Bord Pleanála took 31 weeks to process a major infrastructure appeal 2008 and 26 weeks in 2009, compared with an 18 week statutory guideline target.

    - projects within the strategic consent process operated by An Bord Pleanála;
    - Integrate the foreshore consent process for non strategic infrastructure projects within the wider planning system operated by the local authorities; and
    - Provide for a plan-led approach to the foreshores through the development of coastal zone management objectives in the forward planning hierarchy, and in the medium term the development of a marine spatial planning framework.
- The proposed approach to integrating the foreshore consent process within the planning system is also focused on streamlining parallel consent processes, reducing unnecessary regulatory burden and costs, both for the State and the applicant.
- In order to improve the efficiency of the planning process, the Council supports the rollout of ePlanning which is currently being undertaken by the Department of the Environment, Heritage and Local Government, as has successfully been introduced recently in Scotland[93].

Coordinating the Provision of Infrastructure

While there do not appear to be strong market failure grounds to justify public sector intervention in the direct provision of commercial buildings, the public sector can facilitate commercial development through the provision of key enabling infrastructure (e.g. transport, energy, telecommunications, environmental)[94]. Ireland has made significant progress in terms of improving our physical infrastructure in recent years. It is essential to continue to prioritise investment to ensure Ireland's physical infrastructure can support economic recovery. Investment in infrastructure is essential to ensure that a sufficient supply of serviceable development land is available and to ensure that the commercial sector can maximise the use of existing properties. However, it is equally important (in relation to the user pays principle) that proportionate costs should also be borne by the developers who will be benefitting substantially from State investment.

As a result of cuts in departmental budgets, with the consequential impact on capital allocations for infrastructure, there is a need to prioritise the rollout of projects. Prioritisation should be based on the extent of each project's contribution to the following strategic outcomes:

- It is industry demand led;
- It tackles thematic issues of national or regional importance - given the central role that Dublin and our other cities play in driving national competitiveness, prioritisation should focus resources on their development.;
- It has impact within the enterprise sector and the wider economy;
- Its impact could not be achieved with a different approach or with greater efficiency of government investment;
- It generates value for money, leverage and commercial return;
- There is consideration of the risks involved, especially the dependency on others to deliver; and

93 ePlanning is designed to provide a consistent level of service across Scotland and to make the Planning System simpler, faster and more accessible. It is intended that ePlanning will deliver a range of online and workplace tools, allowing the public and professionals to access policy documents, apply for planning permission, track progress, make comments, understand decisions, and appeal against decisions. ePlanning is also intended to improve the quality and availability of local development plans and planning information online. See ePlanning.scotland.gov.uk

94 This is a role undertaken by regional development agencies in the UK in instances of market failure. In Ireland, IDA Ireland also plays a significant role in this regard.

- The project could not be delivered by another body.

We also need to deliver future infrastructure investment more efficiently. A more integrated approach to infrastructure planning is required to promote improved efficiency, effectiveness and competitiveness. Coordinating the rollout of different infrastructure services (e.g. roads, telecoms, water, energy) also has the potential to deliver significant cost savings particularly where projects are undertaken simultaneously. To ensure that infrastructure is delivered efficiently in Ireland may require institutional change to promote improved coordination of infrastructure planning and delivery.

Construction costs

Ireland is an expensive country in terms of costs of construction – according to Eurostat data, construction prices in Ireland were amongst the highest in Europe in 2005. Based on a comparative price indicator, overall construction prices in Ireland were 40 percent above EU average price levels; in terms of residential buildings, Irish prices were 52 percent above EU27 prices, while for non-residential buildings, Irish prices were 33 percent above the EU average[95]. Construction costs have fallen since the height of the boom as measured by a variety of construction price indices – by 2009 residential construction costs and non-residential building costs in Ireland were equivalent to 101 percent and 97 percent of the EU27 average respectively[96]. However, these falls do not appear sufficient to encourage a resumption of construction activity – thus contributing to fears over a deficit of Grade A office space in Dublin in the next two years.

In the short run, property prices drive land prices. In the medium to long run, a greater supply of zoned and serviced land[97] will reduce house prices, other things being equal. While land costs have fallen dramatically, this is a cyclical response to the recession rather than a result of structural change. Without structural change, we could expect a return to excessive property price inflation when the economy returns to growth. We must ensure that we never again have a rampant property bubble. In the 2010 Competitiveness Challenge report, the NCC noted that in the early 1970s, the Kenny report identified measures to control the price of development land but its recommendations were never implemented[98]. Given the serious consequences of the recent property boom and subsequent collapse, the NCC recommends the establishment of a high level independent review group mandated to put forward policy recommendations to ensure that we never again have a sustained property bubble.

95 Eurostat, Statistics in Focus: Comparative Price Levels for Construction in 33 European Countries for 2005, 108/2007
96 Eurostat online data base.
97 Serviced land refers to land that has "the necessary water, sewerage, transport and other services required to bring the land into development and sufficient for planning permission to be granted and construction to commence"
98 The Kenny report, which was published in 1973, was prepared by the Committee on the Price of Building Land which was chaired by Mr. Justice Kenny, Its key objective was to identify measures to control the price of land required for housing and other development.

5. Utility Costs

5.1 Summary

This section examines the main utility costs for business – energy, waste treatment, water services and telecommunications.

The cost of industrial electricity for large energy users in Ireland decreased significantly (-27%) in 2010. Ireland is now the fifth cheapest of the 14 benchmarked countries and costs are lower than the euro area average (Figure 5.1). Despite reductions also being recorded for electricity costs for SMEs in 2010, Ireland remains the fourth most expensive location benchmarked, although the gap with the euro area average continued to narrow (Figure 5.2). While these recent price falls are welcome, they are unlikely to be sustained as they are largely due to the steep decline in global fuel prices (gas and coal) and temporary subsidies which are to be phased out by the end of 2012. Recent increases in international fuel costs will lead to higher energy costs for business since Ireland is heavily dependent on imported fossil fuels for power generation.

Ireland is relatively competitive in terms of industrial gas prices (Figure 5.3) and Irish industrial gas prices are 12 percent below the euro area average. This is a significant improvement for Ireland which ranked as the seventh least expensive benchmarked location for industrial gas in 2008.

Looking at Ireland's cost performance for environmental utilities (which include water and waste water services and waste treatment services), the average cost of treated water services in Ireland increased by 0.8 percent between 2010 and 2011. Based on 2009 data – the most up to date available that is internationally comparable - Ireland is competitive with our main trading partners on this measure (Figure 5.4). However, there was a more significant increase in the cost of waste water services of 4.1 percent in Ireland between 2010 and 2011. No internationally comparable data is available for waste water costs.

In terms of waste costs, the Irish landfill gate fee is often lower than the advertised fee as the gate charge can be negotiated based on a number of factors (e.g. the volumes of waste offered, the source of the waste etc.). Based on 2010 survey data, the average price that could be negotiated in the Irish market ranged from €86 to €111 per tonne (including the levy). Singapore and New Zealand are the cheapest location for landfill (Figure 5.5). Massachusetts is the cheapest location for thermal treatment at a cost of €46 per tonne - Flanders the most expensive of the benchmarked locations at €110 per tonne (Figure 5.6). Currently, there are no commercial thermal treatment plants in operation in Ireland[99].

With regard to telecommunications, Ireland ranks as the eighth most expensive location of the 13 countries benchmarked for a basket of business calls (excluding VAT) , and is almost 5 percent

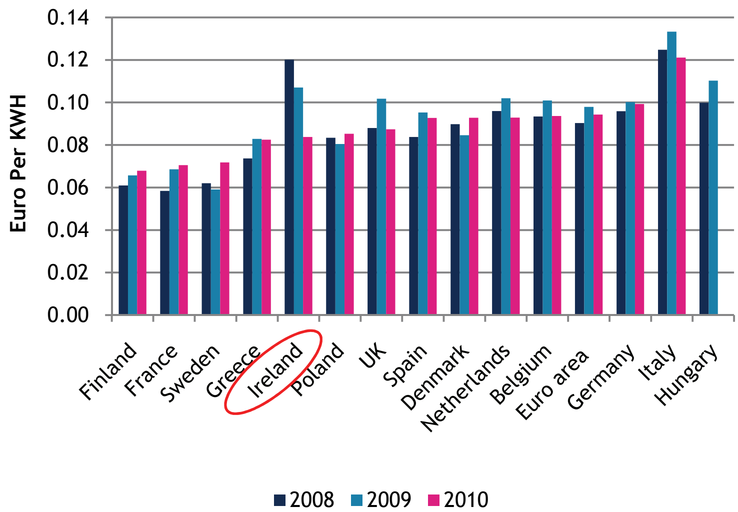
99 200,000 tonnes of capacity is to come on stream in mid 2011, with a further 600,000 tonnes planned for 2014. A number of mechanical biological treatment facilities have also been developed with others in planning. Such developments will help provide a more diverse and competitive range of waste treatments.

cheaper than the euro area average (Figure 5.7). In terms of the monthly costs charged for a high usage basket of mobile calls including VAT, Ireland is the fourth most expensive of the countries benchmarked locations and is 10 percent more expensive than the euro area average (Figure 5.8)

In terms of broadband (Figure 5.9), the fastest package in Ireland costs €706 (excluding VAT) per annum. Significantly faster speeds are available for less than this in many of the countries benchmarked.

5.2 Energy and Fuel

Figure 5.1: Industrial Electricity Prices for Large Energy Users[100] (excluding VAT), 2010



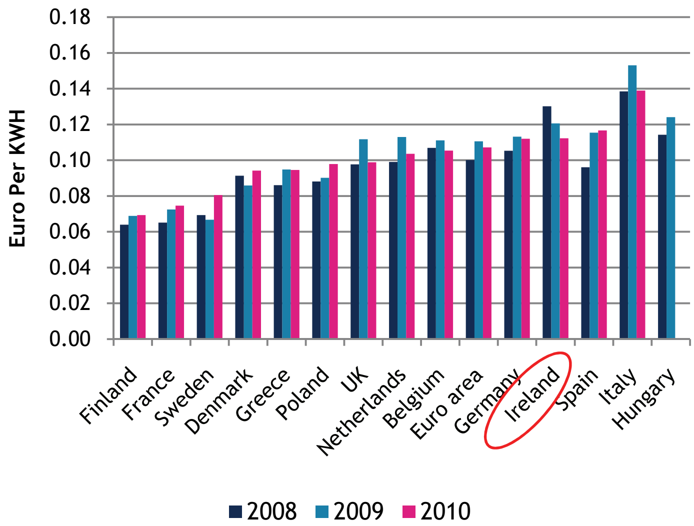
Between the first half of 2009 and 2010, the cost of electricity for high energy users in Ireland decreased by more than 27 percent - the largest decrease among the benchmarked locations. This followed significant decreases in the previous year also.

