Chapter

1 Background

1 Background

This Chapter provides a brief outline of the economic background to the report. It is divided into four sections:

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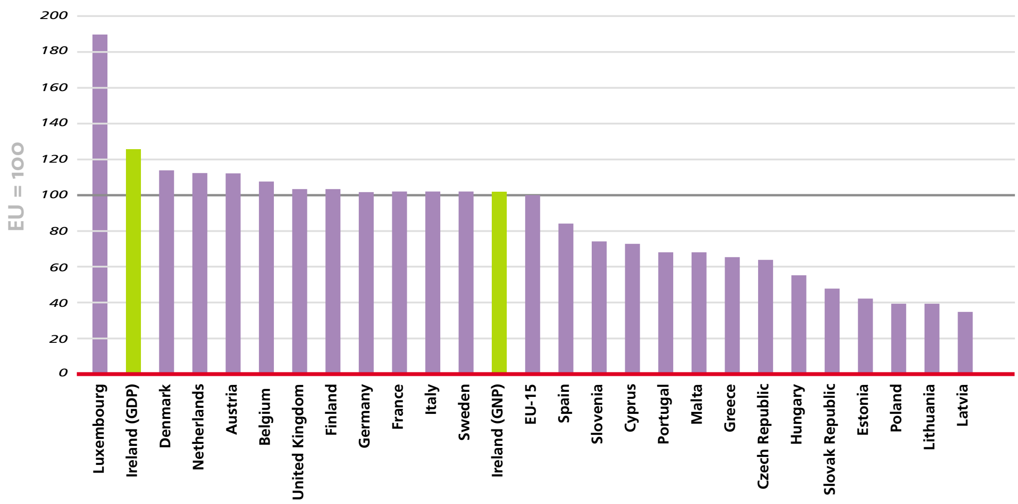
1.1 Where We Are Now

In recent years, the Irish economy has performed exceptionally well by historical standards and by international comparison. Between 1993 and 2003:

- Employment increased from 1.2 million to approximately 1.8 million[1]
- Unemployment fell from over 15% of the workforce to less than 5%[2]
- The value of exports increased from €28.5 billion to €109.3 billion[3]
- The national debt fell from 93% of GNP to 34% of GNP[4]
- GDP per capita[5] rose from 69% to 125% of the EU-15 average in 2002; GNP per capita (a better measure of performance in Ireland's case) rose from 75% to 101% of the EU average[6] as set out in Figure 1.1.

Figure 1.1

EU GDP per capita in Purchasing Power Standards, 2002



Source: Eurostat, National Accounts, 2003

1 *Central Statistics Office (CSO), Quarterly National Household Survey, Quarter 4, 2003.*

2 *Department of Finance, Budgetary and Economic Statistics, 2004.*

3 *CSO, National Income and Accounts, 2003.*

4 *Department of Finance, Budgetary and Economic Statistics, 2004.*

5 *GDP gives an inflated impression of Irish income, as it includes profits repatriated by the Irish operations of foreign-owned enterprises to their parent companies.*

6 *Eurostat, National Accounts, 2003.*

1.2 Reasons for Past Success

Ireland's economic success over the past decade was driven largely by the performance of the internationally-traded goods and services sectors, and in particular by the growth of foreign direct investment. The reasons for Ireland's economic success are well documented. The Department of Enterprise, Trade and Employment's *Review of Industrial Performance and Policy 2003*[7] summarised the key factors as follows:

External Factors

- The positive effects of the growth in global trade and the expansion of the US economy
- The growth of foreign direct investment globally in the 1990s, and in Europe under the impetus provided by the single European market
- Broadly favourable exchange rate trends up to 2002.

Domestic Factors

- The strategic policy decisions to improve human capital and encourage foreign investment from the 1960s
- The enhancement of the enterprise environment created by reform of the public finances, reductions in taxation and wage moderation under the national partnership agreements
- Demographic trends that ensured that labour supply did not limit growth potential.

1.3 Role of Public Policy

The public policy framework that led up to and was further developed during the 1990s helped to strengthen and to sustain Ireland's success. Key elements of those policies are described below.