While costs in Ireland are lower than average Euro area costs, this is partly a result of a temporary rebate which exists for large energy users in Ireland. This rebate is due to be phased out in 2012. The data also does not capture the impact of the reductions in the temporary rebate which came into effect from October 2010.

Source: Eurostat – Environment and Energy

100 Electricity prices for large energy users are based on an annual consumption of 2,000 to 20,000 kilowatt hours. Prices are half-yearly and are taken from the first half of 2010.

Figure 5.2: Industrial Electricity Prices for SMEs[101] (excluding VAT), 2010



After significant reductions in 2009, electricity costs for SMEs in Ireland continued to fall in 2010. Nevertheless, despite these falls, Ireland remains more expensive than the Euro area average as many other countries recorded falls in prices.

Between 2008 and 2010, however, there was significant convergence in prices - the gap between Ireland and the euro area fell from 30 percent to under 4 percent.

Source: Eurostat – Environment and Energy

Figure 5.3: Industrial Gas Prices (excluding VAT), 2010

Across all benchmarked locations, the cost of industrial gas fell significantly between 2009 and 2010, reflecting the large decline in international gas prices.

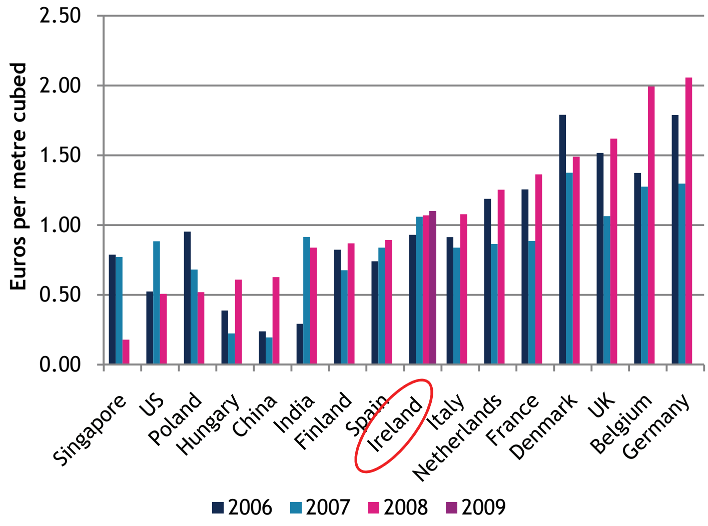
Of the benchmarked group, Ireland has the third lowest industrial gas prices (€7.83 per gigajoule) compared to 2nd lowest in 2009. Prices in Ireland are 12 percent below the euro area average of €8.90.

Source: Eurostat – Environment and Energy

101 Electricity prices for SMEs are based on an annual consumption of 500 to 2,000 kilowatt hours.

5.3 Environmental Utilities

Figure 5.4: Water Costs, 2009

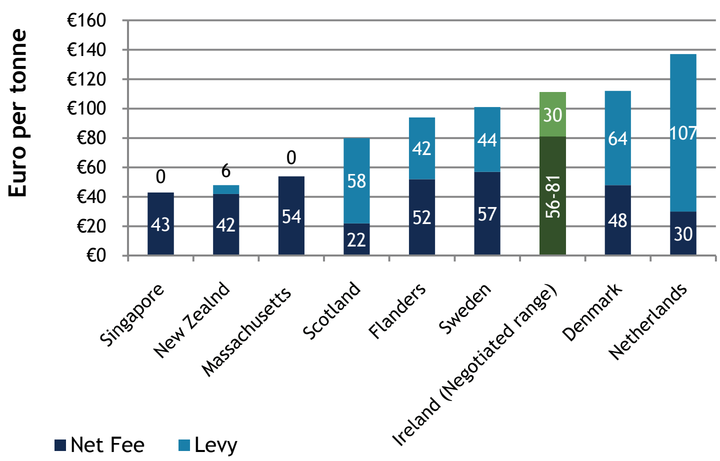


Water costs measure the cost for industrial users per metre cubed. It does not include the cost of waste water services. The average cost of water services rose by 2.6 percent in Ireland between 2008 and 2009[102].

The average cost of waste water services in Ireland in 2009 was €1.20 per metre cubed, an increase of 18.8 percent on 2008. This brought the average consolidated water services charge per metre cubed in Ireland to €2.29, an increase of 10.5 percent on 2008.

Source: EIU, World Investment Service, Department of Environment, Community & Local Govt , Chambers Ireland

Figure 5.5: Negotiable Landfill Gate Fees in Ireland versus Advertised Gate fees in Benchmarked Countries (including levy), 2010 (€ per tonne)



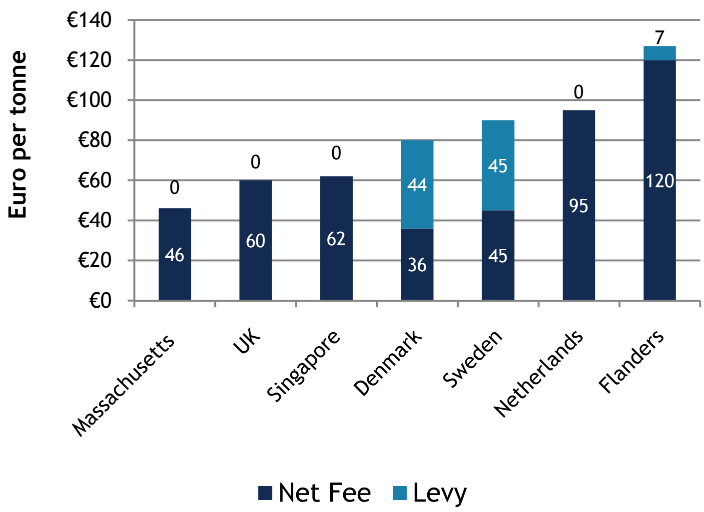
The Irish landfill gate fee is often lower than the advertised fee as the gate charge can be negotiated based on a number of factors such as the volumes of waste offered, the source of the waste, commercial pressures on the landfill owner, credit rating of the supplier offering the waste, etc[103].

Since early 2010, Irish gate fees have continued to fall sharply.

Source: Forfás, Annual Waste Benchmarking Analysis and Policy Priorities: Update 2010

102 Water costs data for 2009 is only available for Ireland.
103 Similar offers are likely to be available in other countries but it was not possible to source data for the negotiable prices in other countries/regions. Based on advertised fees, at an average of €142 per tonne (including the landfill levy), Ireland was the most expensive of the nine locations benchmarked in mid-2010. See Forfás' Waste Management in Ireland, Benchmarking Analysis and Policy Priorities - Update 2010 for a more in-depth discussion on waste costs.

Figure 5.6: Thermal Treatment Gate Fees, (Including Levy), 2010 (€ per tonne)

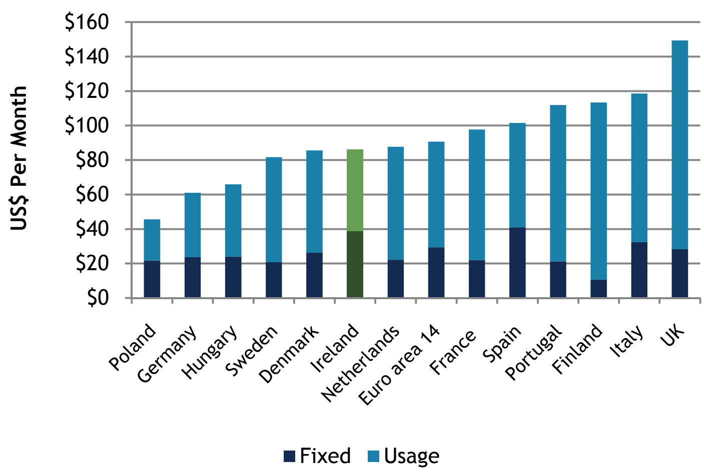


This indicator presents the average cost of thermal treatment for non-hazardous industrial waste. Flanders at €127 per tonne is the most expensive benchmarked location. Ireland is not included in the chart as there are no commercial waste-to-energy treatment plants currently in operation in the country.

Source: Forfás, Annual Waste Benchmarking Analysis and Policy Priorities: Update 2010

5.4 Telecommunications

Figure 5.7: Business Basket of Calls (260 Calls Excluding VAT), US$, 2010[104]



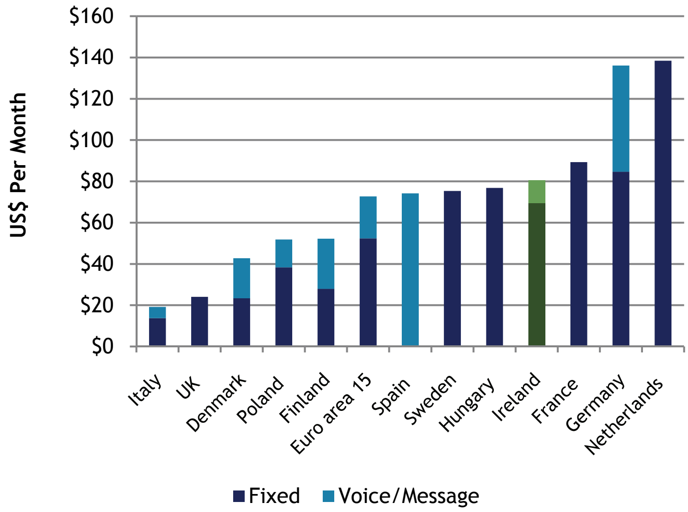
This indicator measures the costs of a business basket of calls excluding VAT. The fixed element is not an indication of the cost of basic line rental.

Ireland ranks as the eighth most expensive location of the 13 countries benchmarked. Ireland is almost 5 percent cheaper than the euro area average.

Source: ComReg /Teligen, 2011, Forfas calculations

104 The euro area-14 is the euro area minus Cyprus, Malta and Slovenia.

Figure 5.8: Monthly Mobile Telephone Costs, High Usage Post Paid Basket (300 Calls), US$, including VAT, 2010[105]

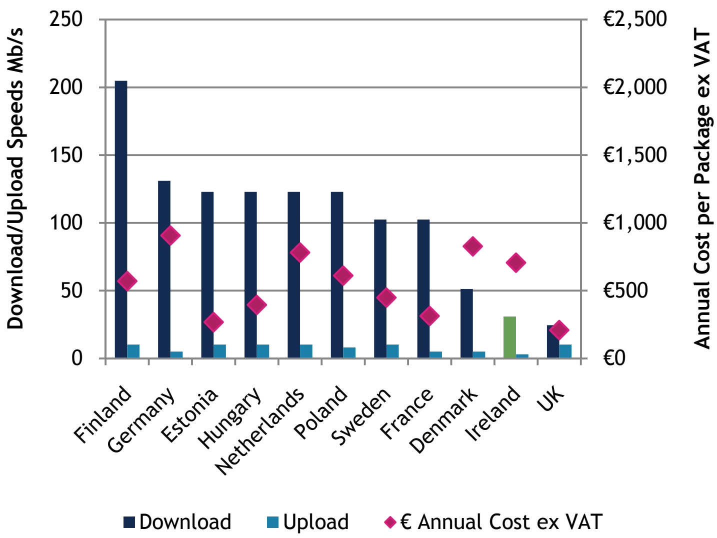


Source: ComReg /Teligen, 2011, OECD Comparative Price Levels, March 2011, Forfas calculations

Mobile voice traffic accounted for almost 60 percent of total voice minutes in the last quarter of 2010 in Ireland[106].

Ireland ranks fourth most expensive of the countries benchmarked locations and is 10 percent more expensive than the euro area average. Average revenues per customer in Ireland fell from €37 per month to €34 per month in the year to Q4 2010 – in line with the decline in average European revenues which fell by 0.6 percent over the same period.

Figure 5.9: Fastest Business Connection and Annual Cost per Mb/s excluding VAT, 2010



Source: Teligen, January 2011

Figure 5.9 shows the fastest download speed available to business, the accompanying upload speed provided and the annual cost per package. Generally the fastest speeds tend to be available in the main urban centres.

Ireland has the 2nd slowest download speed (30 Mb/s) and slowest upload speed (3 Mb/s) amongst the countries benchmarked. The fastest package in Ireland costs €706 (excluding VAT) per annum. Significantly faster speeds are available for less than this in many of the countries benchmarked.

105 The euro area-15 is the euro area minus Cyprus and Malta.
106 ComReg Quarterly Key Data Report, Q4 2010

5.5 Policy Focus – Energy and Waste Recommendations

This policy discussion concentrates on two areas of primary concern – energy costs and waste costs. In relation to the other two utilities examined:

- Water costs: The NCC supports the introduction of user charges for consumers (e.g. water charges for households) which broaden the tax base. The introduction of domestic water charges will be accompanied by a programme of metering as well as structural reform in the water services sector, including the establishment of a new semi-state water utility, Irish Water, as well as the establishment of a regulator for the water sector.
- Telecoms: The primary issue in the telecoms sphere relates to availability of key services (i.e. access to high quality broadband in key regional centres) rather than to cost.

5.5.1 Energy Policy

A reliable and competitively priced supply of energy is vital for business and its ability to compete successfully in international markets. From a national competitiveness perspective, the challenge facing Ireland is to reduce energy costs while delivering on our security of supply and environmental sustainability objectives. The NCC welcomes recent measures to improve energy cost competitiveness such as the efficiency improvements in the operating, maintenance and capital costs of electricity networks and the legislation to recover the carbon windfall gains from electricity generators[107].

Driven by a steep fall in global fuel prices (gas, oil and coal), Irish industrial users enjoyed reductions in energy prices over the last few years. In spite of recent declines in industrial electricity costs, however, Ireland remains an expensive location for SMEs. As gas prices are likely to increase in the future it is crucial that structural measures are progressed as a matter of urgency to ensure a long term improvement in energy cost competitiveness. The phasing out of the current temporary rebate for large energy users will further exacerbate the situation - this rebate was introduced in 2009 for large energy users and has been reduced by 42 percent from 1st October 2010 and will be phased out completely by the end of 2012.

Looking at those aspects of energy pricing that can be influenced domestically, the issue of the public service obligation (PSO) levy is a primary concern for enterprise. The PSO levy is added to each electricity customer's bill to cover the costs of the price supports to peat and renewable energy – these supports are designed to underpin the Government's strategy of promoting renewable energy while at the same time ensuring security of energy supply. While the PSO levy was zero in 2009/2010, it is estimated that the 2010/2011 levy will add about five percent to all bills[108]. The total PSO cost for 2010/2011 is €157 million. The direct subsidy to peat accounts for half of this and supports for renewable energy generation cost €43 million.

107 Every five years the regulator reviews the non-fuel costs allowable for electricity networks, in line with Government legislation. In summer 2010, the CER carried out a comprehensive review of the network charges to apply for the period 2011-2016. As a result of the recent review, the networks cost component of the electricity bill will be 45 percent cheaper for large energy users from the 1st October 2010. The Carbon Revenue Levy Act was enacted in June 2010 to recover the windfall gains accruing to electricity generators until the end of 2012.
108 CER, Information Note on the bill impacts of LEU customer credits (CER/10/155), September 2010

Subsidies for peat generated electricity should be phased out due to the cost implications for electricity customers and the impact on the environment. Price supports for renewable energy play an important role in incentivising investment in renewable generation to meet the EU 2020 target but, as highlighted by the NCC in its 2009 Statement on Energy[109], given that the market and technologies are maturing, we need to review future subsidies to ensure that they do not adversely affect our long term cost competitiveness[110].

Standard guaranteed price supports (such as those operating in Ireland), which are isolated and protected from the risks and competition in the rest of the energy sector, are not economically sustainable as a support scheme in the medium to long-term when renewable energy reaches very large-scale deployment. The International Energy Agency has argued that a premium on the wholesale price is a more efficient mechanism for supporting renewable technologies than guaranteed price supports as it forces energy producers to track market development and manage costs while guaranteeing a high level of investor certainty[111].

The NCC recommend that the existing Renewable Energy Feed-In Tariff (REFIT) scheme should be revised so that the price supports are transitional as they are for other technologies, with decreasing support levels over time to address cost competitiveness concerns. In addition, the price support should be changed from a fixed guaranteed price to a premium on the wholesale price. Providing a premium over the wholesale price can support the development of a more sustainable renewable energy market over the long term. However, the premium should be subject to a cap to protect customers in the event of high fossil fuel prices.

Finally, significant investment in Ireland’s energy transmission and distribution infrastructure is planned over the period to 2025 which will be financed through future increases in electricity prices. This investment is essential to enable renewable technologies to connect to the grid and to ensure that key regional centres can support energy intensive investment projects. Given reduced levels of economic activity, the NCC believes that potential exists to extend delivery over a longer period of time and delay projects which are no longer justified by projected demand growth.

5.5.2 Waste Policy

Following many years of high relative prices, Ireland’s cost competitiveness in terms of waste treatment costs has improved dramatically. However, work published by Forfás has also shown that Irish enterprises have more limited waste management infrastructure options than international competitors, although this is improving with the opening of a number of mechanical-biological treatment (MBT) and waste to energy facilities.[112].

The Programme for Government commits the Government to developing a national waste policy that adheres to the EU waste hierarchy and favours a coherent approach to waste management that

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109 http://www.competitiveness.ie/media/ncc091006_statement_energy.pdf
110 Note that while the wind energy sector in Ireland is relatively mature, other renewable energy sources such as biomass remain underdeveloped.
111 International Energy Agency, Deploying Renewables: Principles for Effective Policies, 2008.
112 Forfás, Waste Management in Ireland, Benchmarking Analysis and Policy Priorities: Update 2010

minimises waste going to landfill and that maximises the resources that can be recovered from it. The NCC recommends that:

- Waste charges to business should reflect the need to deliver cost competitive solutions and optimal environmental performance, while extracting economic value from waste as a resource. Applying much higher - or new - waste levies will increase the costs of doing business further, particularly for those in manufacturing (in key sectors such as food and pharmaceuticals). Increases in the landfill levy should reflect the pricing of externalities (i.e. putting a price on environmental and other damage caused by landfill)[113].
- Due to the need to develop a competitive waste-to-energy market in Ireland as a waste management option for Irish enterprise and to avoid potential damage to Ireland's reputation as a destination for foreign direct investment, the NCC recommends that a waste-to-energy levy should not be considered until a waste-to-energy market is established here.
- A volumetric levy on incineration levels should not be introduced as it stands to inhibit economies of scale which are essential to bring Irish waste costs more into line with our competitors. Such a cap would also run counter to the internationally accepted waste management hierarchy.

113 The ESRI recommends a €44.50-55.10 levy for landfills with no flaring or gas capture and reduced rates for landfills with appropriate methane management. Enterprise can avoid or minimise such increases through greater use of segregated collection, recycling and waste prevention measures, as such charges only apply to residual waste going for disposal.

6. Business and Professional Services Costs

6.1 Summary

This chapter looks at the cost of key professional services to business such as computer programming and consultancy, accountancy and legal services. As discussed in Chapter 2, business and professional services, on average, account for a relatively low proportion of the enterprise cost base – certainly compared with labour costs, and property costs. This reflects experiences elsewhere – for instance, the Italian Antitrust Authority has estimated that in Italy an average of 6 percent of exporting firms' total costs are accounted for by professional services[114].

Nevertheless as an input to almost every enterprise in the country, the competitiveness of professional and business services has a direct impact on the competitiveness of the entire Irish economy. This has been recognised in the EU/IMF Programme of Financial Support for Ireland, which accords significant attention to the promotion of competition in the professional services sector[115]. In a recent update to the stability programme, the Department of Finance, using a European Commission model, have estimated the potential impact of the proposed structural reforms (i.e. the removal of restrictions to trade and competition in sheltered sectors, such as the legal, medical and pharmaceutical professions) on the overall level of GDP[116]. They have found that a one percent reduction of the price mark-up in the final goods sector (a broader categorisation than just the sheltered sectors) increases GDP by 0.37 percent in the medium term, 0.66 percent in the long run and 0.79 percent in the very long run.

Until recently, there were no official statistics on professional services costs. However, over the past number of years, the CSO has, in tandem with other national statistical organisations, developed an experimental Services Producer Price Index (SPPI) to measure changes in business services costs[117]. The data illustrates that the costs of services in Ireland are now 0.7 percent above 2006 levels (Figure 6.1). This contrasts with the experience in other EU states examined, where the costs of these services have increased relative to 2006 prices - the UK (+10.1%), Netherlands (+6.6%), Finland (+13.2%) and Sweden (+7.8%). This represents a substantial competitive gain for the Irish economy. There is limited data available, however, relating to price levels.

While the SSPI is limited in coverage, it indicates that over the course of the economic downturn, four of the five business and professional sectors covered by the SPPI and examined herein have shown substantial corrections in prices. However, the SSPI indicates that the cost of legal services (which increased by 12 percent since 2006) has proven to be an exception (Figure 6.3).

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114 European Commission, Communication from the Commission: Report on Competition in Professional Services, COM(2004) 83 final, 2004
115 EU Commission/IMF, EU/IMF Programme for Financial Support for Ireland- Programme Documents, 2010
116 Department of Finance, Ireland - Stability Programme Update, April 2011
117 The Services Producer Price Index (SPPI) is an experimental survey by the CSO which measures changes in the average prices charged by domestic service producers to other businesses for a selected range of services. In most cases these services are provided to business customers only and so individual price indices should not be considered indicative of more general price trends in the economy. The index covers transaction costs from business to business and excludes consumers who are covered in the Consumer Price Index (CPI). The CSO note that 'the SPPI is experimental, under development and may be subject to methodological improvement'.