1.3.1 Demographics and Human Capital

The availability and quality of the Irish labour force have been major factors in developing internationally trading goods and services sectors into areas of significant output and employment growth. The availability of labour was boosted in the 1990s by three factors: the population increases in the 1960s and 1970s, the increasing rate of female participation through the 1980s and 1990s, and the significant levels of net migration into Ireland. The fact that the labour supply was, in general, well educated made it particularly attractive to foreign direct investment (FDI). In effect, the consistent education policies of the preceding decades were bearing fruit: there was growing demand for educated human capital in all developed countries, and its ready availability in Ireland helped to attract foreign direct investment and to promote the development of indigenous companies.

7 *www.entemp.ie/publications/enterprise/2003/industrialperformanceandpolicy.pdf, 2003.*

1.3.2 Growth of Foreign Direct Investment

Flows of foreign direct investment into Ireland increased from an annual average of around $140 million in the 1980s to $2,700 million per annum in the second half of the 1990s. As a result, the total stock of foreign direct investment in Ireland in 2002 reached $157 billion,[8] the highest in the world in per capita terms after Hong Kong. Throughout this period, the foreign-owned sector was a major contributor to growth in output, exports and employment. Foreign-owned companies also exercised a significant multiplier effect, with positive effects on the indigenous sector in terms of employment creation, skills development and quality improvements.

The potential for foreign direct investment to support economic growth has been recognised since the opening up of the Irish economy in the 1950s. However, when the Telesis Consultancy Group[9] carried out a major review of industrial policy in 1982, it concluded that foreign-owned firms in Ireland were generally manufacturing satellites employing relatively unskilled workers, with few sub-supply linkages into domestic firms. It recommended a more selective approach to the attraction of foreign industry, and the strengthening of indigenous companies and sub-supply activities. The resulting *White Paper on Industrial Policy (1984)* led to the reorganisation of the Industrial Development Authority to provide separate divisional responsibility for overseas and indigenous firms and the development of a national linkages programme.

1.3.3 Enhancement of the Enterprise Environment

The dramatic improvement in the enterprise environment in recent years has played a key role in growing and sustaining the enterprise base. The publication of *A Time for Change* ('the Culliton Report') by the Industrial Policy Review Group in 1992 created stronger awareness of the importance of a competitive business environment to the development of enterprise.

The report recommended development of an export-oriented enterprise sector, by introducing:

- A systematic programme to lower the cost and improve the quality of infrastructure and public utilities – telecommunications, energy, roads and ports – through additional investment and greater competition
- A fundamental reform of the tax system to promote employment.

The report had considerable influence on policy in a range of areas, including the increased investment in infrastructure and human capital under the national development plans 1994-1999 and 2000-2006. The current National Development Plan (NDP) is designed to build on the economic success of the 1990s and to increase the capacity of the economy to maintain strong and sustainable output and employment growth. It involves an investment of over €52 billion of public, private and EU funds (in 1999 prices) over the period 2000-2006. The plan involves significant investment in health services, social housing, education, roads, public transport, rural development, industry, water and waste services, childcare and local development.

8 *United Nations Conference on Trade and Development (UNCTAD), World Investment Report 2003.*

9 *Telesis Consultancy Group, A Review of Industrial Policy: A Report by Telesis Consultancy Group, 1982.*

1.3.4 Taxation

The Irish taxation regime has changed considerably over the past 15 years.

The tax burden on individuals has been reduced, as personal income tax rates have fallen from 35% (lower rate) and 60% (higher rate) in the mid-1980s to 20% and 42% respectively. The introduction of tax credits and the move to individualisation[10] have made the personal tax system more equitable.

In 1980, tax relief on export sales was replaced by a corporation tax rate of 10%, which applied to manufacturing and a limited range of internationally-traded services. This was beneficial to industry in general, and was a major influence on the attraction and retention of manufacturing foreign direct investment.

Between 1998 and 2003, the 40% corporation tax rate that applied to other activities was progressively reduced to 25% for non-trading activities, and the 10% rate was increased to 12.5%. The 12.5% rate (which is low by international comparison) now applies to all traded activities in all sectors.