6.2 Prices for Professional and Business Services

Any examination of the cost competitiveness of business and professional services is made difficult by the dearth of good price level data. In order to fully understand the workings of the professional service sectors, it is vital that improved, robust and internationally comparable data sources are developed. The primary data available focuses on changes in prices, rather than the actual price levels. However, we do know from Eurostat data (see Figure 7.1, Chapter 7) that price levels in Ireland are generally higher than price levels in our key competitors.

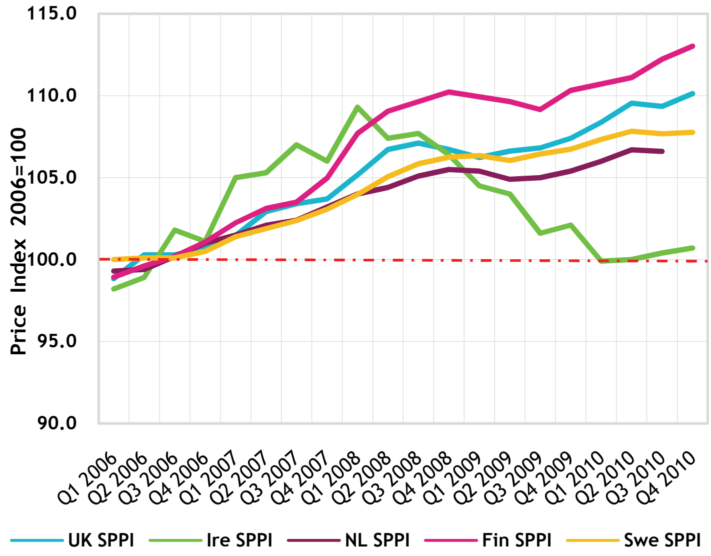
Looking at changes in the price level for professional and business services costs, the main source is the CSO's Services Producer Price Index (SPPI). The SPPI measures changes in the average prices charged by domestic service producers to other businesses for a selected range of services[118]. The index covers transaction costs from business to business and excludes consumers who are covered in the Consumer Price Index (CPI). In most cases these services are provided to business customers only and so individual price indices should not be considered indicative of more general price trends in the economy (i.e. it is not designed to measure changes in the cost of living).

Many of the sub-components which make up the SPPI related directly to business and professional services, and where possible, these components have been isolated for more in-depth analysis in the sections below. SPPI data is available for a number of comparator countries, although there are a number of methodological issues – for instance, at present each country that produces an SPPI captures data on different categories of services. Ultimately, it is intended that a consistent, fully-comparable SPPI will be produced. Nevertheless, comparison is possible.

Figure 6.1 illustrates trends in service prices between 2006 and 2010 for a small number of countries for which data is available. Again, it is important to remember that while this indicator measures price inflation, cost competitiveness is also a function of price level.

118 The Services Producer Price Index (SPPI) is an experimental survey by the CSO which measures changes in the average prices charged by domestic service producers to other businesses for a selected range of services. In most cases these services are provided to business customers only and so individual price indices should not be considered indicative of more general price trends in the economy. The index covers transaction costs from business to business and excludes consumers who are covered in the Consumer Price Index (CPI). It should be noted that the SPPI is an index based measurement - therefore any adjustment witnessed is relative to a base year. In this case, the difference in prices relates to the changes compared to 2006 prices. When examining this data, one must also appreciate that 2006 prices reflected the height of the Irish economic boom.

Figure 6.1: Services Price Index for Selected Countries, 2006-2010 (2006 =100)



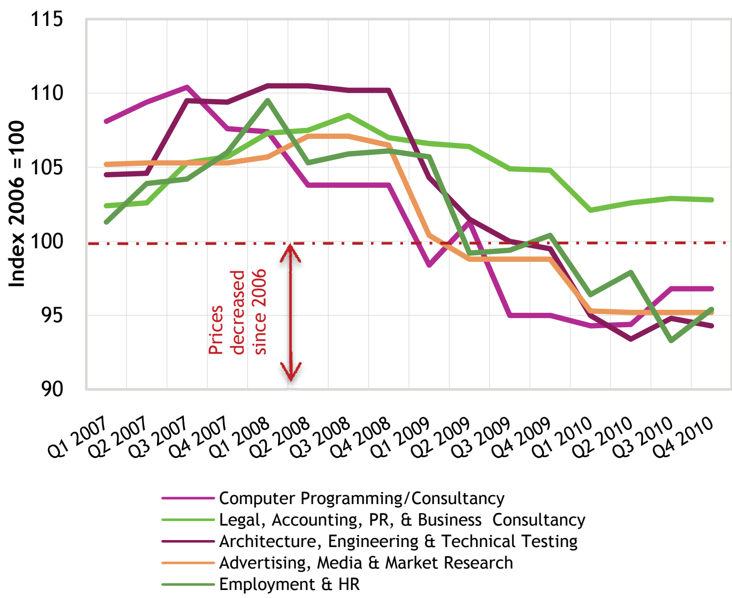
The data shows that the costs of services in Ireland are now 0.2 percent above 2006 levels (the index for Ireland shows a total reduction of 1.4 percent across services in the year to Q4 2010). This contrasts with the experience in other EU states examined, where the costs have generally increased relative to 2006 prices – in the UK, service prices increased by 10.1%, while increases were also recorded in the Netherlands (+ 6.6%), Finland (+13%) and Sweden (+ 7.8%).

Source: National SPPIs, National Statistics Databases

6.3 Focus on Specific Sectors

As mentioned above, the SPPI is made up of a number of sub-components. It is possible, therefore, to disaggregate the overall SPPI data for Ireland, and to examine changes in price levels for each of these components separately. Figure 6.2 focuses on those specific business and professional services of most relevance to the enterprise sector.

Figure 6.2: Services Producer Price Index by Subsector, 2007-2010 (2006 =100)



Price adjustment has occurred at different rates in each sector. Since the beginning of the index in Q1 2007 and Q3 2010, the greatest price reductions have been recorded in architecture, engineering and technical testing (-9.8%), computer programming and consultancy (-10.5%), and advertising, media and market research (-9.5%). By contrast, the price of legal, accounting, PR and business consultancy increased by 0.4 percent over the same time period.

Source: CSO SPPI Q3 2010

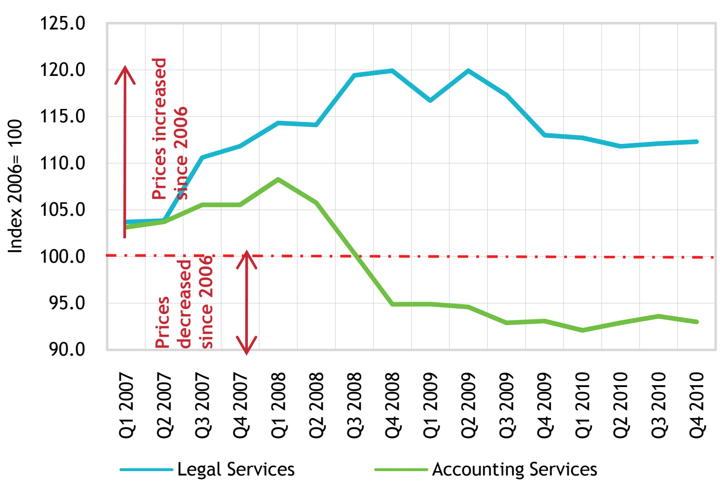
The fact that prices for legal, accounting, PR and business consultancy services have not reacted to the same extent as other services warrants closer inspection. Similarly, data from the Harmonised Indices of Consumer Prices demonstrates that insurance prices have increased since 2006. This chapter will primarily focus on these two sectors as they are illustrating stickiness in price adjustment, suggesting that there may be barriers which are preventing price adjustment.

Finally, it must be borne in mind that while some moderation in prices has occurred, in many sectors Ireland is starting from a high base - further price reductions are required if Ireland is to achieve sustainable and enduring price competitiveness.

6.3.1 Legal, Accounting, PR and Business Consultancy services

It is possible to disaggregate the Irish SPPI data even further, and to examine how prices in each of the various services which comprise the legal, accounting, PR and business consultancy category have evolved.

Figure 6.3: Accountancy and Legal Costs, 2007 -2010, (2006 = 100)[119]



Accountancy costs fell from Q1 2008 and by Q4 2009, they were 6.8 percent below 2006 price levels; conversely, the cost of legal services has not responded significantly to the recession, and in Q2 2009, legal costs were 19.9 percent above the average 2006 price level.

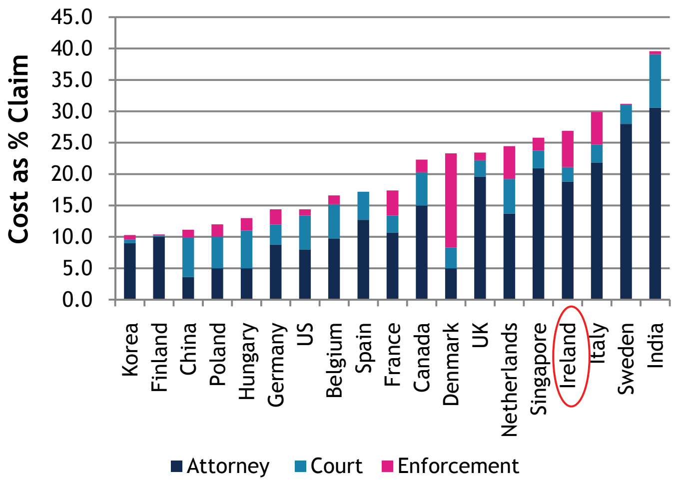
Since then, the cost of legal services in Ireland showed some downward movement between Q2 2009 and Q4 2009. The pace of this decline slowed in Q1 2010 and the index actually increased marginally from Q2 2010 to Q4 2010.

Source: CSO, Services Producer Price Index

It should be noted that the SPPI legal data does not include price data on barrister services. It is difficult to accurately compare legal costs across countries due to differences in national legal systems. Figure 6.4 illustrates the cost of enforcing a contract following a commercial dispute in relation to a sale of goods by one firm to another.

119 SPPI Q4 2010 data on legal services is based on responses received from 18 companies and covers 118 price observations. The majority of firms that responded employ between 10 and 49 employees. The survey does not include data on prices for barrister services. Given the small sample size used to create the sub-indices for accountancy and legal costs caution should be used when analysing the results.