In 1998, the capital gains tax rate was halved from 40% to 20%, providing an incentive to release funds for investment in enterprise.

1.3.5 National Consensus

Social partnership has helped to enhance Ireland's competitiveness and economic success over the past decade. The national partnership agreements established an institutional framework and process in which key economic and social decisions are taken by Government and informed by a consensus amongst employer organisations, trade unions, farmers, and the community and voluntary sector. This ensured a high degree of support from all stakeholders in the economy.

1.3.6 EU Membership and the Internal Market

Ireland's commitment to the realisation of the EU internal market was a significant contributor to economic progress through the late 1980s and early 1990s. This was a major attraction for US and other overseas firms seeking to invest in Europe, and opened new markets in Europe for Irish firms. The Maastricht criteria for entry to European Monetary Union (EMU) set clear parameters for Irish fiscal policy through much of the 1990s. At the same time, the social partnership programmes facilitated a policy approach consistent with low inflation, competitiveness and economic growth. Significant aid from the EU structural and cohesion funds enabled investments in infrastructure and human resources, vital to supporting and maintaining the economy's growth momentum.

10 *Each individual having their own standard rate tax band for income tax purposes.*

1.4 Profile and Assessment of Ireland's Enterprise Base

The performance of the enterprise sector over the past decade has transformed the Irish economy. However, the openness of the Irish economy means that the country's performance is highly sensitive to global economic developments.

By 2003, some 298,000 Irish jobs were in companies supported by the enterprise development agencies – IDA Ireland, Enterprise Ireland, Shannon Development and Údarás na Gaeltachta – an increase from 217,500 in 1993. Over the same period, employment in the entire economy increased from 1.2 million to approximately 1.8 million. Table 1.1 shows the contribution to the economy made by agency-supported companies.

Table 1.1

Agency-supported Firms in Manufacturing and Internationally-traded Services, 2003

	Total	Indigenous	Foreign-owned
Number of Firms	8,663	7,390	1,273
Number of Full-time Employees	297,549	147,895	149,654
Average Number of Employees per Firm	34	20	118
Sales (€m) (2002)	99,341	23,588	75,753
Direct Expenditure in the Economy (Payroll, Procurement of Irish Raw Materials and Services) (€m) (2002)	34,170	16,677	17,493
Exports (€m) (2002)	78,803	8,785	70,018

Source: Forfás Surveys, 2003

1.4.1 Key Features of the Internationally-traded Enterprise Base

Ireland's economic performance in recent years has been driven by a rapid expansion in the country's manufacturing base, which exports an estimated 85% of its output. Mainly because of foreign-owned companies, the proportion of high-technology products (such as Information and Communications Technologies (ICT) and chemicals/pharmaceuticals) in Ireland's exports, at 58%, is the highest in Europe (EU-15 average is 24%).

Despite the recent slowdown in the world economy, the internationally-traded services sector continues to grow. Employment in agency-assisted firms grew from around 11,000 in 1990 to 71,000 in 2002. Irish services exports (eg, financial, software, contact centres and shared services, etc) grew faster than any other of the top 30 exporters in the world in 2002,[11] propelling Ireland to the top of the global league table of services exporters in per capita terms, from third place in 2001. In absolute terms, Ireland became the 18th largest exporter of services in 2002 (up from 21st place in 2001), a global ranking that is now higher than its ranking for merchandise goods (19th).

11 *World Trade Organisation, World Trade Report, 2003.*

Foreign-owned Companies

Foreign-owned companies play a particularly significant role in the Irish economy, exporting approximately 95% of their output.

Foreign-owned companies in Ireland are strongly production-oriented:

- 73% of employment is in manufacturing and assembly activities;[12] the remaining 27% is in internationally-traded services
- 75% of sales (€56.5 billion) are in manufacturing, and 25% (€19.3 billion) are in internationally-traded services.

Foreign-owned manufacturing industry in Ireland has become increasingly concentrated in two sectors:

- The chemicals/pharmaceuticals sector accounted for almost one-third of the output of foreign-owned manufacturing companies in Ireland in 2002, a share that has been increasing steadily over the past decade
- The computer/electronics sector accounted for a quarter of sales in 2002.