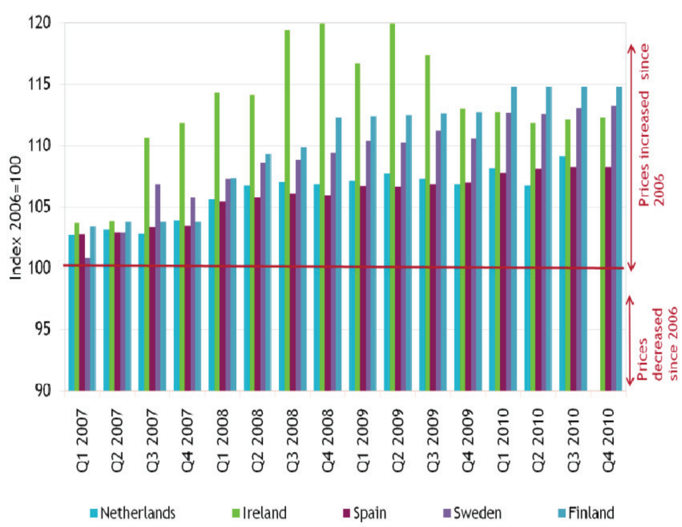
Figure 6.4: Legal Costs of Contract Enforcement, 2010



Source: World Bank, Doing Business 2011

Costs are shown as a percentage of the total claim and are broken down into attorney, court and enforcement fees. Ireland is the fourth most expensive location benchmarked, unchanged from 2009. This is driven by relatively high attorney fees. Ireland's legal system is most comparable with the UK system, which has a lower cost of contract enforcement (23.4%) compared to Ireland (26.9%).

Figure 6.5: Price index of Legal Services across a number of EU states Q1 2007-Q4 2010[120]



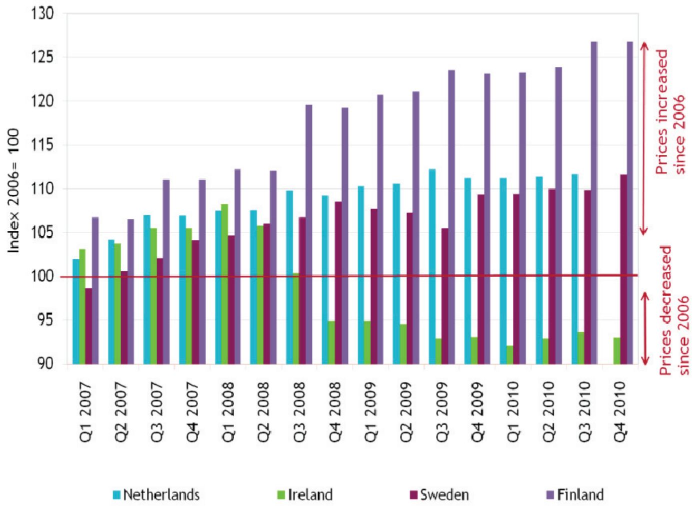
Source: National Statistics Databases

Figure 6.5 illustrates the evolution of legal service costs across a number of countries since Q1 2007. There has not been a large variance in the price index for legal services over the Q4 2009-Q4 2010 period, and the costs of legal services in Ireland appear to have stabilised at 12-13 percent above 2006 price levels.

To ensure that legal costs in Ireland become competitive, the pace of cost deflation must substantially outweigh that of other countries, as the price in Ireland is coming from a higher base level.

120 Economic advice is included with legal services in Spain. Awaiting Q4 2010 data for Netherlands

Figure 6.6: Price index of Accountancy Services across a number of EU states Q1 2007-Q4 2010[121]

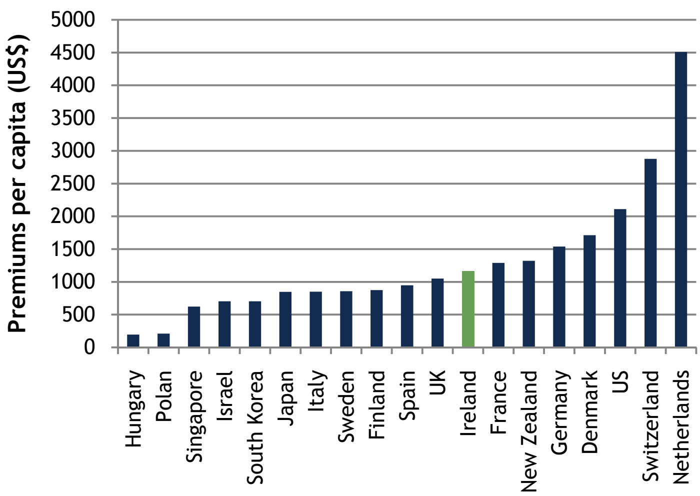


Source: National Statistics Databases

Accountancy services costs have declined since Q1 2008. Costs are now below 2006 levels and have adjusted more aggressively than the other countries examined. This adjustment indicates a competitive gain for enterprise in Ireland - as accountancy costs have reduced relative to 2006 prices and the rate of this reduction is substantially above that of our trading partners.

6.3.2 Insurance Costs

Figure 6.7: Non-Life Insurance Density, Premiums per Capita in US$, 2009



Source: Swiss Re, Sigma No.2, 2010

Limited data is available on insurance costs across countries. High insurance density (insurance spend per capita) can reflect both high insurance costs and a requirement for high coverage levels.

Among the benchmarked locations, Ireland has the eighth highest density of non-life insurance (i.e. motor, property, employer's liability, public liability, travel and other business insurance) per capita.

The SPPI for Ireland does not measure changes in the costs of insurance. The change in the price of insurance is calculated through the *Harmonised Indices of Consumer Prices* (HICP). This data shows

121 Awaiting data for Netherlands Q4 2010

that the cost of insurance in Ireland has increased by almost 34 percent since 2006, with a marked increase in the cost of insurance since 2009. The growth of insurance costs in Ireland since 2006 was almost 24 percentage points above the euro area average for the same period. While there was a minor improvement in relative insurance costs in 2008 and 2009 (in terms of premium per capita), the latest price inflation data for 2010 indicates that those improvements have since been eroded.

The price of transport insurance has actually declined relative to 2006 price, and so, it is evident that increases in insurance costs in Ireland are being driven by health, dwelling and other insurance price inflation[122]. As health insurance can be a cost borne by employers, this can directly increase businesses' cost base.

Other Professional Service Costs

This section has examined only those business and professional service costs of immediate and direct relevance to enterprise. It is important to recognise, however, that price movements in a whole range of other professional services can impact upon the competitiveness of the enterprise sector.

Professional services purchased by consumers can have a significant impact on business costs through spillover effects. High prices which are not justified by high productivity elsewhere in the economy ultimately affect the broader cost environment. Increases in the real prices of goods and services over a protracted period can result can translate into direct business costs, for example, through increased wage demands from workers to meet changes in the cost of living.

The Competition Authority has carried out a number of market studies on other professional services where concerns about market efficiency exist - General Medical Practitioners (2009, 2010), Dentists (2007), and Optometrists (2006). It is important that the recommendations outlined in these reports are responded to, and where appropriate, are acted upon and implemented in order to ensure that these markets operate efficiently and to minimise economy-wide costs. Chapter 7 will examine the broader cost environment in more detail.

6.4 Policy Focus – Competition in Professional Services

We have seen that where price adjustments have taken place these have been correcting from an elevated base relative to other jurisdictions. Therefore, while encouraging trends have emerged in the costs of many business and professional services, this has not been evident in all services and additional adjustment is required to reclaim competitive advantage over many of our trading partners.

122 Health and dwelling insurance have relatively high weightings in calculating the insurance price index. Insurance has a weight of 3.9334 percent in the HCPI. This is made up of a weight of 1.7726 percent for health insurance and 1.4106 percent for transport insurance and 0.7502 percent for dwelling insurance.

There are a number of factors which determine the price of goods and services - these include supply (e.g. barriers to entry), demand (price of substitutes, income of consumers, consumer tastes, quality, expectations about the future and lack of information), input costs, competition, productivity and government intervention. High prices, however, do not necessarily indicate a lack of competition and can often be justified in sectors with high levels of productivity and/or skills. By targeting and isolating the drivers that are keeping the costs of business and professional services artificially high, we can make details specific actions that would initiate a price adjustment in these sheltered sectors.

Two service sectors in particular warrant further discussion – both legal and insurance services have experienced an increase in costs since 2006. The primary focus for the policy discussion below is on professional legal services since price developments here represent a clear outlier from the other business and professional sectors examined. In terms of insurance, a brief discussion is accorded to the issue of transport insurance costs.

Before we delve in detail into sector specific recommendations, however, a number of broad, horizontal themes of relevance to all business and professional services are explored.

6.4.1 Regulation

The NCC recommends that:

- No professional body should be allowed to restrict the number of entrants into that profession;
- Independent regulation is generally preferable to self-regulation for key professional and business services. This would not preclude members of professional bodies from being represented on any regulatory body as a minority;
- Where possible, a variety of pro-competitive mechanisms should be used instead of traditional restrictive rules[123]. Noting the need to protect consumers, for example, European Commission recommends improving the availability and quality of information about professional services in order to empower consumers to make more informed purchasing decisions. Such a mechanism is less restrictive than imposing top-down legislative standards. For example historical or survey-based price information made available to consumers would be a less restrictive mechanism rather than regulatory price controls.

6.4.2 Competition Policy

The Competition Authority has produced an extensive series of reports on the professions over recent years. The NCC believes that a pro-competition policy environment is a pre-requisite for a competitive economy. If Ireland is to build upon recent competitiveness gains which have arisen as a result of cyclical economic factors, more permanent structural reform of markets is required.

Considered, standardised, efficient and timely execution is crucial to achieving successful policy change. Competition policy relates to a number of government departments, bodies and agencies.

123 European Commission, Communication from the Commission: Report on Competition in Professional Services, COM(2004) 83 final, 2004

The Competition Authority is an independent statutory body responsible for promoting and enforcing Irish and European competition law in Ireland. Overall competition policy is the responsibility of the Minister for Enterprise, Jobs and Innovation. Specific policy and legislative responses to competition issues and recommendations are a matter for the relevant Ministers within whose policy area the issues and recommendations lie.

Government departments often need to balance a number of competing policy priorities within their portfolio. In many instances, competition policy may not be a primary concern. At other times, there may be conflicts of interest as Departments attempt to pursue a number of objectives in parallel. There is a need, however, to ensure that competition policy remains a key national policy priority.

Of the approximately 165 recommendations made to date by the Authority, 68 have been implemented. With respect to the other outstanding recommendations, analysis by the Authority has found that 29 recommendations are 'under consideration', 18 are no longer relevant as they have been overtaken by other events, just one has been rejected, while the status of the remaining recommendations is unclear. While there may be well-founded explanations for not implementing some recommendations (e.g. they may contradict other valid public policy goals), implementation of outstanding agreed recommendations should be expedited.

In this context, Government Departments should be formally required to consider and respond to recommendations of the Competition Authority in a timely manner, with specific timelines set down for such consideration and implementation of such recommendations, as appropriate. The Department of Enterprise, Jobs and Innovation should co-ordinate a report to Government on each Department's response to recommendations of the Competition Authority. That report should include, from each Department, specific timelines for the implementation of the recommendations by them, as appropriate, timelines for consideration of outstanding recommendations and the rationale for decisions by those Departments not to implement specific recommendations.