Outside these sectors, other manufacturing activities, such as textiles and general engineering, have decreased in importance.

Even though they are in high-value sectors, a significant proportion of the foreign-owned firms are, by global standards, still positioned at a relatively low point in the value chain. The R&D and marketing activities and those activities that require a direct relationship with the customer – in other words, the activities that underpin the competitive strength of the parent organisations – are not for the most part located in their Irish operations.

Indigenous Enterprise

In 2003, Ireland had the highest rate of new business start-ups[13] in the European Union, at 4.7%, compared to the EU-15 average of 2.8%.[14] Ireland also ranks fifth of the EU-15 member states for the proportion of the workforce that is self-employed.[15]

Over the period 1990-2002, exports by agency-assisted indigenous enterprise grew in nominal terms at 5.5% per annum (versus 15.9% for foreign-owned companies). When inflation is taken into account, the real growth in both sales and exports was negligible.

12 *Increasingly, some of these firms' activities include service elements.*

13 *Rate of new business start-ups per total population (18-64 year olds).*

14 *Fitzsimons, O'Gorman, The Global Entrepreneurship Monitor, 2003 – The Irish Report, How Entrepreneurial is Ireland? 2004.*

15 *OECD, OECD in Figures, 2003.*

Table 1.2

Exports and Export Growth in Irish-owned Companies, 1990-2002

	1990	1995	2000	2001	2002	Per Annum Change 1990-2002
	€m	€m	€m	€m	€m	%
Total - All Sectors	**4,602**	**6,259**	**8,292**	**8,531**	**8,785**	**5.5**
Manufacturing	4,366	5,960	6,848	6,831	7,087	4.1
Food/Drink/Tobacco	2,879	3,879	4,158	4,166	4,490	3.8
All Engineering Sectors	614	844	1,469	1,380	1,260	6.2
All Other Manufacturing[16]	873	1,237	1,221	1,285	1,337	3.6
Internationally Traded Services	236	299	1,444	1,700	1,698	17.9
Software Development	55	70	776	1,098	980	27.2
All Other Services	181	229	668	602	718	12.2

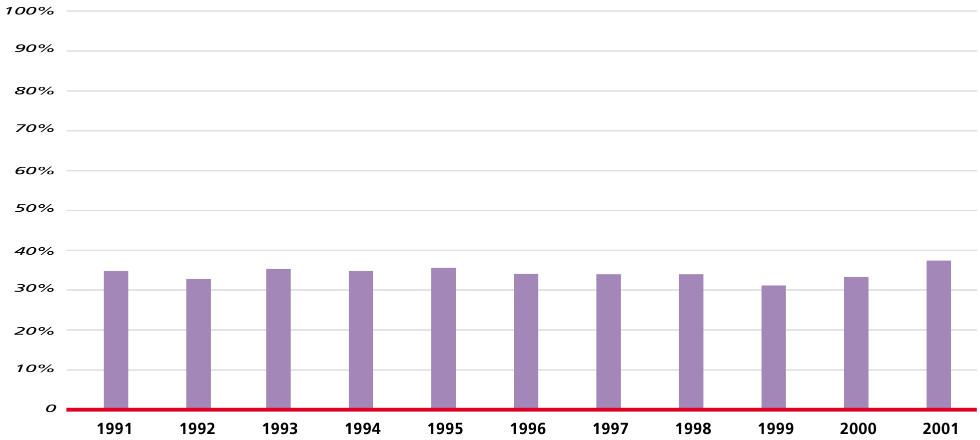
Source: Forfás Surveys, 2003

The Department of Enterprise Trade and Employment's *Review of Industrial Performance and Policy 2003* noted that a majority of indigenous SMEs does not export while many that do engage in exporting continue to focus heavily on the British market. Indigenous companies accounted for 11% of exports for the year 2002. Figure 1.2 highlights that export intensity (export as a proportion of sales) of agency assisted indigenous manufacturing firms has remained stagnant over the past decade.