6.4.3 Promoting Competition in Specific Professions

Legal, Accounting, PR and Business Consultancy Services

In general, accounting, PR and business consultancy services appear to be operating without any major competition barriers. The legal profession, however, is a distinct outlier in this regard. Relative to the other professions examined, prices for legal services have proven extremely sticky and have not adjusted downwards to the degree that might have been expected given current economic circumstances.

The legal profession has already been subject to several studies. Despite several positive recent developments (such as the Bar Council reforming the restrictions it imposes on newly qualified barristers), the profession remains characterised by a range of restrictions on competition. Arising from the existing studies, the NCC has identified a series of recommendations which, if implemented, would contribute to the delivery of more cost-efficient legal services. These recommendations relate to:

(i) The regulation of the legal profession;
(ii) The manner in which legal services are costed;
(iii) The need for competitive tendering for State contracts;
(iv) The need for structural reform of the legal profession;
(v) Empowerment of consumers; and
(vi) Procedural reform.

(i) Regulation of the Legal Profession

As noted in the section relating to principles governing regulation, the NCC believe independent regulation is generally preferable to self-regulation. With specific reference to the legal profession, barristers are self-regulated via the Bar Council, and solicitors are largely self-regulated via the Law Society, with limited independent oversight in some areas (e.g. solicitor advertising is regulated by statute). The Bar Council and the Law Society are also the representative bodies for their members. There is potential for conflict of interest when an entity is tasked as both a representative and regulatory body. Most other professions exhibit separation of powers in terms representation and regulation, e.g. the Medical Council regulates doctors and the IMO represents doctors. It is also at odds with developments in the regulation of the legal profession internationally, in particular in other common-law jurisdictions such as England and Wales and Australia.

The NCC recommends the establishment of an independent regulator for the legal profession – a Legal Services Commission[124]. This recommendation has also featured in the EU/IMF Programme of Financial Support for Ireland and in the Programme for Government. The NCC believes that new body should incorporate the regulation of training for solicitors and barristers, and would be tasked with approving those institutions who wish to provide such training.

In addition to the creation of an independent regulator, consideration should also be given to extending the powers of the Legal Services Ombudsman (which has not yet been established). Under current legislation, the legal services ombudsman – unlike other ombudsmen – has no power of redress.

(ii) Legal Service Costs

The report of the Legal Costs Working Group has already proposed significant changes to the manner in which legal services are charged. At present, the Taxing Master is the officer responsible for assessment and measurement of legal costs. The NCC recommends that a Legal Costs Assessment Office be established to replace the Taxing Master's Office, as recommended by the Legal Costs Working Group. In striking a balance between assessing the costs involved and the level of service provided, the Legal Costs Assessment Office must also ensure that the interests of the consumer are upheld and promoted. In this regard:

- The Legal Costs Assessment Office should have a remit to cover costs arising from all courts, not just the High and Supreme Courts as is the case currently for the Taxing Master;

124 This recommendation echoes previous recommendations by the Competition Authority.

- Legal costs should be assessed on the basis of work done, rather than on the size of awards; and
- The general practice of allowing junior counsel's fees at two-thirds that of senior counsel has been recognised as anti-competitive (e.g. by the Competition Authority). In many instances, however, the practice continues. Parties with responsibility for overseeing legal costs should ensure that the practice is no longer tolerated.

(iii) Competitive Tendering

As a major consumer the Government has a certain amount of market power which it should utilise to ensure that the cost of legal services to the state is minimised – the Dáil Committee of Public Accounts has estimated that the State spends an estimated €500 million per annum on procurement of legal services[125]. The impact of the State on the cost of legal services can be assumed to impact upon legal costs throughout the entire economy. As currently defined, however, legal services are considered non-priority services and so are not subject to the full scope of the EU procurement directives (i.e. legal services are categorised as an "Annex IIB service").

The Committee of Public Accounts have found that while the costs of other professional services to the State have declined significantly in recent years, there have only been marginal reductions in the costs of legal services, despite difficult economic conditions. The Committee concluded that the listing of legal services in Annex IIB is not a sufficient reason to excuse Government departments and public bodies from tendering for solicitors' and barristers' legal services - other EU member states already tender for legal services with the goal of improving value for money. The absence of a competitive tendering process for legal services means that the State cannot be sure that it is paying a fair price for such services. The Committee has stated that "*While it has been mentioned to the Committee on many occasions that the State generally pays less than the market rate for the legal services it purchases, the Committee has a great difficulty in understanding how one can determine what the market rate for legal services is. The essential problem lies in the fact that the market rate cannot be deemed the benchmark given that it is determined outside of any form of competition*"[126].

Further, the Committee has found that the State has been reluctant to challenge the legal profession in relation to cost "*From the exorbitant figures charged and paid to members of the legal professions by the State Claims Agency, HSE, local authorities and public bodies, at the Tribunals and Commissions of Inquiry, during the bank stabilisation process and the provisions being made in NAMA for legal costs, it seems the legal profession is treated very much with a kid-glove approach on the part of the State*"[127].

The NCC recommends that where practicable legal services to be provided to the State by solicitors and barristers in private practice should be procured in accordance with the guidelines set out by National Public Procurement Policy Unit (NPPPU), requiring prospective legal service providers to

125 Committee of Public Accounts, Third Interim Report on the Procurement of Legal Services by Public Bodies, Dáil Éireann January 2011
126 Committee of Public Accounts, Third Interim Report on the Procurement of Legal Services by Public Bodies, Dáil Éireann January 2011, Page 29
127 Committee of Public Accounts, Third Interim Report on the Procurement of Legal Services by Public Bodies, Dáil Éireann January 2011, Page 36

compete with one another on the basis of cost and quality. This ensures that contracts are awarded in accordance with EU Treaty principles of transparency (this implies appropriate advertising), non – discrimination on the grounds of nationality, freedom to provide services, freedom of establishment. There may be instances where certain types of contracts cannot be procured in this fashion (e.g. where issues of confidentiality etc. exist).

(iv) Structural Reform of the Legal Profession

At present, the Irish legal system comprises a two-tier structure made up of junior and senior counsel. Such a structure allows for higher fees to be charged but does not offer a definitive guide as to the quality of the barrister in question. This is an obvious additional cost which must be borne by enterprise and individual consumers alike. The NCC recommends that the present manner in which Senior Counsel are appointed be reformed so that the title becomes a useful quality signal facilitating competition in legal services. Further, consideration should be given to the creation of a single tier counsel system - the removal of the distinction would promote meritocracy and would, for example, lessen the requirement for the State and other clients to engage senior counsels for High Court and Supreme Court cases where the complexity does not necessarily require a senior. A number of reports have already suggested that a range of reforms be considered in relation to Junior and Senior Counsel, but in most cases, these have not yet been acted upon[128].

At present, solicitors are prohibited from being the lead advocate where a legal team of both barristers and solicitors is representing a client. The NCC recommends that this restriction be removed and that solicitors be permitted to act as lead counsel when advocating in court with a barrister in order to promote enhanced competition in legal services.

The legal profession plays an important role in the property market, specifically through their conveyancing role. Previous studies have found that the cost of conveyancing in Ireland is significantly higher than other countries with similar legal systems. Notwithstanding the current collapse in demand for conveyancing, the NCC, therefore, recommends that suitably qualified professionals, in addition to solicitors, be allowed to provide conveyancing services. The NCC supports the Competition Authority's recommendation that a specialist conveyancer profession be developed in Ireland, with appropriate regulations and standards. This profession could then compete with solicitors for conveyancing business. This occurred in the UK in 1987 with the creation of licensed conveyancers, allowing conveyancing to be done by non-solicitors. Subsequent evaluations have found that the creation of this profession had a positive effect on price competition[129]. In Australia, the removal of lawyers' reserved rights to provide conveyancing services and the barristers' monopoly in courtroom work contributed to a 12 percent drop in overall legal costs[130].

128 See Competition in Professional Services- Solicitors and Barristers by the Competition Authority (2006), The Report of the Special Group on Public Service Numbers and Expenditures Programmes Volume 1 (2009), and the Report of Study into Restrictive Practices in the Legal Profession by the Trade Commission (1990)
129 Zerp et al , COMP/2006/D3/003 (2007), "Summary of the comparative legal and economic study into the EU conveyancing services market" available at URL: http://ec.europa.eu/competition/sectors/professional_services/studies/csm_standalone_en.pdf
130 EU Commission, (2004), "Report on Competition in Professional Services" available at URL: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2004:0083:FIN:EN:PDF

(v) Empowering the Consumer

There a number of actions which could be used to empower the consumer and thus address inefficiencies in the market and allow prices to adjust in response to wider economic conditions and price movements elsewhere.

- The current restrictions which prevent consumers from switching solicitors should be abolished. For instance solicitors have the right to withhold a client's file if payment is outstanding or disputed. However, full payment may not be possible to achieve in a short space of time and in the interim the client may be disadvantaged with possibly serious consequences;
- Individual consumers and enterprises should be allowed to directly access legal advice from barristers – access to such advice is currently restricted by the Bar Council; and
- Both solicitors and barristers should be required to issue detailed and meaningful fee and/or fee estimate letters to prospective clients.

(vi) Procedural Reform

Other actions could be undertaken to reduce legal service costs by eliminating practises which generate costs unnecessarily or operate as an impediment to containing costs. In this regard the Legal Cost Working Group recommended a number of procedural measures to the operation of the legal system. For instance, the group recommended that the rules of the court should include a specific order facilitating supervision by the court of the pace of litigation and this should also contain measures to sanction delay.

Non-Life Insurance

Significant reform of the insurance market occurred in Ireland in the mid 2000's with, for example, the establishment of the Personal Injuries Assessment Board (now known as InjuriesBoard.ie) in 2003[131]. Despite such interventions, concerns over insurance costs have re-emerged. Given the widespread incidence of insurance on the enterprise base, any actions which can positively impact on cost could have a potentially significant effect on competitiveness.

In 2005, the Competition Authority published a study focusing on motor insurance, employer's liability insurance and public liability insurance[132]. This study found that the persistence of high profits among insurance companies, combined with slow rates of entry and low levels of cost reduction, suggested that competition was not as vigorous as would be expected in a truly competitive market. The Authority made 47 recommendations, focusing on three areas:

- **Barriers to Entry:** Implementation of some of the Authorities recommendations has increased the availability of information on costs and claims statistics. Accurate, timely and easily accessible information on claims helps insurers, including potential new insurers, to assess the insurance market.
- **Ease of Switching:** It was recommended that companies providing liability insurance must issue a renewal notice at least 15 working days prior to the expiration of the insurance policy. This gives businesses time to shop around for lower quotes from rival insurers.

131 InjuriesBoard.ie is a statutory body which provides independent assessment of personal injury compensation for victims of Workplace, Motor and Public Liability accidents. This assessment is provided without the need for the majority of current litigation costs, such as Solicitors, Barristers and Experts' fees, associated with such claims.
132 Competition Authority, Competition Issues in the (Non-Life) Insurance Market, 2005

- **Transparency:** As a result of this report's recommendations, greater transparency in relation to the role played by intermediaries in the insurance market.