16 *'All Other Manufacturing' includes textiles, printing, wood products, chemicals, rubber and plastics and non-metallic minerals.*

Figure 1.2

Export Intensity (All Indigenous Manufacturing), 1991-2001



Source: CSO, Census of Industrial Production, 2001

Despite the strong growth of indigenous internationally-traded services companies, in 2002, 81% of turnover was derived from manufacturing activities. The food and drink sector accounted for almost half of the output of indigenous industry and for 29% of employment.

Broad Economic Impact of Agency Assisted Firms

The total corporation tax yield from all sources was €5.2 billion in 2003,[17] an increase of 7.5% on the previous year. Agency-supported companies paying tax at the 10% rate (including companies in the international financial services sector) accounted for €2.7 billion (52%) of this total. Foreign-owned companies assisted by the development agencies accounted for approximately €2.4 billion (47%) of all corporation tax in 2003.[18]

Overall, agency-supported companies spent €34.2 billion in the Irish economy in 2002,[19] as follows:

- €10.8 billion on payroll costs
- €14.4 billion on raw materials produced in Ireland
- €9.0 billion on Irish-supplied services (energy, telecommunications, etc).

Indigenous companies accounted for 49% (€16.7 billion) of this expenditure, equivalent to 71% of their sales. Foreign-owned companies accounted for the remaining 51% (€17.5 billion), equivalent to 23% of their sales.

The difference between the expenditure of the two sectors is accounted for by the fact that indigenous firms are more likely to source their raw materials within Ireland, and is also a reflection of the high sales of some foreign-owned companies in sectors such as chemicals and electronics.

17 *Department of Finance, Exchequer Returns for 2003, January 2004.*

18 *Forfás, Annual Business Survey of Economic Impact, 2003.*

19 *ibid.*

In 2002, average annual wage and salary payments in foreign-owned companies (€39,600) were almost 14% higher than in indigenous companies (€34,700). Foreign-owned companies also devoted marginally more resources to training and staff development. In 2002, foreign-owned manufacturing enterprises spent an average of €600 per employee on training, compared with an average of €540 per employee by agency assisted Irish firms.

Four in ten foreign-owned firms have some involvement in R&D in Ireland, with three in ten firms spending at least €127,000 a year on R&D. In 2001, indigenous firms accounted for 35% of business expenditure on R&D (BERD), and represented five of the top twenty R&D performers.

1.4.2 Domestically-trading Enterprises

As in all economies, the vast majority of businesses in Ireland are small and medium sized enterprises (SMEs).[20] These businesses make up at least 95% of all trading entities and employ over 80% of the workforce. Based on estimates from the Revenue Commissioners, there are approximately 250,000 businesses in Ireland. While there are no precise figures available, it is estimated that approximately 100,000 are single-person businesses or partnerships that are run solely by their proprietors and have no employees.

In terms of sectoral composition, the majority of businesses are engaged in service activities. These can broadly be divided into:

- Producers of business services such as financial services that are supplied mainly to business customers
- Distributive services such as transport and wholesale/retail distribution
- Consumer services such as hotels, catering and entertainment, that are supplied mainly to personal consumers.

Many of these businesses operate in local markets in which both customers and competitors are drawn from a limited geographical area.

Significant parts of this sector operate in a relatively sheltered regulatory and competitive environment; as a result, their efficiency and innovativeness are dampened, impacting on the cost base of their customers.

20 *Enterprises with fewer than 250 employees.*

1.4.3 Conclusions

The success of the Irish economy in the 1990s was unprecedented by both Irish and international standards. In a relatively short time, living standards in Ireland converged with those in leading countries.

Ireland's performance was driven primarily by a relatively small number of foreign-owned firms who chose Ireland as their base for serving European markets. The effect of these firms on the economy was such that it masked the generally poor performance of the indigenous sector, with the exception of a small number of high-performing firms.

Much of the business that Ireland developed in the past now faces significant competitive pressure. The purpose of the strategy detailed in this report is to position the enterprise sector in Ireland to build on its strengths and exploit new opportunities over the coming decade.