While a substantial number of Competition Authority recommendations have been accepted by Government, a small number of recommendations relating to the collection and publication of insurance related data (targeted at the Financial Regulator) remain outstanding. Elsewhere, the status of a small number of recommendations relating to motor insurance and the Motor Insurers' Bureau of Ireland (MIBI)[133] require clarification.

It is interesting to note that the ability of many professions examined herein to conduct business is partially determined by developments in other professional services. For instance, the high cost of professional indemnity insurance for solicitors has been cited as a major issue for many legal firms. Solicitors cannot get a renewal of their practising certificates if they do not have professional indemnity insurance, yet the rise in some premia over recent years has made it more difficult to acquire such insurance.

133 The MIBI was set up in 1955 by an Agreement between the Government and the Companies underwriting motor insurance in Ireland for the purpose of compensating victims of road traffic accidents caused by uninsured and unidentified vehicles.

7. Indirect Business Costs

The previous four chapters examined direct enterprise costs. Enterprise, however, does not operate in a vacuum, separate from the rest of the economy. The price of all goods and services contributes to the overall price level in the economy and ultimately impacts upon a county's international competitiveness.

Consumer prices, measured by the Consumer Price Index (CPI), can be viewed as indirect costs for business. Outside of work, employees purchase goods and services. Movements in these prices impact upon wage demands, and so the impact of price changes in consumer markets spill over into the cost base of the enterprise sector. For instance, the correlation between rapidly escalating house prices and increases in average wage levels is widely recognised.

This chapter, therefore, focuses on the overall cost environment for consumers and changes in the price levels for goods and service. The analysis draws primarily from the CSO's Consumer Price Index.

7.1 Summary

Figure 7.1 draws on Eurostat price data to illustrate that price levels in Ireland are higher than might be expected, even factoring in Ireland's relatively high GNP per capita. Using an alternative data source, Figure 7.2 illustrates that Ireland (or at least Dublin) has regained some competitiveness over recent years. A comparison of consumer costs between major international cities indicates that Dublin's cost competitiveness improved between 2009 and 2010 as the city moved from sixth most expensive to ninth most expensive out of 18 cities.

Following a period of significant increase, the consumer price index peaked in 2008 when prices were 28 percent above 2001 prices. Since then the index has fallen and prices in March 2011 were 4.5 percent below the peak level. However, the pace of decline in the consumer price index slowed towards the end of 2010 and increased in February and March 2011. Furthermore price levels remain significantly above their 2001 levels (Figure 7.3). Between February 2010 and February 2011, Ireland experienced a 0.9 percent increase in the harmonised index of consumer prices (HICP), the smallest increase in the European Union. During the same period the euro area HICP increased by 2.4 percent (Figure 7.4).

Ireland is an expensive location for purchasing groceries. For a comparable basket of food and non-alcoholic beverages, Ireland ranks as the second most expensive European country, 19.4 percent above the euro area-16 average (Figure 7.6).

The cost of public and administered services affects the competitiveness environment for firms. This section looks at some indicative measures of the cost competitiveness of public and administered services in Ireland. The cost of health and education services continues to rise rapidly, (Figure 7.7).

7.2 Consumer Price Levels and Trends in Prices

Figure 7.1: Price levels and GDP per Capita

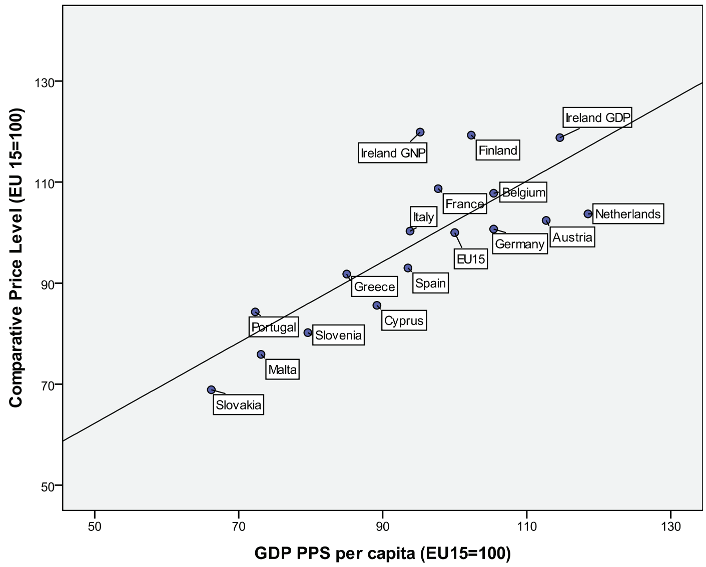
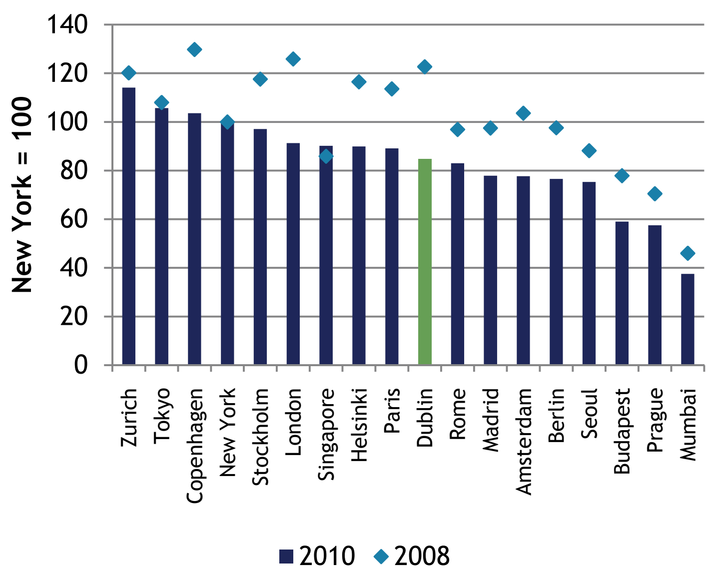


Figure 7.1 illustrates data on price levels and GDP purchasing power standard per capita. This data shows that when GNP per capita is used for Ireland (a more accurate reflection of income), Ireland's price level appears relatively high even taking account of the higher per capita income levels on offer. It is notable that some other small high income countries have lower consumer prices levels than Ireland including the Netherland and Austria.

Source: Eurostat

Figure 7.2: Consumer Price Level Comparison 2008 - 2010 (New York = 100)



This indicator shows the cost of a weighted basket of 122 goods and services (excluding rent) in a number of large cities.

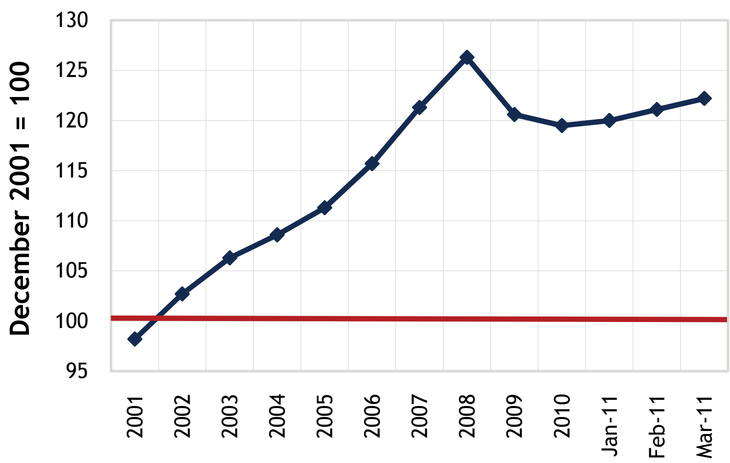
In 2008, Dublin ranked as the third most expensive location for the basket of goods amongst the group of 18 benchmarked cities. Following relatively large price declines, Dublin was ranked the 6th most expensive location in 2009 and 9th in 2010. London's relative position has improved dramatically following sterling's steep devaluation.

Source: UBS, Prices and Earnings 2008 - 2010

7.3 Consumer Price Index

The weighting of the consumer price index is derived from the CSO's household budget survey and therefore reflects average expenditure by all households on various categories of goods and services. As a result it provides a representative indication of the changes in the costs of the primary consumption components in the wider cost environment.

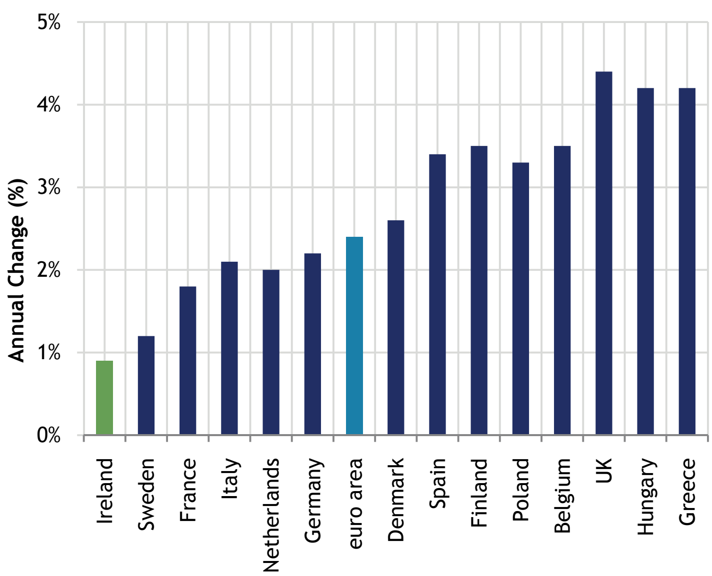
Figure 7.3: Consumer Price Index, 2001 – March 2011 (December 2001 =100)



The Consumer Price Index (CPI) measures the change in the average level of prices (inclusive of all indirect taxes) for a basket of consumer goods and services in Ireland. Overall since 2008 the CPI has declined by 3.3 percent. However, the recent deflationary trend has come to an end and Irish prices are once again increasing. Services price inflation was significantly higher than goods price inflation over the entire period examined.

Source: CSO, Consumer Price Index

Figure 7.4: Harmonised Index of Consumer Prices, Annual % Change, February, 2011

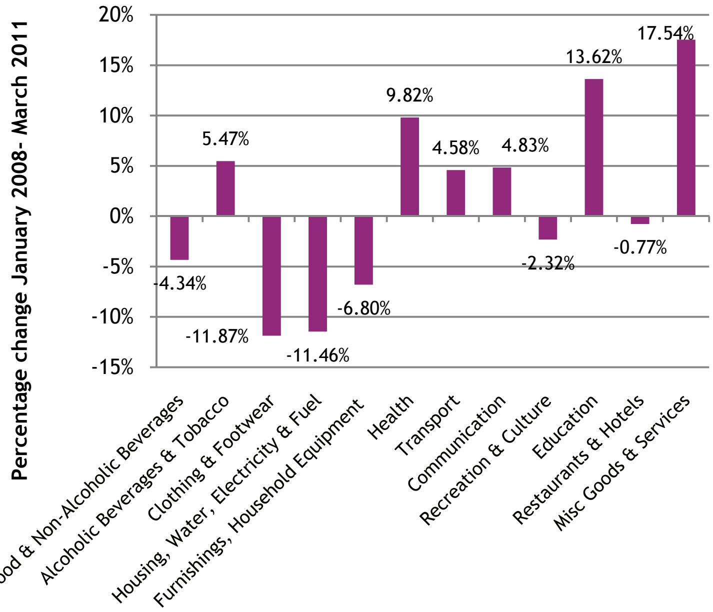


The Harmonised Index of Consumer Prices (HICP) is calculated in each EU member state to enable the accurate comparison of consumer price trends. Of the euro area countries, Ireland experienced the smallest increase in the HICP (0.9%), during the twelve months to February 2011. The HICP for the euro area increased during that period by 2.4 percent.

Source: CSO, Consumer Price Index

This indicates that Ireland's cost competitiveness for consumers is improving relative to the euro area and other trading partners, such as the UK which increased by 4.4 percent over the same period. Looking at annual HICP in more detail, between 2005 and 2010, consumer prices for services in the economy have consistently increased by more than consumer prices for goods: the price for consumer services have increased by 12.6 percent since 2005, while goods prices have fallen by 0.7 percent. Administered prices, however, have witnessed an even more substantial increase. Between 2005 and 2010 administered prices increased by 23.5 percent[135].

Figure 7.5: Percentage change in the subcomponents of Ireland's Consumer Price Index, January 2008- March 2011



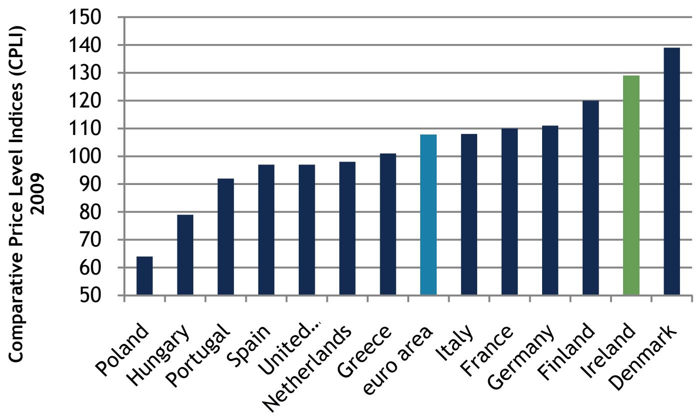
There have been notable variations in the price change across CPI components since January 2008. Increases have been recorded in alcoholic beverages, tobacco, health, transport, communication, education and miscellaneous goods and services.

Since January 2008, prices for food and non-alcoholic beverages, clothing and footwear, housing, water, electricity and fuel, furnishings, household equipment, recreation and culture and restaurants and hotels have all declined.

Source: CSO, Consumer Price Index Source

135 Calculations are based on Eurostat data. When one examines a longer period, the change is more pronounced; between 2001 and 2010 the overall HICP grew by 20 percent. Over the same time period, goods prices increased by 6.9 percent between 2001 and 2010; services prices increased by 37.5 percent; administered price increased 74 percent.

Figure 7.6: Food and Non-Alcoholic Beverage Indices, 2009 (EU-27=100)



Ireland is the second most expensive country for a basket of food and non-alcoholic beverages after Denmark. Ireland is 29 percent above the EU-27 average and 19.4 percent above the euro area-16 average. Ireland ranks as the most expensive country for milk, cheese and egg products[136].

Source: Eurostat, Economy and Finance, 2010

Eurostat data on consumer prices, however, indicate that throughout late 2009 and into 2010 food prices in Ireland fell, while prices across Europe generally continued to increase. It is also worth noting that high consumer prices for food do not necessarily reflect farm gate prices[137].

Figure 7.7: Health and Education, 2005 - March 2011 (December 2001 =100)

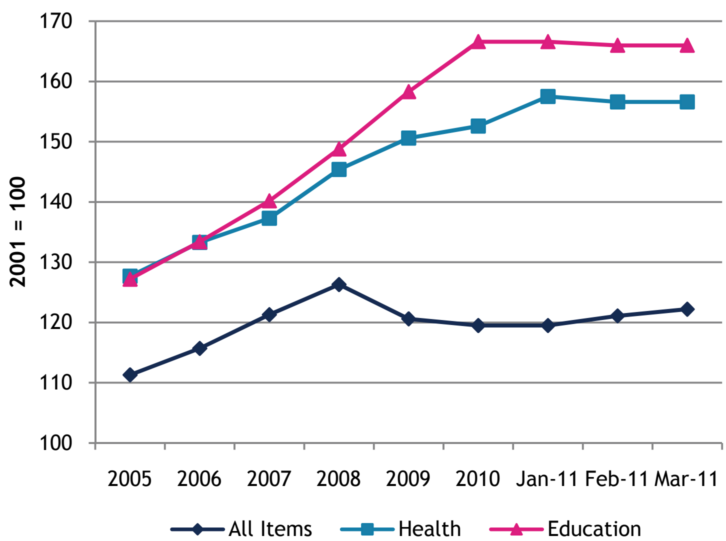


Figure 7.7 shows the health and education components of the consumer price index (CPI) and their indexed cost relative to the total CPI basket. In 2005, health and education (which are influenced by public sector policy but which contain significant private sector elements) were 15 percent above the overall CPI. Despite falls in the overall CPI in 2010, prices for health and education continued to rise. In March 2011 they were 28 and 35 percent higher than the CPI respectively.

Source: CSO, Consumer Price Index

136 http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-SF-10-030/EN/KS-SF-10-030-EN.PDF
137 Eurostat's Food Prices Monitoring Tool provides data on commodity and producer prices as well as consumer prices for food. Interpreting this data, however, is complex. For example, while an increase in commodity prices benefits farmers producing commodities, other farmers must purchase those same commodities as inputs. Further, there is a complex relationship between commodity and producer prices. In order to fully understand the data, it is necessary to disaggregate the producer price index and examine its individual components. Other inputs, such as high energy and transport costs, are also factors in food prices.

Health and education services are assigned a small weighting in the CPI[138] (reflecting the small proportion of total average household expenditure which they account for). Notwithstanding this, given that these costs have risen despite a decrease in overall costs, there is scope for the government to use its influence to reduce these prices.

7.4 Policy Discussion

While Ireland has already regained some cost competitiveness, further progress is required if Ireland is to return to strong economic and employment growth. To achieve a greater restoration in cost competitiveness, further price adjustment is required relative to our main competitors. It is, however, relative prices that matter from a competitiveness perspective. So long as Irish prices grow at a slower rate than prices in our competitor economies, Ireland will continue to achieve competitiveness gains.

There are risks, however. Given the large debt burden which has arisen as a result of the property bust, economic recession, and bank bailout, it is inevitable that taxes will rise further. The required increases in taxation are likely to have a further impact on domestic demand which has already been adversely affected by recent policy changes. The proportion of employment supported by the domestic activity has fallen from 50 percent in 2007 to 40 percent in 2011, largely as a result of the collapse in consumption[139]. In addressing the fiscal and labour market challenges which confront us, the Government must be cognisant of the impact of its actions on domestic demand. The key is to ensure that additional taxation measures are designed to protect job creation and facilitate a recovery in consumer demand.

As noted, the period of deflation in Ireland appears to have come to an end and prices are rising again. A combination of domestic price increases (many in regulated or government influence sectors) allied to external factors such as oil prices threaten to undermine recent competitiveness gains.

It is difficult for small open economies, particularly those that share a currency with larger regions, to control their rate of price inflation, as this is, to a significant degree, determined by events outside domestic control. Nonetheless, as noted throughout this report, there are a number of policy levers available to Government which can be used to restore Ireland's cost competitiveness. Continued reductions in costs for labour, property, utilities and professional services would exert downward pressure on overall costs and prices across the economy. Implementation of these recommendations would represent a major step in ensuring Ireland's future competitiveness and prosperity.

138 Health has a weighting of 3.1536 and Education 2.0429. This compares to the weighting of 11.7423 for Food and non-alcoholic beverages.
139 CSO, Quarterly National Household Survey; Forfás Annual Employment Survey; Forfás calculations

Appendix - Summary of Specialist Databases

Where possible the OECD, Eurostat and the CSO are used as the data sources for the indicators in this report. In a number of cases, other databases are used to provide comparable data in specialist areas. These are listed and detailed below.

1. KPMG – Competitive Alternatives Report, 2010

KPMG's Competitive Alternatives Report was used to develop the sectoral cost profiles in Chapter 2. Competitive Alternatives 2010 is an expansion and update of previous KPMG publications, and measures the combined impact of 26 significant business cost components that are most likely to vary by location. The study examines 17 industry operations in ten countries: Australia, Canada, France, Germany, Italy, Japan, Mexico, the Netherlands, the United Kingdom, and the United States. The basis for comparison is the after-tax cost of start-up and operations over 10 years.

2. Cushman and Wakefield – Global Research Reports

Cushman and Wakefield is the world's largest privately owned real estate solutions firm with offices in 52 countries. The firm performs proprietary research and data-driven analysis using a web-based system, tracks over 10 billion square feet of office and industrial real estate. The annual Cushman and Wakefield "Office Space across the World" and "Industrial Space across the World" reports provide a detailed analysis of prime office and industrial property rental performance and occupancy costs across the globe in the previous year.

3. Gardner and Theobald – International Construction Costs Survey

Gardner and Theobald is a worldwide construction consultancy providing services in the areas of project, cost, construction, dispute management, management consultancy and planning. The annual "International Construction Costs Survey" contains data on building cost information (across a variety of unit types), labour rates, material costs and inflation statistics.

5. The Economist Intelligence Unit (EIU) – World Investment Service

The Economist Intelligence Unit's World Investment Service provides a detailed database containing business costs, flows of investment by country and industry and overseas mergers and acquisitions. The service covers the world's 60 largest economies and provides analysis on political and economic background, business environment, foreign investment regulations and trends in foreign investment.

6. World Bank - Doing Business 2011

The World Bank publishes the results of its Doing Business survey annually. It measures the regulations applying to small and medium-size companies through their life cycle. The report covers ten indicators sets and covers 181 different countries and aims to provide an objective basis for understanding and improving the regulatory environment for business.

7. UBS - Prices and Earnings, 2009 edition - Update August 2010

UBS is a financial services firm that offers wealth management, asset management and investment banking services. The study uses a standardised survey to provide a detailed look at the prices of goods and services, wages working hours for 14 professions in 73 cities. The data for the 2009 report was collected in March 2009. All amounts were converted into a single currency (US$) to ensure that the surveyed prices and earnings could be compared. To compensate for daily exchange rate fluctuations, the average exchange rate over the data collection period was applied.

Notes

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